2009-11 Financial Plan

GENERAL FISCAL OUTLOOK

November 2008

City of San Luis Obispo

2009-11 Financial Plan
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GENERAL FISCAL OUTLOOK

OVERVIEW

We will present a comprehensive analysis of our fiscal outlook when we present the results of our five-year General Fund fiscal forecast to the Council at the upcoming "Budget Foundation" workshop scheduled for December 16, 2008. However, in "setting the table" for this upcoming forecast, we have prepared this *General Fiscal Outlook*, which highlights six key factors that will shape our fiscal outlook over the next two years:

1. Where we've been: past fiscal challenges and budget balancing solutions
2. Interim financial results for 2007-08: our current financial condition
3. General economic trends and current trends for revenues
4. State budget situation
5. Key cost drivers
6. Infrastructure and facilities maintenance

The Very Short Story

Just two years ago, we characterized the City's fiscal outlook as the best in many years, largely due to the passage of Measure Y combined with an improved local economy, the absence of the threat of more State budget takeaways and stable labor costs.

Unfortunately, this is not the case today. While Measure Y revenues continue to be a bright spot – in fact, without them we would be facing a dire fiscal situation instead of "just" a very tough one – all of the other bright spots have darkened:

General Fiscal Outlook

Another very tough budget season that would be much worse without Measure Y revenues

1. **Adverse Economy.** Stated simply, the national and state economy is in shambles. And while we are better positioned than many communities to deal with this, we are not immune to these powerful economic forces. We have seen – and will continue to see – adverse trends in our top three General Fund revenues of sales, property and transient occupancy (TOT) taxes.

2. **Adverse State Fiscal Outlook.** We dodged a big bullet with the State budget process this year – we thought. After adopting its 2008-09 budget after the longest delay in the State's history, the State is now facing an added $11 billion deficit for the balance of this year – and $28 billion over the next twenty months. It is cold comfort that at this point the Governor is not proposing any major cuts to cities, since it will take two-thirds legislative approval to balance the budget; and there is not a ready legislative constituency for the deep cuts and significant revenue increases proposed by the Governor in closing this gap. In short, while we may again escape any deep State budget cuts, this major threat will continue to hang over us for the foreseeable future.

3. **Adverse Binding Arbitration Decision.** Lastly, as discussed in detail in the special September 30, 2008 report to the Council, the June 2008 binding arbitration decision with the Police Officers Association (POA) cost the City an added $4 million in 2007-09; and will

cost an added $2.3 million every year into the future. Along with revenue shortfalls, this resulted in $4.8 million in budget "rebalancing" actions by the Council in September 2008. The most significant of these was to "freeze" implementation of the neighborhood patrol program and deletion of $2.4 million in capital improvement plan (CIP) projects, including $925,000 for paving.

This means we are facing a very tough fiscal outlook in 2009-11, which would be much worse without Measure Y revenues. Stated simply, without deep service cuts in other areas, we will not be able to sustain the service and infrastructure improvements that were initiated in the 2007-09 Financial Plan, let alone consider further service improvements. It also means that we need to retain strong reserves in responding to the many uncertainties ahead of us.

We will better define how big the challenge facing us will be in the December 2008 forecast, but we know it will be bigger than a bread box. On the other hand, largely due to Measure Y revenues, balancing the budget in 2009-11 should not be as difficult as 2003-05 or 2005-07.

Lastly, we go into 2009-11 with a number of positives compared with many communities in California:

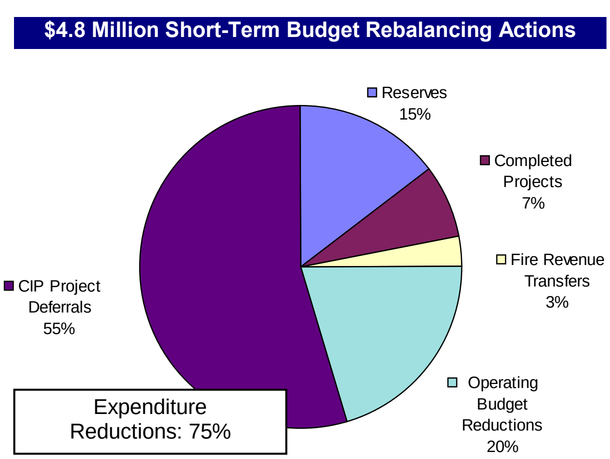
1. Good fiscal shape (but it wasn't easy)
2. Good information
3. Solid systems and procedures in place.
4. Excellent organization and capable staff
5. Excellent Council leadership
6. Great tradition of responsible stewardship

❶ WHERE WE'VE BEEN

Binding Arbitration and September 30, 2008 Budget Rebalancing Actions

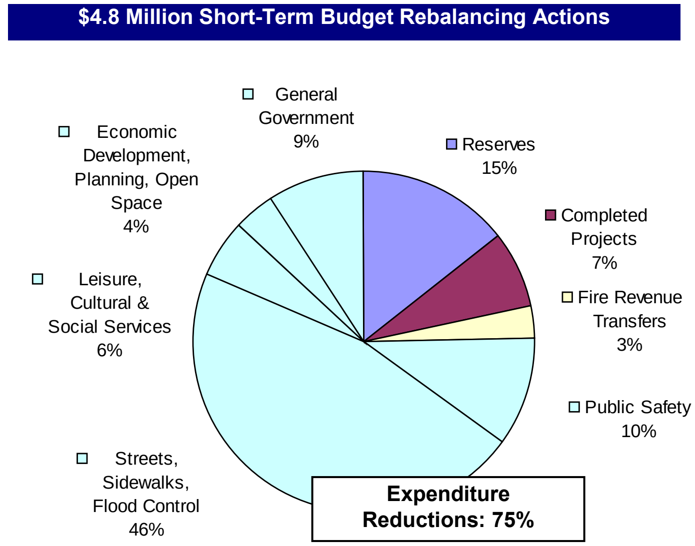
Two years ago, we were facing our best fiscal outlook in many years. Largely due to the passage of Measure Y in November 2006, which enacted a general purpose ½-cent sales tax that generates $6 million annually, we were able to fund a number of new initiatives in the 2007-09 Financial Plan, including public safety service improvements, restoration of the neighborhood paving program, creek and flood protection improvements, traffic congestion relief, senior services, code enforcement and open space preservation.

However, largely due to the binding arbitration decision, on September 30, 2008 the Council took a number of budget rebalancing actions to close a $4.8 million gap. As reflected in the sidebar chart, 75% of the short-term budget rebalancing actions relied on expenditure reductions (20% operating and 55% capital).



GENERAL FISCAL OUTLOOK

When viewed on a functional basis, the sidebar chart below shows that all areas of the City's operations were affected by the expenditure reductions. It also shows that reduced funding for infrastructure maintenance like streets and flood protection took the lead role in closing the gap.



Short-Term Budget Actions. As noted in the September 30 report, these actions were intended to be short-term steps in rebalancing the 2008-09 budget in the wake of the binding arbitration decision. Long-term budget-balancing will be an integral part of the 2009-11 Financial Plan process.

Cost Impact of Binding Arbitration Decision. The compensation results of the binding arbitration decision were fully discussed in the July 15 and September 30, 2008 reports to the Council. These reports are available for review in the Council office and on-line on the City's web site (www.slocity.org), and should be consulted for a full understanding of the City's history with binding arbitration, the arbitrator's decision and its cost impacts.

While there were a number of key compensation changes as part of that decision, including educational incentives and health insurance increases, the salary award was the largest cost driver. Over a four year period, the arbitrator awarded base salary increases of 30% for sworn employees over the four year term; and a 37% salary increase for all other members of the POA. These across-the-board increases represent pay increases that are about 67% higher than the City's offer of 20% for the same period. These salary increases exclude added educational education incentives, which can add up to 5.3% more pay beyond this. They also exclude annual step increases of 5% for those who are not at the top of the range.

Cost Summary. Including pay increases for members of the San Luis Obispo Police Staff Officers Association (SLOPSOA), which has a re-opener in its contract to address salary compaction issues caused by the binding arbitration decision, the total cost of the binding arbitration decision from January 2006 through the end of the current fiscal year (June 30, 2009) is $5.8 million. Adjusting for available funding in the Memorandum of Agreement (MOA)/Other Compensation Adjustments account, this results in a net added cost of $4 million for 2007-09.

As shown in the chart below, $1.9 million of this cost was incurred retroactively from January 2006 through June 2008; and the balance of $2.1 million will be incurred in 2008-09.

Summary of Binding Arbitration Costs

Summary of Binding Arbitration Costs: Janaury 2006 through June 30, 2009			
	2005-06 to 2007-08	2008-09	Total
POA	2,685,800	2,749,000	5,434,800
SLOPSOA	60,000	343,000	403,000
Total	2,745,800	3,092,000	5,837,800
MOA/Other Compensation Adjustments	(810,600)	(996,100)	(1,806,700)
Net Cost	**$1,935,200**	**$2,095,900**	**$4,031,100**

As shown above, the estimated annual cost for 2008-09 is $3.1 million. However, this only reflects six months of the January 2009 raise through June 30, 2009. Accordingly, accounting for the cost of the January 2009 raise for a full year, the ongoing annual cost of the arbitration decision is $3.3 million, with a net ongoing cost of $2.3 million after adjusting for available MOA funding.

Fiscal Health Contingency Plan in Place. In response to the adverse impacts of the binding arbitration decision, in June 2008 we immediately began implementing the actions set forth in the City's *Fiscal Health Contingency Plan*. Along with the actions taken by the Council in September 2008, this includes a hiring "chill."

The "chill" is not an absolute freeze in filling vacant positions. However, City Manager approval is required to fill all vacant regular positions. To do so, Department Heads must demonstrate that it is necessary in meeting public health, safety or other high-priority service needs that cannot be met on an interim basis through contract, overtime or temporary staffing. In implementing the "chill," the goal is not just short-term savings, but preserving future options in the longer term. This applies to regular positions in the enterprise and other funds as well as the General Fund. It does not apply to filling temporary positions, as this may be one of the strategies for short-term mitigations of the hiring chill.

"Banking" vacant positions has been a key strategy in avoiding lay-offs in the past when responding to tough fiscal times. While we made position reduction decisions in the past based solely on service priorities and minimizing community impacts (not on vacant positions, which are solely due to serendipity), we banked enough vacant positions during the "chill" to avoid regular staff lay-offs.

In positioning us for difficult challenges that lie ahead of us in preparing the 2009-11 Financial Plan, the hiring chill is likely to remain in effect until June 2009.

❷ INTERIM FINANCIAL RESULTS FOR 2007-08

Our Current Financial Condition

We broadly distributed interim financial results for 2007-08 for the General Fund in September 2008. As we noted at that time, we do not expect to issue audited financial statements until December 2008. (Council review of the audited results for 2007-08 is scheduled for the "Budget Foundation" workshop on December 16). However, we believe the interim report provides a reasonable basis for assessing the General Fund's financial position at the beginning of the current fiscal year.

Ending Fund Balance

The results of the interim report were discussed in-depth at the September 30, 2008 special Council meeting. The most current data is consistent with the results presented at that meeting. We will end 2007-08 with available fund balance of $12.7 million. After adjusting for 2007-08 added binding arbitration costs, this is better than formal budget estimates by about $800,000. This in turn is about the amount of reserves that were used in rebalancing the budget for 2008-09. As shown in the sidebar summary, most of this favorable variance is due to expenditure savings.

General Fund Balance	Budget	Actual	Variance	%
Revenues	53,968,200	54,152,000	183,800	0%
Expenditures	48,344,100	47,862,000	482,100	1%
Other Sources (Uses)	(12,560,400)	(12,342,100)	218,300	2%
Fund Balance, 7-01-07	18,830,000	18,830,000	-	
Fund Balance, 6-30-08	11,893,700	12,777,900	884,200	

What does this mean? In short, we will end in the same fiscal place as projected in the September 30, 2008 report to the Council.

Top Ten Revenues

Our top ten revenues account for over 90% of total General Fund revenues. By focusing on these, we can get an excellent understanding of our revenue position. Overall, these top ten revenues were less than projected by $409,000, largely due to lower property tax revenues than estimated. As discussed below, favorable variances of $584,000 in mutual aid revenues account for the difference between the "top ten" revenues and the overall revenue results. The following highlights key results for the year and implications for the future.

Top Ten Revenues	Budget	Actual	Variance	%
Sales Tax				
General	13,725,000	13,581,700	(143,300)	-1%
Measure Y	5,900,000	5,996,600	96,600	2%
Property Tax	8,832,900	8,374,200	(458,700)	-5%
TOT	5,121,000	5,054,700	(66,300)	-1%
Utility Users Tax	4,187,700	4,177,700	(10,000)	0%
VLF Swap	3,294,200	3,280,100	(14,100)	0%
Franchise Fees	2,288,100	2,361,700	73,600	3%
Business Tax	1,865,000	1,866,400	1,400	0%
Dev Review Fees	2,715,800	2,705,500	(10,300)	0%
Recreation Fees	1,108,600	1,207,400	98,800	9%
Interest Earnings	925,000	948,100	23,100	2%
Total	**49,963,300**	**49,554,100**	**(409,200)**	**-1%**

1. ***Sales Tax.*** General sales tax receipts in 2007-08 were $412,000 lower than the prior year and $143,300 lower than our estimated downturn. This was due to a decline in sales in nearly every major business category, an experience that is common across the nation. The slowing economy has resulted in fewer sales of new motor vehicles, lumber and building materials, home furnishings and purchases at department stores. The losses were partially offset by higher fuel prices, which boosted revenues from service stations. As gas prices come down, we will not see this offset in the future. In short, this downward trend is going to continue into 2009-11.

On the other hand, revenues from our local ½- cent sales tax (Measure Y) accounted for just over $6 million in revenues, performing slightly better than expected. This underscores Measure Y's importance for the City's ability to deliver services to the community, especially in light of adverse results in other key revenues.

2. ***Property Tax.*** The $458,000 shortfall in property tax revenues is largely due to a decrease in supplemental tax roll revenues. Property taxes are based on assessed valuation in January of the prior year. However certain events during the year such as property sales and construction in progress can trigger supplemental taxes. As reflected in the side bar chart, supplemental assessments in 2007-08 were down by $381,000 (49%) from 2006-07. This accounts for over 80% of the decrease. The County Assessor can also make downward valuation adjustments based on market conditions. Each of these factors played a role in our supplemental assessments being lower than anticipated.

Supplemental Current Secured Property Taxes			
Fiscal		Incr (Decr) from Prior Year	
Year	Receipts	Amount	%
2007-08	397,968	(381,671)	-49%
2006-07	779,639	28,896	4%
2005-06	750,743	346,265	86%
2004-05	404,478	100,480	33%
2003-04	303,998	22,406	8%
2002-03	281,592		

The good news from this analysis is that while the growth in property taxes is down compared with prior years, we do not seem to be experiencing the drop in property values that many other communities are experiencing. On the other hand, we can expect to see this lower level of supplemental assessments as the "new normal" for the foreseeable future.

3. ***Transient Occupancy Tax (TOT).*** Results for the year did not meet our projections after a weak fourth quarter. This weaker "base" will result in lower revenue projections for future years. Additionally, recent results show declines in this key revenue source.

4. ***Weak Performance from Our Top Three Revenues.*** The City's top three General Fund revenue sources – sales tax, property tax and TOT – account for over 60% of total General Fund revenues. The 2007-08 shortfall from estimated revenues from these top three revenues is about $600,000 – and this lower base will carry over into 2009-11.

   The Moral of the Story: Maintaining sustainable operations is very difficult when your top revenues are not performing well.

5. ***Development Review Fees.*** While development review fees were right on target for 2007-08, these are driven by the timing of private sector permit applications, which are difficult to project. Fees for several large projects were received during 2007-08, and as such, revenue we received this year may simply mean lower revenues next year. Moreover, based on current trends in the construction market, we may see significantly lower development review activity in the future, which would result in significantly lower development review fees.

6. ***Recreation Fees.*** Revenues from the recently completed therapy pool exceeded estimates, which largely accounts for the variance in recreation fees.

7. ***Interest Earnings.*** Revenues from interest earnings in 2007-08 were on target with our estimates. However, we will see declines from this level in 2008-09 due to lower interest rates as well as lower investable balances.

8. ***Mutual Aid Revenues.*** As noted above, this "one-time" revenue was above estimates by $584,000. These revenues result when Fire personnel respond to significant events (usually wildland fires) for which the City receives reimbursement from Federal or State sources. This amount reflects reimbursements for indirect and other costs that were greater than our direct cost of responding to the event. This was an unusually high year for this one-time revenue source. For this reason, the Council approved using this one-time revenue for a strategic one-time purpose by transferring these funds to the Fleet Replacement Fund to partially offset the $1.03 million estimated cost of a 100-foot ladder truck scheduled for replacement in 2009-10.

Expenditures

On the other hand after adjusting for projected expenditure savings, encumbrances and carryovers, expenditures were less than estimated by $482,100. This reflects well on department stewardship practices; and was a key factor in offsetting revenue declines. (It should be noted that departments achieved these savings in addition to $1.5 million we budgeted for.)

Expenditures By Type	Budget	Actual	Variance	%
Staffing	41,301,600	39,539,000	1,762,600	4%
Contract Services	5,494,400	4,550,100	944,300	17%
Telecomm & Utilities	1,647,300	1,539,700	107,600	7%
Insurance	1,077,800	1,054,900	22,900	2%
Other Operating Costs	3,935,300	3,040,000	895,300	23%
Minor Capital	270,200	162,500	107,700	40%
Total by Type	53,726,600	49,886,200	3,840,400	7%
Reimbursed Expenses	(4,058,500)	(4,075,300)	16,800	0%
Total Expenditures	49,668,100	45,810,900	3,857,200	
Estimated Savings	(1,473,200)		(1,473,200)	
Encumbrances/Prepaid Expenses		808,000	(808,000)	
Carryovers/MOA Adjustments	149,200	1,243,100	(1,093,900)	
Total	**48,344,100**	**47,862,000**	**482,100**	**1%**

As shown in the sidebar chart, all expenditures were well within budget. However, most of these savings are one-time in nature and will not be ongoing. In most cases, the savings we saw in 2007-08 have already been reflected in reduced budgets in 2008-09; or were due to one-time circumstances that are not likely to recur.

Other Sources (Uses)

Two factors account for the positive variance of $218,000: operating transfers in from the Gas Tax, TDA and Proposition 42 Funds were slightly better than projected, resulting in a variance of $147,600; and the Golf Fund required a lower subsidy than estimated of $62,000.

Summary

Based on the most recent information pending completion of the audit, final results for 2007-08 are on target with our September 2008 estimate. The strong reserve position of 27% of operating expenditures compared with our policy minimum of 20% will hold us in good stead in light of the uncertainties facing us. And in fact, we have already drawn on this reserve to about the 20% level as one of the budget rebalancing actions on September 30, 2008.

❸ CURRENT ECONOMIC AND RELATED REVENUE TRENDS

Current Economic Trends

National and State Economy

Stated simply, the national and state economies are on a downward spiral that is not likely to improve until 2010 at the soonest. And San Luis Obispo's economy is directly tied to these.

Locally, the recent UCSB Forecast for the County concludes that:

"The result of these factors is that we believe San Luis Obispo County is in a recession that will be more challenging than the one in the early part of this decade, but not as challenging as the one in the 1990s. A weak recovery will probably commence in 2010. It will probably be some time before the County achieves even the 2.5 percent or so economic growth rates that have been the best of this decade to date."

"The recession is likely to be extended because of new regulation and continued tight credit markets. However, we will avoid a depression. California is worse off. San Luis Obispo County is not as bad off as California."

The most likely outlook in their opinion? A long, slow descent with a long bottom and slower recovery.

"We examine possible recovery scenarios and reject both a rapid recovery and an extended decline. We expect a decline followed by a period of little or no growth. The eventual recovery will likely be weaker than most."

Some quick observations by others on the challenges facing the national, state and local economies:

- "We are really going to have to rebuild this system from the ground up," former Fed Chairman Paul Volcker said. "**I don't think we can escape damage to the real economy. I think we almost inevitably face a considerable recession**."

- **"Given the financial damage to date,"** Alan Greenspan told Congress. "I cannot see how we can avoid a significant rise in layoffs and unemployment."

- **Gross Domestic Product (GDP) officially contracted in the third quarter,** reported the Commerce Department. The economy shrank 0.3%. That is the biggest quarterly decline in seven years, when the United States entered a post-tech bust recession.

GENERAL FISCAL OUTLOOK

- **In the third quarter of 2008, consumers reduced their spending by the greatest margin in 17 years.** Consumer purchases now make up over 70% of economic activity in the United States. Recent GDP data shows that the Commerce Department's measure of consumer spending fell by an annual rate of negative 3.1%. This is the biggest pullback since 1980.

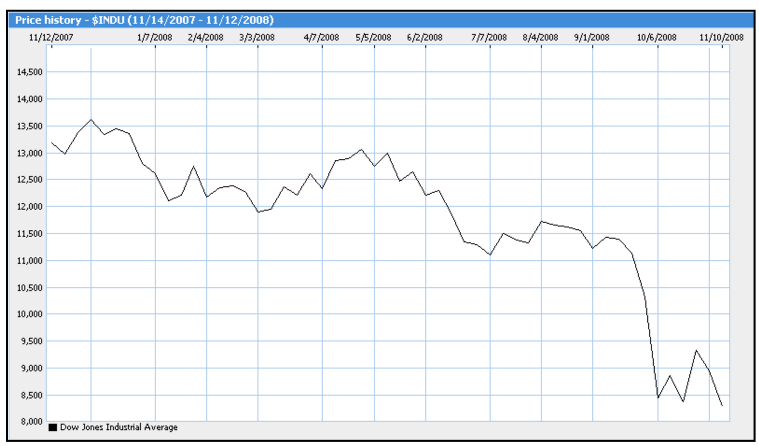
- **America's Research Group predicts holiday sales will decrease at least 4 percent, the first decline since it started forecasting in 1979**, as consumers grapple with sinking home and stock values. Their projections have been correct in 16 of the past 17 years.

- **The volume of "mass layoffs" in the U.S. has reached a seven-year high.** According to a Labor Department report, the number of firings involving at least 50 workers increased more than fivefold from August to September. There were 2,269 such events in September, up 497 from August.

- **Foreclosures grew by 71% in the third quarter compared with the same time in 2007.** About 766,000 homes received at least one foreclosure notice during the period, according to RealtyTrac; and 250,000 properties were repossessed.

- The Conference Board's gauge of confidence sunk to 38 in October, from a score of 61 in September. **This is the lowest score since the report's inception in 1967.**

- **And of course, the stock market has plunged over the last year: in fact, in just the last six months, the Dow Jones Industrial Average has lost 35% of its value.**



In short, except for declining gas prices (and even that is a mixed blessing in terms of resource conservation and climate change), the economic news is all bad – and it's likely to remain so for a large portion of 2009-11.

Impact on City Revenues

The recent performance of two of our top General Fund revenues reflects the bad news:

1. **Sales Tax.** The last sales tax newsletter showed a 4% drop in sales tax revenues (following a 3% drop the previous quarter). And that was for the second quarter of 2008 – before things got really bad.

2. **TOT.** As noted in the September TOT Report, September revenues were down by 10% compared with last year; and down by 1% overall for the first quarter. Since July, August and September are among our most important months, this first quarter result will be hard to overcome as the year progresses.

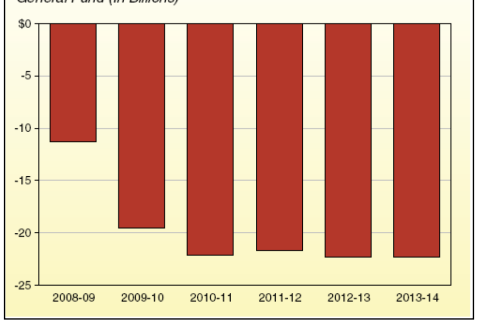
In summary, as discussed above under interim results for 2007-08, we go into 2009-11 with a lower base for key revenues than we estimated; and the trends since then are not encouraging.

❹ STATE BUDGET SITUATION

While the State has huge governance problems in managing its finances, the fact is that the factors discussed above have had a huge impact on the State's budget that transcends its usual inability to manage itself. Given current circumstances, even the Governor now agrees that the State has a revenue problem, not just an expenditure one. On top of the budget fixes just made by the State a month ago, the Legislative Analyst's Office (LAO) projects annual gaps of over $20 billion annually unless corrective action is taken (see side bar chart).

Huge Operating Shortfalls Projected Throughout Forecast Period

General Fund (In Billions)



The Governor has proposed a series of very tough revenue and expenditure solutions over the next 20 months, which are supported by the LAO, including:

1. Increasing the State sales tax rate by 1.5%: $10.1 billion. This would bring the rate in Los Angeles County to over 10%.

2. Expanding the sales tax to selected services: $1.6 billion.

3. Imposing an oil extraction tax: $1.7 billion.

4. Cutting local school support by $3.2 billion, social services by $2.7 billion and health services by $1 billion. These are on top of the cuts already imposed for 2008-09.

At this point, the Governor is not proposing any significant reductions to cities. However, it's very early innings yet; and the Governor's proposals are not likely to gather a lot of support.

And even if the State's budget solution does not have a large

Governor's Special Session Proposals[a]

(In Millions)

	2008-09	2009-10
Revenue Increases		
Increase sales tax by 1.5 cents for three years[b]	$3,540	$6,643
Expand sales tax to some services	357	1,156
Impose oil severance tax	530	1,202
Raise alcohol tax by a nickel a drink	293	585
Subtotals, Revenue Increases	($4,720)	($9,586)
Expenditure Savings		
Reduce Proposition 98 spending	$2,500	$729
Reduce higher education spending (unallocated)	132	132
Reduce regional center rates by 3 percent	34	60
Restrict Medi-Cal eligibility and benefits	142	715
Reduce SSI/SSP grants	391	1,176
Eliminate California Food Assistance Program	—	30
Reduce CalWORKs grants and implement reforms	274	847
Reduce IHSS state wage participation and target services	118	357
Implement parole reform and other corrections savings	78	678
Eliminate funding for public safety grant programs	250	501
Eliminate state funding to transit agencies	230	306
Furlough state workers and reduce other costs	320	556
Eliminate funding for the Williamson Act	35	35
Subtotals, Expenditure Savings	($4,504)	($6,120)
Total Solutions	**$9,224**	**$15,706**

a Scoring reflects administration's estimates.

b Sales tax revenues are the net benefit to the General Fund, after accounting for higher spending required under Proposition 42.

direct impact on the City, deep cuts to schools, heath and human services, corrections and higher education will have significant impacts on our community.

❺ KEY COST DRIVERS

Based on past experience, there are five key cost areas we need to pay special attention to:

1. **Workers Compensation, General Liability and Property Insurance**. At $2.7 million annually, these account for about 6% of the General Fund budget. In the not so distant past, theses costs were rising at very high rates. The good news is that while there have been cost swings between workers compensation and general liability coverage, total insurance costs have been very stable since we joined the California Joint Powers Insurance Authority (CJPIA). At this time, this does not appear to be a major cost driver in 2009-11, with one caveat: insurance companies set rates based on many other factors than actuarial loss history. One of these is the return on their investments; and this has not been a banner year for major insurers like AIG. On the other hand, the CJPIA is largely self-insured, so this may not be a major factor for us.

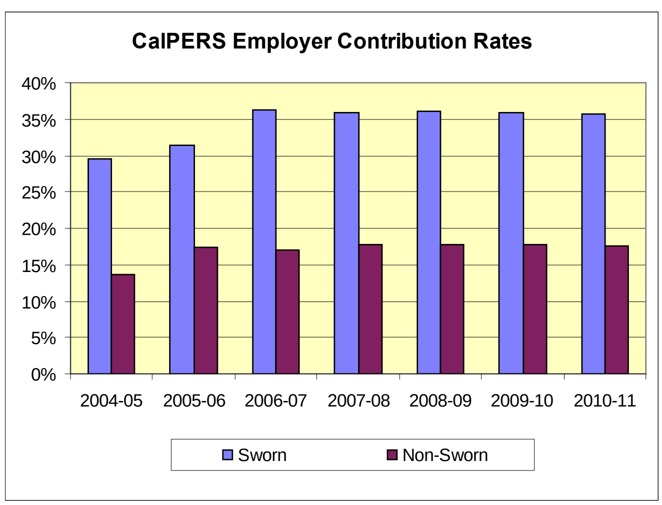
2. **Energy and Fuel.** With declining oil prices, this is not likely to be a major cost driver in 2009-11.

3. **Construction Costs.** This may be the only silver lining to the storm clouds facing us: based on our recent bidding experience, we are likely to get a "bigger bang for our construction project buck" in the current economic environment. Along with this general trend, falling petrochemical costs should reduce paving costs.

4. **Retirement: Projected Rate Stabilization Is Happening**. As detailed below, our projected stabilization of rates is in fact occurring; and while we are not likely to see reductions in our rates in the near future, continuing increases are not on the horizon.

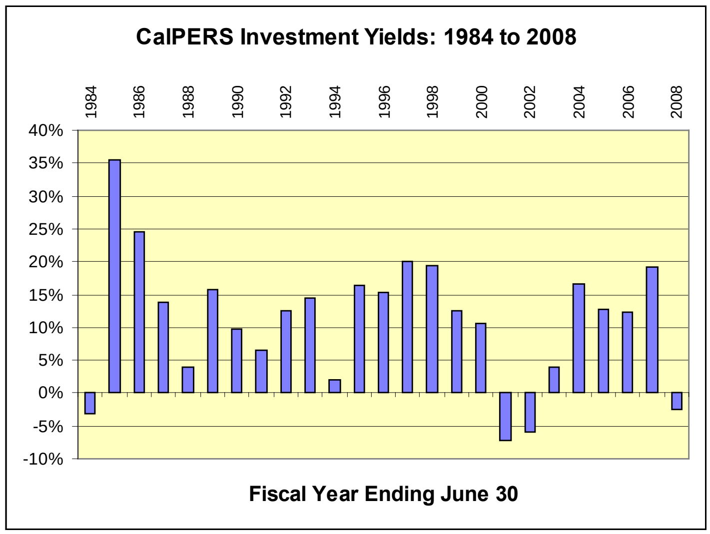
   CalPERS Costs in Context. For 2008-09, our estimated CalPERS cost for employer contributions is $6.6 million. To place this in perspective, this represents 6.8% of our total City budget for 2008-09 of $96.6 million. So, while it's certainly a significant cost, it is not an undue portion of total City costs. This 6% share has remained stable over the past five years; and it is likely to remain the same (or lower) over the next two years.

   Rate Stabilization. As projected, our employer contribution rates have stabilized. We recently received our rates for 2009-10 and projections for 2010-11, which reinforce our "stable" outlook. This is reflected in the sidebar chart, which shows the seven-year stability in rates for both sworn and non-sworn employees.



Improved Liability Funding Levels. On the good news front, while rates have remained stable, the level of unfunded liabilities has improved. An 80% ratio is considered a reasonable funding level. As of the most recent actuarial analysis, the City's plans are now at 99.0% for safety employees and 90.2% for non-safety employees.

What About Future Rate Increases, Given Current Investment Market Conditions? Following several years of double-digit gains, CalPERS has recently experienced – like most investors – a decline in the value of its investment portfolio. However, because of CalPERS 15-year "smoothing" methodology, we do not expect to see any significant changes in employer contribution rates in the foreseeable future. Stated simply, because of this long-term approach to rate-setting, we did not see significant changes downward when CalPERS had double-digit gains after 2001; and likewise, there should not be any significant immediate impacts even if CalPERS experiences similar losses like it did following the "dot.com" meltdown and 9/11.



For context, CalPERS rates are based on an actuarial assumption of a 7.75% return on investments. As the side-bar chart shows, while there have been years where yields have fallen below this target over the last 25 years, long-term yields have averaged over 9%.

On the other hand, while rates are likely to remain stable, our retirement costs will go up as salary costs increase. For example, we recently saw a significant increase in CalPERS costs for POA employees. However, this is solely due to the salary increases awarded by the arbitrator of 33% to 42% (including educational incentives and depending on sworn/non-sworn status). As noted above, the underlying actuarial basis for rate setting has been – and is projected to be – stable. In short, POA retirement costs went up significantly, because the salaries upon which the rates are applied went up significantly; but the rates themselves have been stable and are likely to remain so.

This leads to the point below: the importance of containing labor costs while remaining competitive in attracting and retaining quality employees.

5. **Labor Costs.** These will be largely determined by the "meet and confer" contracts we enter into in the coming year. The key question facing us is: will salary agreements look like the:

- POA binding arbitration decision, where salary costs (including educational incentives) rose about 9% per year over the last four years, based on the arbitrators decision to pay salaries at the 85% percentile of comparable cities (versus the City's policy of focusing on the median – 50% percentile – for all other positions)?

- Agreements with all other units, where salary costs rose about 4.5% per year over the last four years?

- Or more like the 2% salary increase recommended for managers for 2009?

Since staffing costs represent about 80% of General Fund operating costs, the answers to these questions will have a profound impact on our fiscal outlook.

❻ INFRASTRUCTURE AND FACILITIES MAINTENANCE

The forecast we prepared two years ago estimated that adequately maintaining, repairing or replacing existing General Fund facilities, infrastructure and equipment we already have in place would cost about $8.3 million annually. This excludes any enhancements or "betterments."

While the CIP approved in the 2007-09 Financial Plan included some "new" projects, it was funded at about this level. To place this in context, the General Fund CIP appropriation in 2006-07 – the year prior to the 2007-09 Financial Plan – was $2.1 million: about 25% of the level approved in 2007-09. This very lean CIP reflected the significant reductions in infrastructure maintenance the City had made in balancing the budget in the five years prior to 2007-09. This included reducing our street paving program by 67%; and the tough decisions the Council had to make in preserving critical day-to-day services like police and fire protection. The passage of Measure Y was a major factor in this turn-around.

On one hand, it is likely that our ability to fund needed infrastructure, facility and equipment improvements will be better in 2009-11 than it was in the five years before the passage of Measure Y. On the other hand, without significant cuts in other areas, it is unlikely that the level of CIP funding initially funded in the 2007-09 Financial Plan can be sustained. This simply underscores the tough decisions ahead of the Council in preparing a balanced budget for 2009-11.

SUMMARY

The purpose of this "general fiscal outlook" is to highlight the key factors that are likely to affect us financially over the next two years. We will be better able to place these in a more "empirical" context, along with other key factors, after we have finalized the five-year General Fund forecast, which we plan to present to the Council on December 16, 2008. However, based on this initial "high-level" look, our fiscal situation as we enter the 2009-11 Financial Plan will be much tougher than it was two years ago,

However, even with this tougher fiscal environment, we are in much better position than many other cities in California to weather this storm; and we are very fortunate to have Measure Y revenues. But regardless of our specific fiscal circumstances, the fundamental policy questions posed by the budget process remain ahead of us in both good times and bad: Of all the things we want to do in making our community an even better place to live, work and play, which are the most important? And what are the resource trade-offs we have to make to do them?