Culver CITY

INTEROFFICE MEMORANDUM

DATE: 12/19/2005

TO: The Honorable Members of the City Council

FROM: Jerry B. Fulwood, Chief Administrative Officer

SUBJECT: Financial State of the City

Tonight I wanted to provide the City Council with a more in-depth report on the fiscal state of the City (especially the City's General Fund).

FINANCIAL ISSUES

The City is facing challenging financial issues in the coming months and years. Because of the significant portion of the City's budget allocated for personnel costs, it is important to review the City's financial conditions at this time. It is also important to keep this situation in mind as the Council considers various new programs and funding requests.

FINANCIAL ANALYSIS

Executive Summary

With consideration of the mid-year budget review, salary survey, labor negotiations and preparation of the 2006/07 budget in progress, it is important to provide an updated financial forecast and show the current City's financial condition with appropriate recommendations. The following report provides statistical trends and projections that should be factored into any financial policy decisions.

The City has had years in which General Fund revenues increased sufficiently to keep up with increased expenditures; however, sometimes budget outcomes deviate from the projections. Therefore, it is crucial to develop a plan to deal with unanticipated budget outcomes and take actions to bring the budget back into line. To assist the Council in developing this plan, the City Controller has prepared a five year projection of revenues, expenditures, and reserve balance. According to this projection, if the City continues with its current budget practice, expenditures will outpace revenues and the General Fund reserve balance will be completely depleted by fiscal year 2010-11 (page 2).

Following are potential negative impacts and challenges to the City's financial condition that the City faces in the next few years:

- Increasing recurring expenditures (i.e. personnel costs), which are accounting for a greater proportion of the City's General Fund (pages 5 & 6). This may potentially place an on-going drain on the General Fund; possibly leading to the need for service reductions to return the City to financial stability.
- To compound the issue of increasing personnel costs, the City absorbed funding for a number of positions over the past few years due to expiring grant money (approximately $700,000 per year).
- Another area of concern is the City's unfunded liability exposure (pages 9-12. Currently, there is approximately $17 million of unfunded future liability associated with the Workers' Compensation and General Liability programs. Additionally, GASB 45 will require the City to report unfunded retiree health benefits beginning in 2007. The City needs to develop and implement a long term financial plan to adequately address funding for these future liabilities.

- There are also a number of issues on the horizon that will effect the City's financial well being. Some of these issues include: 1) funding for deferred maintenance costs, 2) establishing a constant and sufficient funding stream for capital projects, 3) possible reductions in available grant money due to budget cuts at the State and Federal level, which may cause the City to absorb funding for ongoing personnel and maintenance costs.

Recommendations:

- Evaluate current City services, identify the essential services, and determine the level of services that the City would like to provide.
- Appropriate 50% of surplus (when applicable) to the Capital Improvement Fund, 25% to Self Insurance Fund fund balance, 15% to deferred maintenance, and 10% to IT and Communication Equipment Capital Fund.
- Take a more conservative approach to budgeting. Eliminate the 96% spending assumption and replace it with a 100% spending assumption; therefore, any savings realized in the previous fiscal year may be appropriated as a surplus.

Revenues and Expenditures

Projected

The following table summarizes the five year revenue and expenditure projection completed by the City Controller. The projected expenditures assume the following: 1) 1%, 3% and 5% annual increase in salary and salary related costs each year for all employee groups, and 2) a 3% annual increase in maintenance and operating expenses. Projected 2006-07 revenues include $1,462,000 of **one-time** Commercial Industrial tax and Permit fees. As a result, the estimated deficit for fiscal year 2006-07 is approximately ($320,000) at 3% salary increase.

At 1% Salary Increase

Fiscal Year	Fund Balance July 1st	Revenues/ Transfers	Expenditures/ Transfers	Annual Surplus/(Deficit)	Fund Balance End of Year	% Of Reserve	30% Of Expenditures
2005-06 *	24,000,000	72,258,000	74,507,978	**(2,249,978)**	21,750,022	**29.19%**	22,352,000
2006-07	21,750,022	73,983,000	73,257,277	**725,723**	22,475,745	**30.68%**	21,977,000
2007-08	22,475,745	74,663,000	75,871,296	**(1,208,296)**	21,267,449	**28.03%**	22,761,000
2008-09	21,267,449	76,778,000	78,657,173	**(1,879,173)**	19,388,276	**24.65%**	23,597,000
2009-10	19,388,276	78,924,000	81,634,090	**(2,710,090)**	16,678,186	**20.43%**	24,490,000
2010-11	16,678,186	81,135,000	83,983,990	**(2,848,990)**	13,829,196	**16.47%**	25,195,000

At 3% Salary Increase

Fiscal Year	Fund Balance July 1st	Revenues/ Transfers	Expenditures/ Transfers	Annual Surplus/(Deficit)	Fund Balance End of Year	% Of Reserve	30% Of Expenditures
2005-06 *	24,000,000	72,258,000	74,507,978	**(2,249,978)**	21,750,022	**29.19%**	22,352,000
2006-07	21,750,022	73,983,000	74,254,437	**(271,437)**	21,478,585	**28.93%**	22,276,000
2007-08	21,478,585	74,663,000	77,957,716	**(3,294,716)**	18,183,869	**23.33%**	23,387,000
2008-09	18,183,869	76,778,000	81,898,235	**(5,120,235)**	13,063,634	**15.95%**	24,569,000
2009-10	13,063,634	78,924,000	86,097,790	**(7,173,790)**	5,889,844	**6.84%**	25,829,000
2010-11	5,889,844	81,135,000	89,684,090	**(8,549,090)**	(2,659,246)	**-2.97%**	26,905,000

At 5% Salary Increase

Fiscal Year	Fund Balance July 1st	Revenues/ Transfers	Expenditures/ Transfers	Annual Surplus/(Deficit)	Fund Balance End of Year	% Of Reserve	30% Of Expenditures
2005-06 *	24,000,000	72,258,000	74,507,978	**(2,249,978)**	21,750,022	**29.19%**	22,352,000
2006-07	21,750,022	73,983,000	75,251,045	**(1,268,045)**	20,481,977	**27.22%**	22,575,000
2007-08	20,481,977	74,663,000	80,083,826	**(5,420,826)**	15,061,151	**18.81%**	24,025,000
2008-09	15,061,151	76,778,000	85,265,720	**(8,487,720)**	6,573,431	**7.71%**	25,580,000
2009-10	6,573,431	78,924,000	90,826,490	**(11,902,490)**	(5,329,059)	**-5.87%**	27,248,000
2010-11	(5,329,059)	81,135,000	95,841,090	**(14,706,090)**	(20,035,149)	**-20.90%**	28,752,000

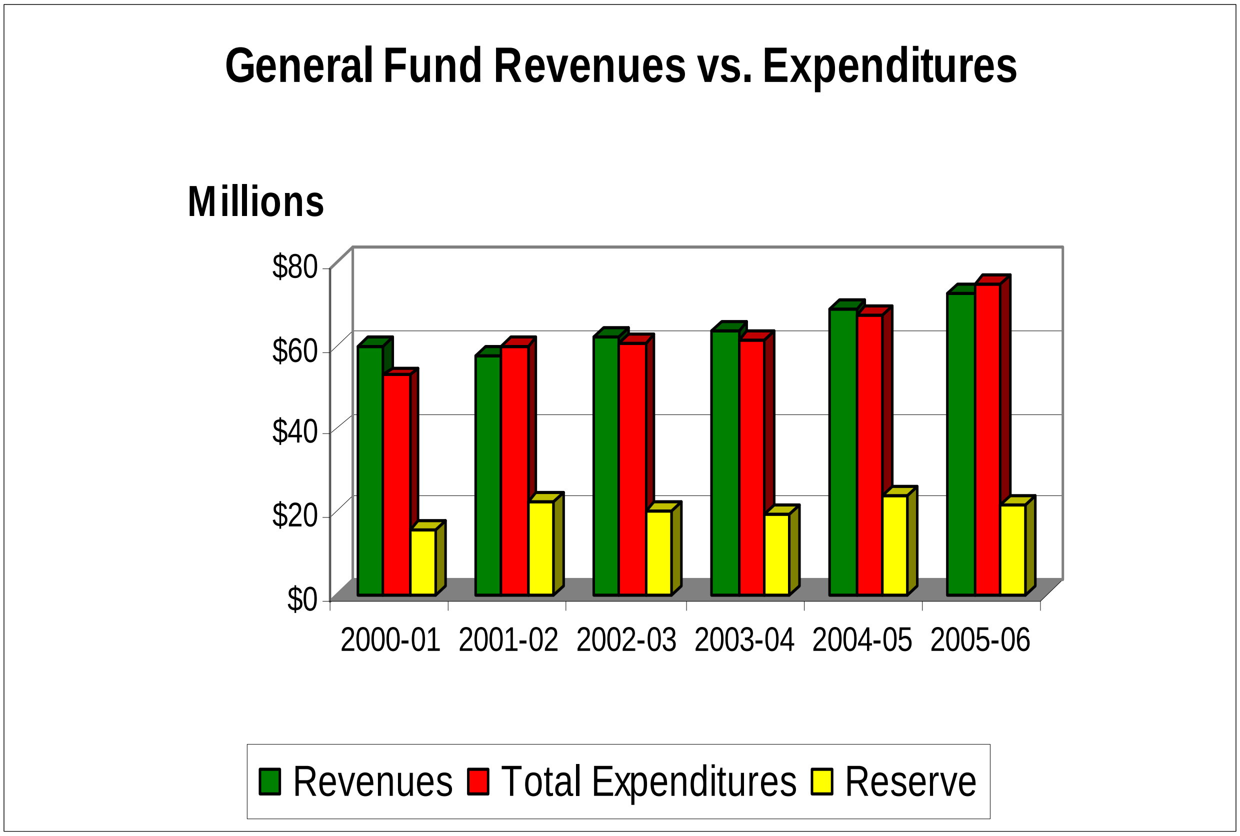
In the coming years, the City's General Fund budget position shows substantial declines unless major deficit-reducing actions are taken. The reason for this pattern is that there are several categories of appropriations that will rise faster than the CPI, such as medical insurance. In addition, it reflects a change of the projected excess appropriation percentage from 96% to 97% for fiscal year 2006-07. The projection also assumed it continues to increase by 1% annually for the next three years until a 100% spending assumption is realized. The one percent can be reduced to a lesser amount. However, it does not include capital project funding (including the additional $1 million needed for Fire Station #3), increasing contribution to Self-insurance fund, and possible additional funding for vacation and sick leave accrual payoffs due to retirements. There may be sales tax revenue adjustments based on the updated 1st quarter data in early 2006 which will be provided by our consultant, HdL. The projected collection of Transient Occupancy Tax revenue in the amount of approximately $500,000 may not be realized in the near future and it will impact the revenue projection as well.

Trend
On average, the growth rate of expenditures has outpaced the growth rate of revenues over the past five years. As a result, the General Fund reserve level has decreased and is projected to fall below 30% for the first time since fiscal year 2000-01 (see Table 2). Chart 1 illustrates that the City generally allocates a significant portion of the revenues each year.

Table 2:

	EXPENDITURES			REVENUES			GENERAL FUND RESERVE	
FY	**Expenditures**	**Capital Projects**	**% Change**	**Revenues**	**% Change**	**Surplus (Deficit)**	**Reserve**	**%**
00-01	$52,652,188	$131,820		$59,910,103		$7,126,095	$15,553,000	29.5%
01-02	$58,626,842	$1,159,618	11.3%	$57,413,436	-4.2%	($2,373,024)	$22,678,000	37.9%
02-03	$60,362,353	$117,813	3.0%	$62,154,897	8.3%	$1,674,731	$20,304,000	33.6%
03-04	$61,220,424	$37,134	1.4%	$63,689,518	2.5%	$2,431,960	$19,568,000	31.9%
04-05	$66,320,465	$1,151,650	8.3%	$68,620,902	7.7%	$1,148,787	$24,030,000	35.6%
05-06	$73,318,000	$1,190,000	10.6%	$72,258,000	5.3%	($2,250,000)	$21,758,000	29.2%
5 Yr Avg			**6.9%**		**3.9%**			

Chart 1:



There have been a number of significant one-time revenues and expenditures over the last five years that have affected the City's cash flow, which are outlined in Table 3. The negative values in 2004-05 and 2005-06 represent the State takeaway of property tax.

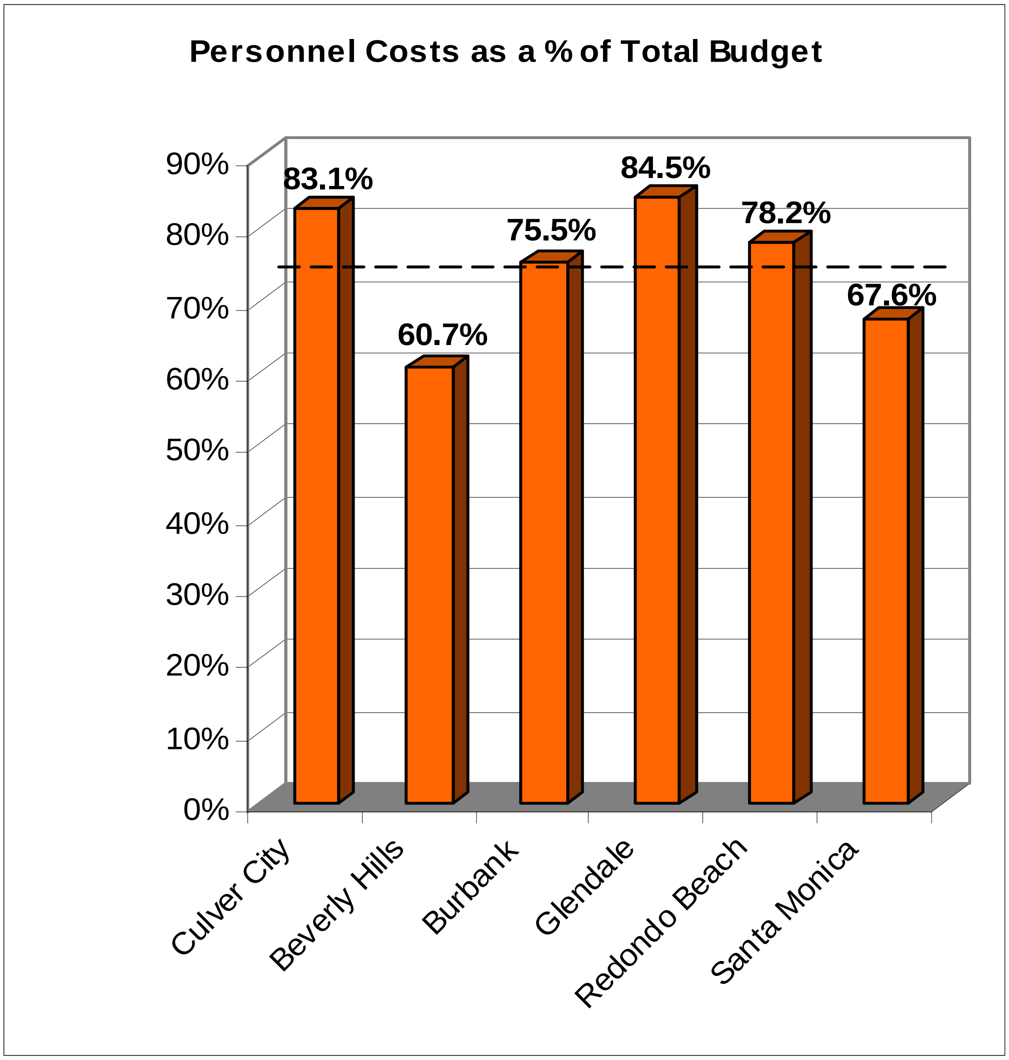
Table 3:

ONE-TIME REVENUES AND EXPENDITURES		
Fiscal Year	**Category**	**Approx. Amount**
2002-03	Business License	$1,000,000
2002-03	Franchise Tax	$1,000,000
2004-05	State Motor Vehicle Early Loan Repayment	$682,632
2004-05	Property Tax	($971,000)
2005-06	Property Tax	($971,000)
2005-06	Misc. Revenues from New Development	$2,400,000

Personnel Costs
Personnel costs (i.e. salaries and benefits) represent a significant portion of the City's General Fund appropriations. Since personnel costs represent locked in dollars, it limits the flexibility that the City has from year to year to implement new programs or projects or add new positions.

Chart 2 compares Culver City's personnel costs as a percentage of the total General Fund budget to the personnel costs of other cities in the area. The chart shows Culver City's personnel costs as a percentage of the total budget are higher than most comparable cities in the area (avg. = 74%).

Chart 2:



Personnel costs are basically fixed, with employees' salary and benefit increases predetermined, often for multiple years, by MOU contracts that are negotiated with the labor groups.

In the past, City Council has had to take drastic steps to decrease personnel costs in order to balance the budget. In 2002-03 and 2003-04, the Council reduced personnel costs through attrition and elimination of positions.

Chart 4 shows the number of General Fund staff before and after those layoffs. Despite the layoffs, personnel costs have continued to increase as a percentage of the total General Fund budget (Table 5).

Chart 4:

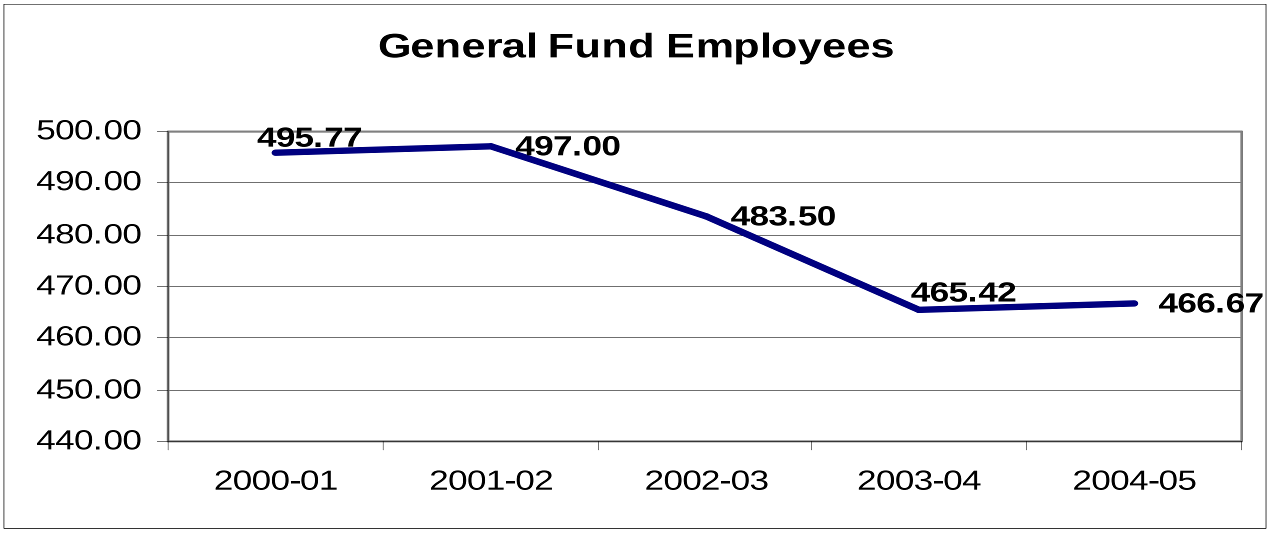


Table 5:

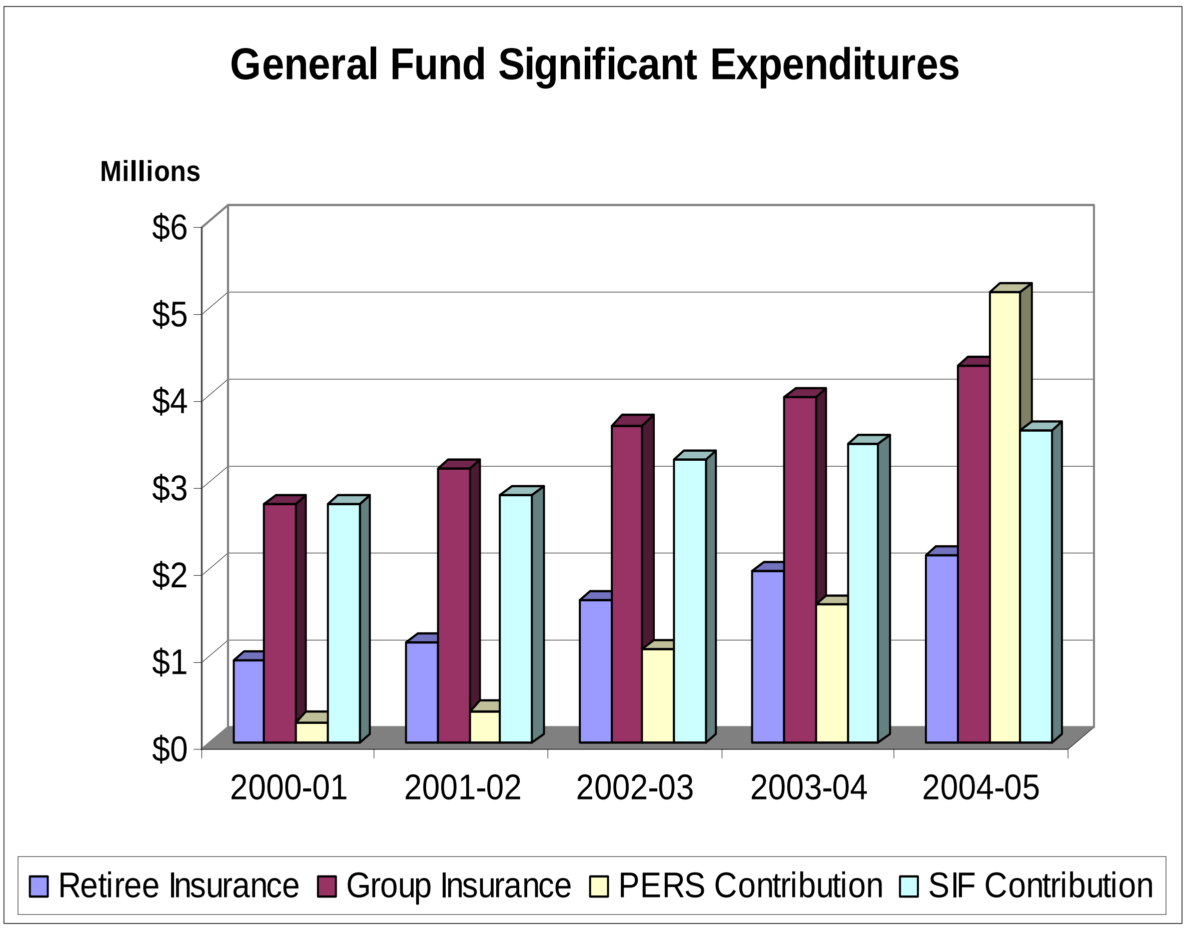
PERSONNEL COSTS		
FY	**Personnel Costs**	**% Total Budget**
2000-01	$42,407,030	80.5%
2001-02	$45,787,140	78.1%
2002-03	$48,722,355	80.7%
2003-04	$49,612,182	81.0%
2004-05	$54,693,323	82.5%

The following table and chart illustrate the three fastest growing expenditures over the past five years: retiree and group medical benefits, PERS contributions, and self insurance costs.

Table 6:

General Fund Significant Expenditures											
FY	**Retiree Insurance**	**%**	**Group Insurance**	**%**	**PERS Contribution**	**%**	**SIF Contribution**	**%**	**Total Expense**	**%**
00-01	$952,764		$2,741,734		$241,000		$2,739,636		**$6,675,134**	
01-02	$1,159,370	21.[illegible]	$3,153,090	15.0%	$369,000	53	$2,834,182	3	**$7,515,642**	**12.6%**
02-03	$1,647,320	42.[illegible]	$3,655,335	15.9%	$1,084,000	193	$3,247,326	14	**$9,633,981**	**28.2%**
03-04	$1,979,710	20.[illegible]	$3,968,596	8.6%	$1,586,000	46	$3,445,282	6	**$10,979,588**	**14.0%**
04-05	$2,157,160	9.[illegible]	$4,325,146	9.0%	$5,191,000	227	$3,591,576	4	**$15,264,882**	**39.0%**

Chart 5:



Workers' Compensation Future Liability
Across the State of California, exponential increases in workers' compensation costs forced the legislature to pass a sweeping set of reforms with SB 899 (2004). Despite these reforms, workers' compensation continues to be a significant expense for the City. Culver City is self-insured for workers' compensation, which means that the City is responsible to pay all claims from the first dollar. This has a significant impact on the General Fund.

Chart 6 compares Culver City to the other cities in the ICRMA's (the City's insurance risk pool) Workers' Compensation program. As you can see, Culver City has the highest workers' compensation claims cost per %50,000 of payroll; approximately 82% above the average for ICRMA cities. It should be noted that Culver City provides a higher level of service, with full service Police, Fire, and Transportation departments, than the comparative cities.

Chart 6:

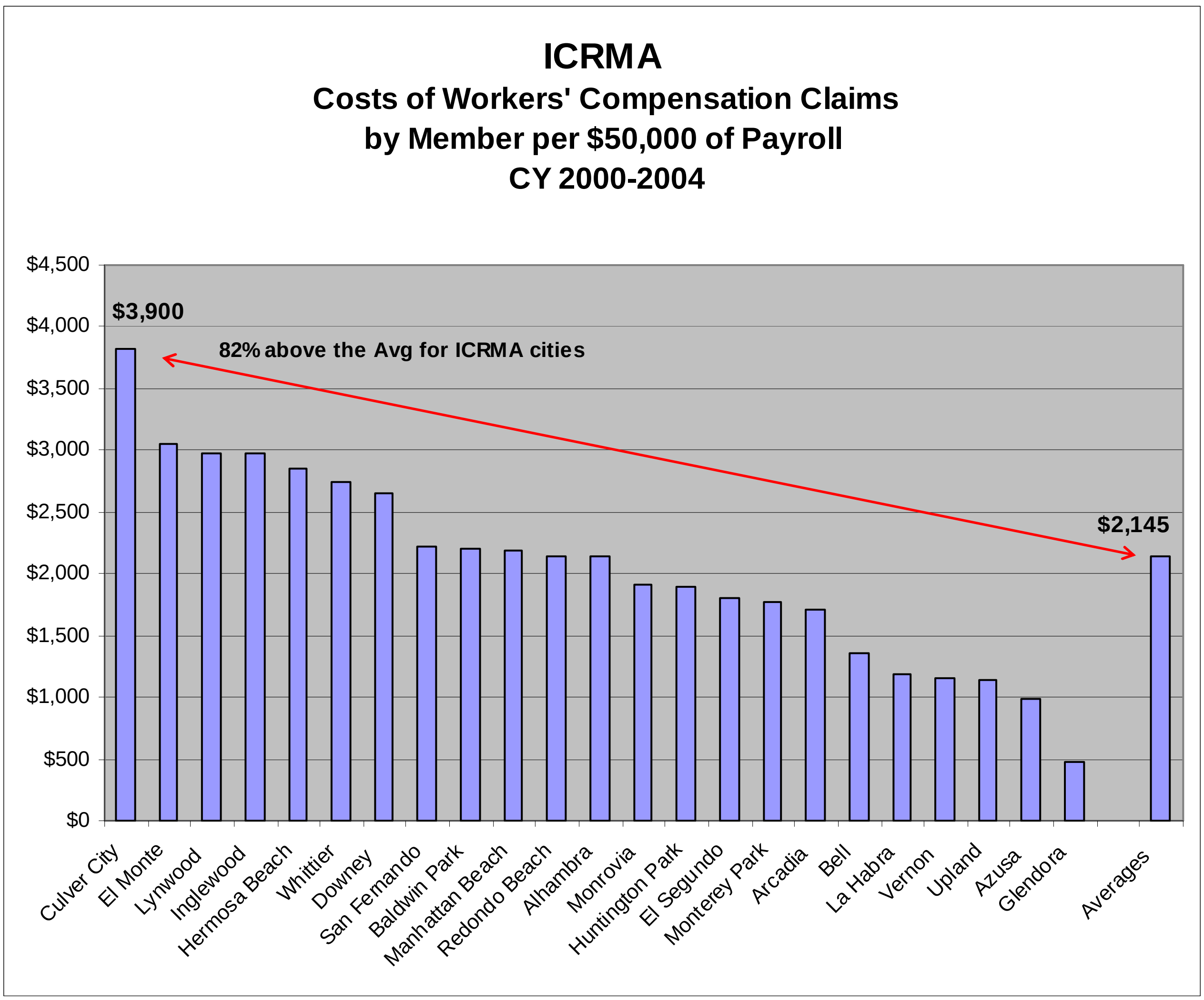
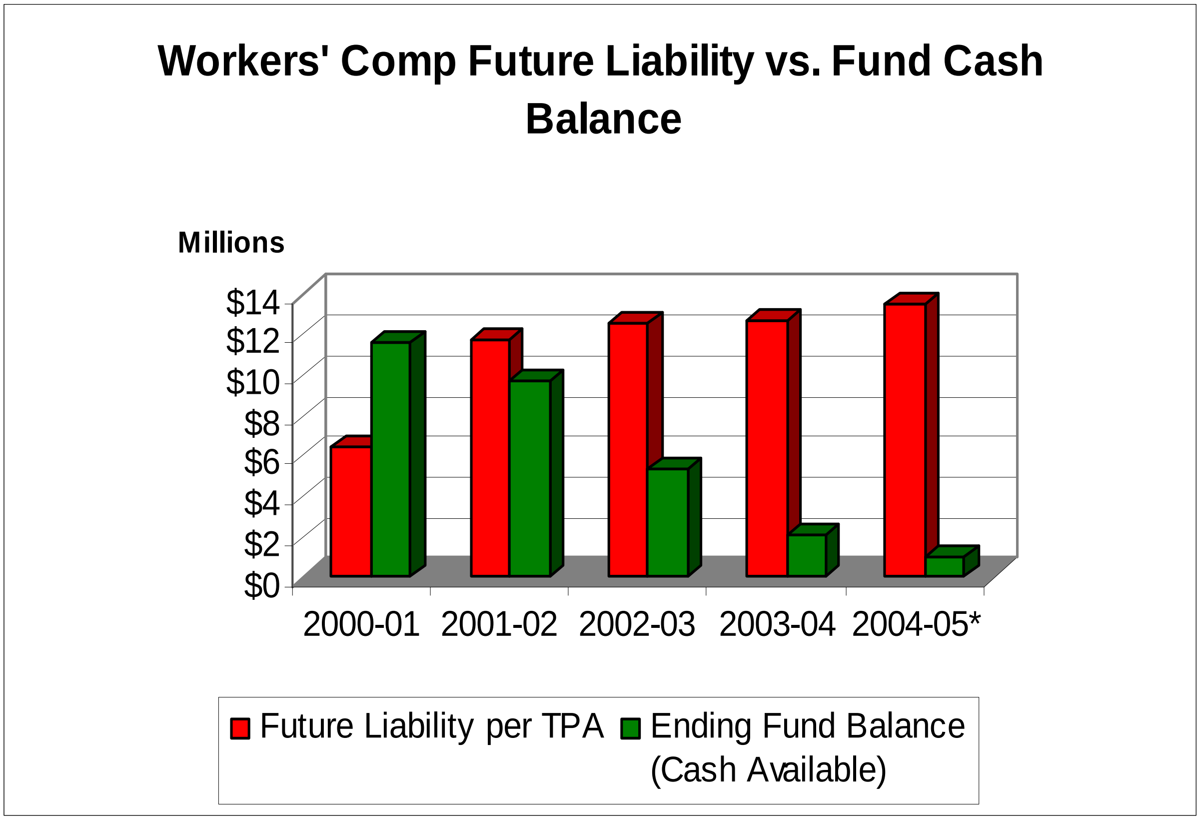


Chart 7 shows the Self Insurance Fund expense over the past five years. It also shows the corresponding decrease in the SIF's cash reserves over the same time period. In order to avoid a significant increase in the General Fund's contribution to the SIF, cash reserves were used to cover operations. As a result, the SIF cash reserves have been reduced from $12 million to less than $1 million.

Chart 7:



Cash reserves are needed in the Self Insurance fund for two reasons: 1) cover unexpected large claims costs, settlements or awards, and 2) cover any future outstanding liabilities (e.g. ongoing long term medical treatment for employees who have been injured at work). The City relies on two outside consultants to determine the value of our future liabilities: 1) our third party workers' compensation claims administrator, Colen & Lee, and 2) an actuarial report provided by Bay Actuarial Services. Colen & Lee determines future liability based on the total cost incurred over the life of an injury. Each claim is evaluated and a reserve is set aside to pay for future medical expenses. Total future liability is derived by adding the reserves for all open claims. The actuarial uses a larger sample of data to derive a formula based on claims experience and frequency. Generally, the actuarial's determination is more conservative, and therefore higher, than Colen & Lee's determination.

Table 7 contains the City's future liability as determined by Colen & Lee for the past five years and the Actuarial Report for the past four years. Actuarial studies were not conducted on a consistent basis prior to 2001-02; therefore some prior year information is not available.

Table 7:

WORKERS' COMP FUTURE LIABILITY					FUND BALANCE
FY	**Future Liability per TPA**	**% Change**	**Future Liability per Actuarial**	**% Change**	**Beginning Fund Balance (Cash Available)**
2000-01	$6,500,508		N/A		$11,570,000
2001-02	$11,781,243	81.2%	$9,531,338		$9,785,000
2002-03	$12,625,772	7.2%	$13,124,679	37.7%	$5,342,000
2003-04	$12,738,439	0.9%	$17,404,452	32.6%	$2,040,000
2004-05	$13,551,429	6.4%	$20,295,000	16.6%	$1,076,000

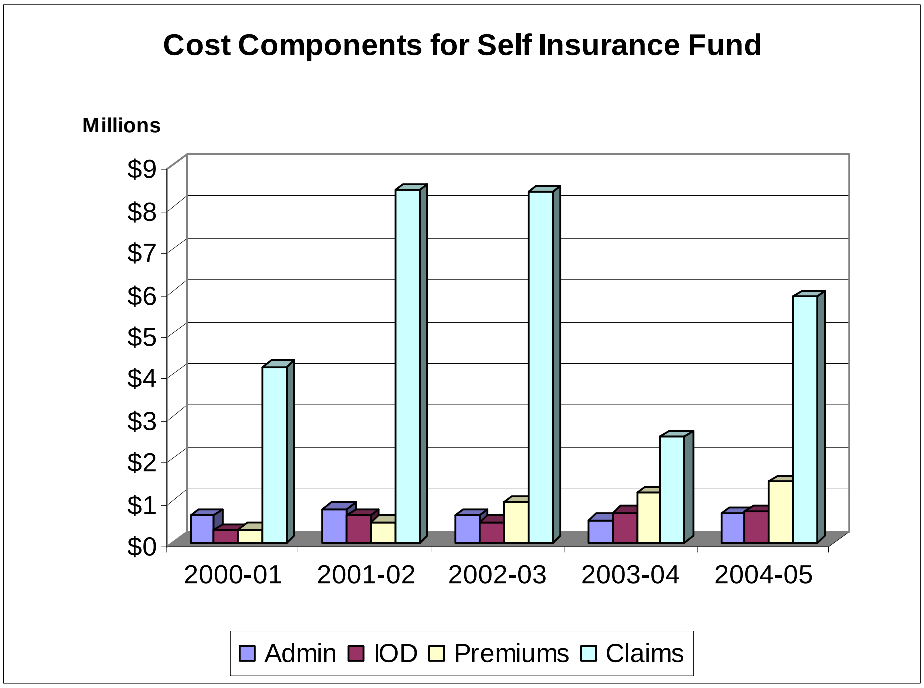
Table 8 contains the three cost components of the Self Insurance Fund. These components are: 1) Administration, 2) Injured on Duty (IOD), and 3) Premiums and Claims. The administration costs pay the salaries of the staff that manage the workers' compensation and general liability programs (i.e. Risk Management staff and a portion of City Attorney staff). IOD pays the salaries and benefits of employees who are missing work due to a work related injury. After an employee has missed 30 days of work, their salary is paid out of the IOD fund rather than from their Department's personnel costs until the employee returns to work. The Premiums and Claims component is used to pay for insurance premiums (including Property insurance, General Liability insurance, and excess Workers' Compensation insurance) and any workers' compensation and liability claims costs. Claims costs include medical treatment, litigation expenses, third party administration expenses, and all other expenses associated with workers' comp and liability claims.

Table 8:

Self Insurance Fund Costs										
FY	**Admin**	**% Change**	**IOD**	**% Change**	**Premiums**	**% Change**	**Claims**	**% Change**	**Total Expense**	**% Change**
2000-01	$639,889		$289,134		$311,374		$4,182,594		**$5,422,991**	
2001-02	$795,304	24.3%	$653,033	125.9	$480,751	54.4%	$8,414,704	101.2%	**$10,343,792**	**90.7%**
2002-03	$654,808	-17.7%	$483,078	-26.0	$951,984	98.0%	$8,368,570	-0.5%	**$10,458,440**	**1.1%**
2003-04	$524,137	-20.0%	$703,741	45.7	$1,161,872	22.0%	$2,516,833	-69.9%	**$4,906,583**	**-53.1%**
2004-05	$690,879	31.8%	$730,606	3.8	$1,449,810	24.8%	$5,856,087	132.7%	**$8,727,382**	**77.9%**

Chart 8 illustrates that Claims are the largest cost component of the SIF.

Chart 8:



Miscellaneous Financial Issues
In addition to cash flow concerns, rising personnel costs, and a large unfunded workers' compensation liability, the City will be faced with a number of other issues over the next few years including:

- GASB 45 (Governmental Accounting Standards Board) will require the City to record non-pension benefits for retirees' liabilities; failure to adhere to the requirement can result in poor audits and poor bond ratings.
- Deferred maintenance costs for streets, buildings, and other infrastructure maintenance;
- Reduced State and Federal grant money (e.g. CDBG) due to budget cuts at those levels may put the City in the position of absorbing additional personnel and maintenance costs.
- Other Issues: TMDL, increased fuel costs ($50,000), funding for Fire Station #3, Promote and attract economic development projects;
- Review and may be implement program proposed cost saving in the Management audit report which conducted several years;
- Evaluate how to maximize the use of the Graphic Service to all department and reduce the operating costs;
- Contract management compliance;
- Decrease service level to save costs; and
- Increase service fees.
- 3% @50 Police Safety PERS contribution costs should be a negotiation item?
- Part-time employee salary increase;

RECOMMENDATION

In formulating the following recommendations, I have considered many issues. The three of greatest importance are: (1) developing an overall financial management strategy for the entire City organization (City and Redevelopment Agency) that helps encourage structural operating surpluses in the long term while providing the high level of services to the Citizens of Culver City in accordance with the high standards set by the City Council; (2) within budgetary ability, maintain a competitive employment environment for the City's valued workforce that allows the City to retain and attract highly qualified and motivated employees; and (3) provide a systematic approach to allow the City to accumulate sufficient financial resources to provide the Council broader opportunity to address the mounting costs of deferred maintenance and needed infrastructure maintenance and improvements. With those important goals in mind, I recommend the following specific items for the Council's consideration

Financial Management Strategy

Pursuant to the Culver City Charter, accounting functions are a responsibility of the City Treasurer's Office. Therefore, any meaningful reform of the financial management of the City must include an evaluation of the City Treasurer's Office.

Accounts Receivable

It is important the City collect amounts legally due to it. To this end, I propose the production of an Accounts Receivable Listing generated on a monthly basis including an "Aging Report." This A/R Listing would be provided to the Chief Administrative Officer and Department Heads and reviewed to ensure progress in collecting sums due the City. This includes refuse billing, ambulance fees, miscellaneous billings and grants. So that all amounts due the City, regardless of size, are collected using a systematic approach, the past practice of individual departments invoicing and collection should be centralized.

100% Appropriation Based Budgeting

The past practice of the City appropriating certain funds and then forecasting an amount of expenditures at some percentage less than 100% has lead to increased unpredictability in projecting actual year end operational results. In those years of increased financial difficulty (including recent years where the State of California redirected traditional City funds to the State coffers), this practice can be particularly problematic. To reinforce the goal of obtaining "structural operational surpluses," I propose basing budgetary appropriations at 100% of expected expenditures.

Fees and Charges

In accordance with State Law, the City has the ability to charge fees for certain services that are commensurate with the City's expenses in providing that service. Therefore, I propose the City Council review the City's fee system to ensure the City's fee schedule is set at an appropriate level.

Deferred Maintenance and Equipment Replacement

Working with all City Departments, but particularly the Departments of Public Works and Parks, Recreation, and Community Services, Information Technology, Police, and Fire, develop a plan to systematically address the ever increasing costs of deferred maintenance of the City's public rights-of-way and public parks and facilities.

Realization of Bulk Purchasing Economies and Prompt Payment Discounts

While the City already attempts to achieve savings in bulk purchases and taking advantage of prompt payment discounts, both of these practices should be expanded to increase savings.

Economic Development Program

The City's economic development efforts have produced impressive results. The improved commercial base of the City has resulted in a more varied environment for the City's residents to obtain goods and services and provided increased sales tax, property tax, and business license tax income to the City. Economic development efforts should continue. However, the tendency for the City's expenditures to "grow into" the expected revenue stream generated by successful economic development should be discontinued and increased revenues placed in a special fund in the City's accounts for allocation by the City Council to address unmet needs.

Competitive Employment Environment

Overall, the City Council has provided a competitive salary and benefits package for the men and women who deliver the various services to the City's residents – the City's employees. However, in times of challenging finances, the City has reluctantly been required to institute lay-offs to keep the City's operations in surplus. I believe this is a symptom of the "feast or famine" financial cycle experienced in previous years. To build a more stable financial foundation upon which current employees and retirees can rely and to improve financial conditions in the long-term, I propose the following:

Two-Tier Benefits System

As the City Council is aware, costs for medical and retirement benefits have risen by double-digit factors over the past several years. These increased costs have placed a significant financial burden on the City with costs rising at a rate outpacing the rate of growth of the City's revenues. To balance the City's desire to retain current employees within the current salary and benefit structure, I propose the implementation of a two-tier benefits system. Employees appointed on or before June 30, 2006 would be retained under the current system with employees appointed afterwards being placed in a second benefit tier. This provides a plan by which the City can both maintain its current workforce at the traditional benefits structure and still recruit new employees with full disclosure of the terms of employment.

Risk Management

As outlined earlier this evening, the City's Self-Insurance Fund has experienced significant costs increases over the past five year period. As part of cost management, the City should undertake increased education efforts to minimize worker's compensation and interior liability costs. More broadly, wherever possible, City employees should be encouraged to help minimize general liability claims through reporting of potential hazards.

Accumulation of Financial Resources to Address Unmet Needs

While Culver City provides a high level of services to its Citizens, as mentioned above, the City has significant unmet needs in the areas of deferred maintenance and infrastructure repair and replacement. By implementing these recommendations, it is expected the City Council could increase its General Fund Reserve from the current 25%-30% to 30%-35%. This would place the City in a better financial position to respond to an emergency and to increase investment income. Additional reserves should be set aside for designated use, such as the Capital Improvement Project Fund.

Attrition

To avoid further lay-offs of current employees, I propose each City Department develop a ten-year attrition plan that strategically addresses the potential for reorganization of departmental operations to realize savings through efficiencies with a goal of reducing staff by 5%.

Consultant Evaluation of the City Treasurer's Office

To ensure the accounting process is properly evaluated and improved, I propose the City Council consider two items. The first: issuance of a request for proposals for a consulting firm to perform a comprehensive evaluation of the operations of the City Treasurer's Office. The consultant would review and make recommendations issues of concern to the City Council, including the timely preparation and distribution to the City Council, CAO, and Department Heads of periodic financial reports, consistent with those reports prepared by other cities, which include accurate and meaningful information necessary to proactively manage the City.

Clearly Define the Responsibilities of the City Treasurer and City Controller

Additionally, I recommend the City Council consider clear definition of responsibility for financial management of the City's resources between the City Treasurer and the City Controller, including the potential reassignment of the revenue management component to the City Controller. This would include addressing the items of ongoing production of accurate and useful periodic financial reports.

CONCLUSION

These recommendations are submitted to the City Council at a time when the City's financial situation is challenging but not dire. The proposals outlined above request the City Council to consider changing core elements pertaining to management of the City's financial resources. By taking action now, the Council has many options open to it with time to implement them. Ultimately, by placing the City on a firmer financial foundation, the core values of high service levels to the City's residential and business communities, competitive employment environment, and blossoming economic development efforts can not only be maintained, but ultimately, expanded to meet the future needs of the Culver City community.

These recommendations are presented to the City Council this evening for consideration and initial discussion. It is staff's intent to return to the City Council on March 13, 2006 for additional discussion and to receive direction from the City Council.