



June 3, 2004

*Build a Great
Community
Together*

Honorable Mayor Ira and Members of the City Council:

INTRODUCTION AND ECONOMIC OVERVIEW

Declines in sales tax revenues from structural and economic causes, an extended downturn in the local economy, a continuation of State raids on local treasuries, and increasing employee benefit costs have collectively put Redwood City in the midst of its most challenging financial times.

While the proposed budget reflects substantial reductions in expenditures and service level reductions, it still leaves us with a \$4.1 million operating deficit (projected annual expenditures exceeding annual projected revenues) for FY 2004/05 and a forecasted operating deficit of \$5.7 million for FY 2005/06. The recommended FY 2004/05 budget is the third successive budget in which departments have been asked to make expenditure reductions. FY 2004/05 will also be the third successive year in which the City is spending more out of its general fund than the revenues it receives in this fund.

The Council's fiscal forecast in earlier years have enabled the City to accumulate significant reserves upon which the City is relying very heavily. Caution should be exercised as these reserves are now being consumed. Without significant corrective action in balancing expenditures with revenue, our reserves will be dangerously reduced in the years ahead.

We do not see the current circumstance as one from which we will quickly grow our way out. The local economy is showing little signs of expansion as evidenced by the job growth and commercial real estate vacancies. San Mateo County employment reached a peak in November 2000 at 401,600 jobs and a low point of 348,300 jobs in May 2003. As of April 2004, the most recent data available showed an estimated 349,600 jobs in the County. Santa Clara County, an area to which our economic fortunes are closely linked, reached its peak of 1,006,500 jobs in December 2000 and the trough with 812,900 jobs in January 2004. As of April 2004, 813,600 jobs were reported in Santa Clara County.

Earlier this year the Association of Bay Area Governments (ABAG) reported that between 2000 and 2003, the nine county bay area region lost over 268,600 jobs. ABAG forecasts a very modest increase of 16,770 jobs in 2004 and 32,890 jobs in 2005.

According to a report released by BT Commercial Real Estate, as of March 2004 the Redwood City, including Redwood Shores, commercial office real estate markets had 3.1 million square feet of vacant office space for a vacancy factor of 31.5%. Moreover, Redwood City was continuing to experience an increase in office vacancies though the first quarter of this year. Countywide the vacancy rate in San Mateo County was 26.6%, down slightly from the December 2003 rate of 27.9%.

Clearly, the foregoing data paints a picture that shows the local economy, which at its best, is scraping along the bottom. When and how strong the next expansion will be are very significant unknowns at this time.

GENERAL FUND

Revenues

General fund revenues (including transfers into the general fund) are expected to increase modestly to \$62.3 million (or 1.9%) in FY 2004/05 from \$61.1 million in FY 2003/04. In FY 2005/06, revenues are expected to increase 1.8% to \$63.4 million.

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Passion
to do our
Best in Each
Moment*

The major assumptions behind these revenue estimates are:

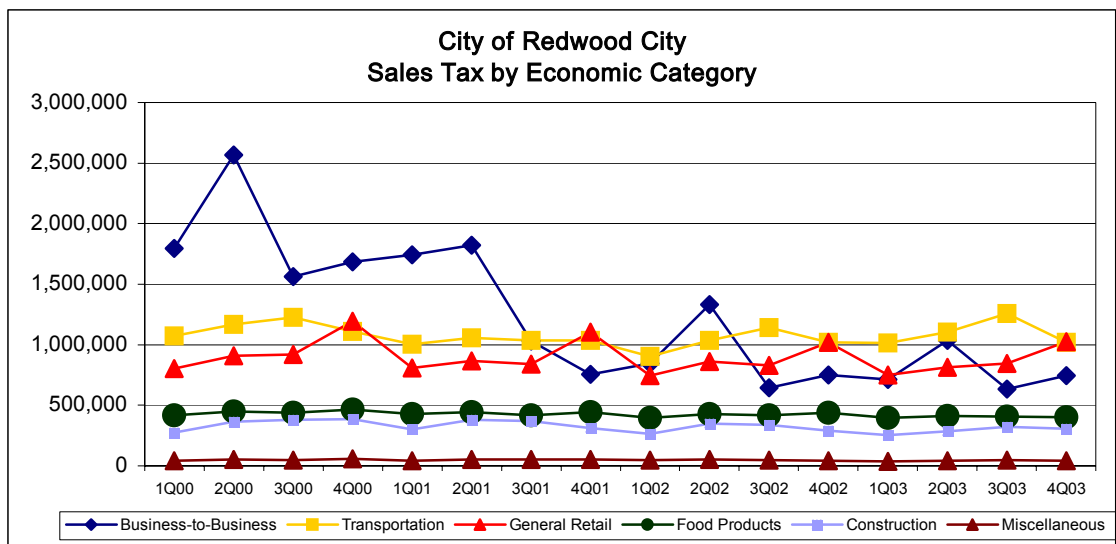
- No additional cuts from the State other than the \$1.5 million that is included in the Governor’s proposed (May 2004) budget. Our preliminary understanding is that the source of these reductions will be from sales tax, vehicle license fees, and property tax. The exact amount by which each of these revenues will be reduced is unknown at this time. Accordingly, we have not adjusted our revenue estimates for these items but have included a -\$1.5 million revenue item labeled “State Takeaway” in our revenue projections to reflect the effect of this reduction. Please see the section titled “State Impact” for more discussion on this subject.
- Sales tax will recover modestly (3% increase in FY 2004/05 and 3.5% in FY 2005/06) and that there is no further erosion in our business-to-business sales tax revenues.
- Property tax revenues will increase about 4% in FY 2004/05 and 4% in FY 2005/06 as the result of continued strength in the residential real estate market and that there is no further significant erosion in the assessed valuations of commercial properties.

Barring intervention by the courts, the State will be implementing the “triple flip” provision of Proposition 57 (the initiative approved by the voters that enabled the State to issue its “Economic Recovery Bonds” to pay off the bills from its spending binge), which was approved by the voters in March of this year. For cities this means that the State will take 25% of our sales tax revenue and replace it dollar-for-dollar with property tax revenue. This will not reduce our revenues, but will likely cause cash flow delays depending on how the final mechanics of this swap operate. Also, we are trusting that the State will honor its promise to make this swap revenue neutral. Trusting a political entity that has in recent history viewed local governments as ATMs is risky.

One bright spot in our revenues has been the recent growth in the City’s transient occupancy tax (TOT) or hotel tax. Due to the voter-approved tax rate increase from 8% to 10% in November 2003 and improved performance in the local hotel industry, we are forecasting an increase in TOT revenue of \$241,000 (or 13%) to \$2 million in FY 2004/05 over FY 2003/04.

Sales tax revenue continues to drag along the bottom with only modest increases expected in the next fiscal year. We believe this is reflective of a stagnant local economy. Although not factored into this budget, we remain very concerned about future losses of sales tax revenue due to the electronic delivery of software by local businesses engaged in software sales. Should a significant sales tax decline become evident in FY 2004/05 or FY 2005/06, staff will advise Council and provide options for dealing with this.

The following graph illustrates the performance of locally generated sales tax revenues (which accounts for about 95% of our total sales tax revenues) for the past 16 quarters. The key story here is the decline of “business-to-business” sales tax revenues. While a portion of this decline is due to the recession in the local economy, a substantial component of this decline is the electronic delivery of software and other businesses leaving the area or going out of business.



Expenditures

Despite \$5.1 million in recommended expenditure reductions, expenditures (including transfers to other funds) are still expected to increase 4.4% from \$63.6 million in FY 2003/04 to \$66.4 million in FY 2004/05 and 4.0% to \$69.1 million in FY 2005/06. Offsetting these reductions were higher costs of over \$1.1 million in expenditures related to the City's workers' compensation insurance program. Higher employee benefit costs are the key drivers here. Contributions to the California Public Employees Retirement System are up due to investment losses and improved retirement benefits to police and fire. Although the recommended budget calls for \$5.1 million in expenditure reductions from the general fund's base budget, the net reduction from the base budget is \$3.9 million.

Although there have been recent reforms to the State laws that govern the workers' compensation system, we are uncertain as to any savings that the City will realize in the next two fiscal years. It is worth noting that these reforms did not extend to the presumptive injuries and illnesses for public safety employees which will likely continue to be a significant general fund expense.

Another expenditure that is rapidly growing is the cost of providing health insurance for employees and retirees. In FY 2004/05, we foresee spending about \$4.3 million (or 6.6% of general fund expenditures) on health benefits and \$4.9 million (or 7.2% of general fund expenditures) in FY 2005/06. Controlling these costs will require the organization to consider alternatives to the CalPERS health insurance system.

Given the breadth and depth of the recommended expenditure reductions, a separate section of the budget document has been prepared which deals exclusively with staff's recommended budget reductions. This section appears immediately after this letter.

Transfers

Included are the "normal" transfers from the general fund to the traffic safety fund (\$962,000), and the water fund (\$130,000) in FY 2004/05 with similar amounts in FY 2005/06.

State Impact

The Governor's proposed budget reflects his agreement with the League of California Cities to support a constitutional amendment that he will urge the legislature to place on the November 2004 ballot and will cause the City to lose \$1.5 million each year in FY 2004/05 and FY 2005/06. In FY 2006/07, these funds will no longer be taken by the State so accordingly we should expect our revenues to increase by \$1.5 million in FY 2006/07.

Based on the budget the Governor proposed in January 2004, staff had estimated that the City would lose about \$1 million in FY 2004/05 and in all following years.

The Governor's proposal has been factored into our budget. Several conditions must, however, be met before the Governor's proposal becomes a reality: 1) This proposal must be approved by the legislature and the constitutional amendment placed on the November 2004 ballot, and 2) the proposed constitutional amendment must then be approved by the voters in November.

To further complicate and confuse the question of how much money the City will lose to the State is that the League's sponsored LOCAL (Leave Our Community Assets Local) initiative has qualified and will appear on the November 2004 ballot. This ballot measure offers similar long-term revenue protections to local government but goes into effect sooner and does not provide for local governments to lose any revenue to the State in FY 2004/05 and FY 2005/06.

The bottom line is that we will not have a clear understanding until after the November 2004 election as to how much of our revenue we will lose to the State in FY 2004/05.

General Fund Reserves

Since FY 2002/03, revenues have not kept pace with expenditures. The result has been the consumption of \$3.4 million in reserves through June 30, 2004.

We anticipate having \$14.4 million in reserves as of June 30, 2004. Given the projected operating deficits in each of the next two fiscal years and absent any further changes, the general fund will have \$4.5 million in reserves (7.2% of expected FY 2005/06 revenues) on June 30, 2006, which is the end of the upcoming two-year budget cycle. This is well below the minimum 15% level called for in the Council's policy on general fund reserves and definitely below the comfort level of the City Manager and Finance Director.

Future Years

As you will see from the Five Year Projection, based on the best information currently available we foresee deficits in FY 2006/07 through FY 2008/09. Given the magnitude of the anticipated deficits, it is reasonably safe to say that absent a bushel full of positive financial news, budget cutting and service reductions will be an ongoing process for Redwood City.

CAPITAL PROJECTS

With the economic downturn and the anticipated shortfall in Measure A revenues, the proposed Capital Improvement Program (CIP) for the next two years has been trimmed in some ongoing replacement programs and the Roadway Management Program. However, the CIP continues to emphasize the upgrade of essential infrastructure such as roofs, heating, ventilation, and air conditioning, carpet, painting, sidewalk, storm drainage, lagoon dredging, and technology.

For the FY 2004/2005 and FY 2005/2006 CIP, the proposed budget for the capital project fund, gas tax construction fund, transportation fund, grants and fees fund, water improvement fund, sewer improvement fund, General Improvement District 1-64, and the Redevelopment Agency totals \$13,132,014 and \$10,137,000, respectively.

Seven (7) multi-million dollar projects and programs are already in progress and will take multi-year efforts for design and construction. They are:

1. Recycled Water Program
2. Downtown Courthouse Plaza
3. Ralston Avenue/Route 101 Interchange
4. Friendly Acres/Bayfront Canal Flood Control (Phase IV & V)
5. Redwood Shores Library
6. Water Conservation Program
7. Downtown Parking Garage

In summary, with the continuation of all existing ongoing programs, the focus of the next two fiscal years' CIP will be on the following:

1. Redwood Shores Lagoon Dredging
2. Playfields Replacement
3. Water System Seismic and Security System Improvement
4. Storm Drainage Collection System Upgrade
5. Sidewalk Replacement Program
6. Roadway Management Program
7. Water/Sewer Main Replacement Program
8. Geographic Information System (GIS)
9. Street Light Installation Program
10. Redwood Shores Sewer Pump Station Renovation

REDEVELOPMENT AGENCY (RDA)

The implementation of Council/Agency priorities for downtown took major steps forward in FY 2003/04 with the adoption of an almost \$37 million multi-year funding plan and the issuance of tax increment bonds by the Agency in October 2003. The proceeds of this bond issue, plus a loan from the City to the Agency, provide the majority of the funding needed to complete a series of projects that address the Council/Agency priorities and actions related to downtown revitalization.

The work program and goals for FY 2003/04 continued the progress made in FY 2002/03. They included activities related to public parking facilities to support downtown business and the retail/cinema project, planning and design work for the courthouse façade restoration and plaza projects, as well as streetscape improvements, and implementation planning for the downtown area plan, such as directional signage and gateway improvements, the downtown precise plan, a downtown parking management strategy, and planning for special events and activities to mitigate construction impacts.

The proposed budget for FY 2004/05 basically continues the implementation of this multi-year funding plan. Additional funding for the streetscape project (primarily "Theater Way") is recommended, as well as an operational budget to provide the administrative support and leadership necessary to see the projects completed. In terms of affordable housing, the budget proposal increases funding for the El Camino/Vera Street affordable housing project in response to the proposal received from First Community Housing and Peninsula Habitat for Humanity. Negotiations are underway for the transaction. Funding for unidentified affordable housing projects is also included in the recommended budget.

ENTERPRISE FUNDS

Water Fund

The water enterprise fund is in sound fiscal condition, with a \$2 million emergency reserve at the beginning of the fiscal year. Over \$7 million of previously unappropriated fund balance has been budgeted to date for additional future water supply (including implementation of the recycled water project) in the water fund capital improvement program. Most of the expenditures to date (approximately \$2 million) are reimbursable to the fund via the subsequent sale of revenue bonds. The City Council will consider a financing plan for the \$43 million recycled water project in the summer of 2004, and then make a series of policy decisions that would ultimately restore the fund balance to an estimated \$8 million.

On July 14, 2003, the City Council approved a resolution increasing the "lifeline" water rate from \$0.88 to \$1.10 per unit, continuing the established practice of setting the Redwood City "lifeline" rate at the San Francisco Public Utilities Commission (SFPUC) wholesale rate. The Council also approved a 3.5% increase to the monthly basic service charge that provides the financial support for the operations and maintenance of the City's water system from \$10.80 to \$11.17, driven primarily by increases in salaries and benefits. In order to fund the first year of the new, multi-year "active" water conservation program including a major toilet replacement and rebate program, the Council also increased all water conservation usage rates for all customer classes in order to raise \$1.4 million in additional revenues to pay for the new conservation measures.

Sewer Fund

The sewer enterprise fund remains in sound fiscal condition, with a \$1 million emergency reserve.

On July 14, 2003, the City Council approved an increase in the sewer service charge from \$20.35 to \$21.45. The 5.4% increase was driven primarily by increases in salaries and benefits and a projected increase of 3.2% for sewage treatment services provided by South Bayside System Authority.

APPROPRIATIONS LIMITS

Article XIII B of the California Constitution defines and establishes the City's appropriations limit. No city in California may spend from its "proceeds of taxes" more than the amount of its "appropriations limit." The appropriations limit is determined by a formula contained within Article XIII B. Redwood City's appropriations limit for FY 2004/05 is estimated to be \$202,894,813. The FY 2004/05 appropriations subject to limitations are \$51,418,325. We are well within our legal limit.

ACKNOWLEDGMENTS

This document reflects the toils and deliberations of many throughout the organization, especially the executive team. I want to thank the budget committee of Magda Gonzalez, Assistant to the City Manager, Corinne Centeno, Assistant City Manager, and Brian Ponty, Finance Director for their strategic thinking and thorough reviews of the departmental budget requests. Laura Snidemen is to be commended for her efforts in organizing and managing the performance measurement and benchmarking elements of this process.

My sincere appreciation and thank you to the very talented Finance Department team: Alison Freeman, Financial Services Manager; Senior Accountants, Irv Weinstock, Gloria del Rosario, and Kyi Khin; Jill Greenhorn, Accountant; Senior I.T. Analyst Debbie Matsuura; and Supervisor of Software Development Services Faith Marte-Kroeger. Their relentless "number crunching," analysis, and attention to details has made this budget document possible. My compliments to Sandy Jennings, Administrative Assistant to the Finance Director, for her patience, talents, and long hours to publish the document you have before you.

The entire organization, particularly the management team, responded very well to the challenge of presenting reasonable and logical budget reduction packages. All proposed and recommended departmental budget reductions were discussed. We are learning and adapting to systematic challenges posed by the budget reduction process. We are developing new systems and reporting mechanisms to facilitate this process. This is an excellent example of how a "learning organization" is able to respond to new ways of doing business.

Sincerely,

A handwritten signature in black ink, appearing to read 'Ed Everett', written over a light blue horizontal line.

Ed Everett
City Manager