



MEMORANDUM

DATE: June 7, 2006

TO: Mayor and Members of the City Council

FROM: City Manager

SUBJECT: PROPOSED BUDGET FOR FISCAL YEAR 2007

General Fund

The last five years have been five of the most difficult years in the City's history. They were the aftermath of the robust years of the late 1990s, when the Northern California economy and the taxes it generated grew rapidly. An economic correction was inevitable. However, the natural and expected economic cycle was only part of the story of the last five years. The other part was the State of California's failure to competently manage its financial affairs.

The State made the economic correction that began in 2001 considerably worse for local governments by taking local tax revenues to compensate for declining State tax revenues. Local government responded with Proposition 1A, the passage of which in November 2004 altered the basic relationship between the State and local government by protecting local government's basic tax base from State takeaways. Despite this triumph, however, local government remains subordinate to the State in myriad other ways.

The City of Santa Cruz had no choice but to cut spending again and again over the past five years. Six major sets of reductions were approved by Santa Cruz City Councils. Eighty jobs have been eliminated, and millions of dollars of services have been deleted. Fees have also been raised to offset the costs of fee-eligible services.

We have long recognized that we have a systemic budget shortfall, but we had reason to hope that the City's General Fund would level off for a period of time. The economy has recovered from recession and is growing, albeit slowly. The State is no longer redirecting local government's tax receipts elsewhere, though the reductions already made are permanent. Also, the City realized budget savings by holding off on filling even essential positions while last summer's vote on Measure X was pending. Had voters not approved the conversion of the City's "franchise fee" to a "franchise tax," which they did, extensive additional cuts would have been implemented.

Unfortunately, the budget numbers for next year reveal a continuing deficit in the General Fund. The City's actual general government spending is forecast to exceed general government revenues by approximately \$1.5 million in the next fiscal year. This is consistent with our expectations. This budget picture reflects a simple, longstanding, fundamental financial reality: taxable economic activity inside the City limits does not generate enough money to pay for City services.

We should reduce the recurring deficit to \$1 million or less during the course of the upcoming fiscal year, to put the City in a reasonable position to approach fiscal year 2008. We will bring recommendations to the City Council to accomplish this result in the first half of the upcoming fiscal year. Our goal will be to accomplish this with as little trauma as possible, though as the City Council knows, options grow fewer with every set of cuts.

Four City departments have of late borne exceptional burdens. The Human Resources Department lost the majority of its staff in just a few months. The Planning Department lost its Director and several other key members of the staff. The Finance Department lost its Director, Assistant Director, and payroll staff, also in a short period of time. Finally, the Parks and Recreation Department is adjusting to major restructuring in the face of substantial budget reductions. Each of these departments is hard-pressed to get by day-to-day, much less plan for a new and revised future. It will not be easy to further reduce the cost of general government services.

We are still working to adjust to the cuts of the past few years. This means adapting to a smaller complement of employees and to diminished purchasing power. It means exploring alternative means of providing services. It means being an attractive place for productive and capable people to work, a place where they can feel satisfied even if they might earn more elsewhere.

In addition to the immediate budget deficit, the City faces two larger issues. The first has to do with Measure F, the five-year, one-quarter cent sales tax that will expire at the end of June 2009. If the voters do not renew this tax before its expiration, the City will face another general government crisis, as the tax produces upwards of \$2.2 million per year. There will be two chances to propose a renewal of this tax: November 2006 and November 2008. This has to be the single-most consequential short-term issue for the future of general government services.

The second issue is the City's streets, about which more will be said below. Stated briefly, in the absence of a huge infusion of money, mile after mile of the City's streets will require rebuilding rather than resurfacing, at five times the cost of resurfacing. The condition of the City's streets constitutes its own financial crisis.

The City Council has authorized the polling of City voters to determine their attitudes toward potential long-term fixes of the Measure F and streets issues. Perhaps there will be interest in and support for long-term solutions. At this writing, decisions have yet to be made in this regard.

Clearly, then, the City of Santa Cruz continues to face daunting financial challenges. There will be no easy solutions.

The City's Failing Streets

Last year we estimated that it would take \$42 million to return the City's streets to satisfactory condition. We spent \$1.7 million. We resurfaced portions of Front Street, Water Street, Beach Street, and smaller sections on Fairmount, Wharf Entrance, and West Cliff Drive. We also completed a rubberized chip seal surface treatment to the streets in the Harvey West area. The streets in these areas look good and are watertight.

This winter's rains were a benefit in terms of water supply, but a disaster to our aging streets. With the majority of streets in marginal or poor condition to begin with, the rains soaked the base material under the pavement surface and reduced the carrying capacity of the roadway. As a result, heavy vehicles caused significant damage, the evidence of which is seen in potholes everywhere.

A cost-effective street maintenance program would resurface streets before they fail and need to be totally rebuilt. Postponing street repairs makes them hugely more expensive than they would be if properly maintained. This year's budget includes a loan of \$2 million from the Public Trust Fund for street maintenance. Still, a long-term dedicated funding source is required to bring the streets back into adequate condition. We are investigating a "construction vehicles impact fee" for new development, a "refuse vehicle impact fee," and a sales tax and/or parcel tax to support street maintenance.

Refuse and Recycling

A new \$2.5 million single-stream recycling system is now in place at the Resource Recovery Facility. The equipment can process ten tons per hour. This allows us to remove the dividers out of the blue recycle carts, commingling recyclables that previously required manual separation. We anticipate that this convenience will increase recycling by 10 percent to 20 percent.

On the collection side, we continue to upgrade our refuse and recycle trucks and look for ways to improve service and reduce costs. The use of new vehicles and the practice of commingling is expected to achieve a significant reduction in noise, as we can collect green cycle materials and recyclables in one truck, which allows for a reduction in the number of routes and trucks.

Major Construction Projects

The next few years will feature several truly major construction projects. The most significant project is Highway 1/17 safety improvements. This Caltrans-managed project will significantly impact traffic and City residents near the project area for the next three years. The second major project is the water trunk line replacement from Ocean Street to the Bay Street Reservoir. This is also a three-year project. High Street will be significantly impacted for many months, but will be repaved as part of the project. The third major project will be the completion of the Mission Street utility undergrounding from Bay Street to Chestnut Street. This project is scheduled to start this summer, and has an estimated duration of ten months for the utility trenching and infrastructure. Electrical, phone and cable wiring, and pole removal will take longer than ten months, but is less disruptive.

These three projects will have a significant impact on traffic.

Water Department

As was reported in last year's budget message regarding the City's water operations, the focus in the Water Department will continue to be on capital improvements. Next year's budget will include debt service payments for \$12 million borrowed at the close of last fiscal year to fund the majority of the Bay Street Transmission Main Project.

The rate increases adopted by Council in 2004 will continue to mature through 2007, enabling the City to fund the required capital projects through a balance of pay-as-you-go and debt financing.

Most important of all, operations of the desalination pilot plant are expected to be nearly complete by the end of this fiscal year. With the information gained from the pilot plant and other work, the City should be in a position to initiate the final design and a project-level Environmental Impact Report by the end of calendar year 2007.

A Question of Governance: The Desalination Plant

The City of Santa Cruz and the Soquel Creek Water District will need to enter into an agreement that sets forth the parties' responsibilities for the construction and operation of the jointly owned and operated desalination plant. Also, the agencies have yet to work out how the operation will be governed. In the near future, if the project is going to proceed, the Santa Cruz City Council and the Soquel Creek Water District Board, as well as their staffs and attorneys, will need to develop a plan for governance and other long-term matters.

Police

The Police Department's biggest challenge is to recruit qualified Police Officers. This is a national problem, but that is of little comfort. Housing costs are the primary issue for prospective candidates. We do our best to recruit from the local community, and have many successes to show for it, but we are unable to keep up with demand.

Fire Apparatus

Many things have been postponed in the financial duress of the past five years, including the purchase of Fire Department equipment and apparatus. We anticipate the need to purchase a fire pumper in 2008, a rescue vehicle in 2009, another pumper in 2010, and an aerial truck in 2011. Equipment from mobile data computers, to rescue tools, to confined space rescue equipment will also be needed. The current level of capital spending is insufficient.

Planning and Community Development

After four years of significant staff cuts, no changes are proposed for next year. At this writing the recruitment process for a new Director is underway. A Senior Planner position and an Associate position are also vacant.

The retirement of the Director of Planning and Community Development caused us to reconsider our plan to prepare the next General Plan "in-house." Naphtali Knox, an experienced and highly regarded General Plan consultant, has been retained to advise and assist with the General Plan Advisory Committee's work. The revised approach is working well. The City Council increased the established General Plan Maintenance Fee to cover the cost of the General Plan update and partially defray the ongoing staff costs associated with maintaining the General Plan/Local Coastal Program and Zoning Ordinance.

Community Development Block Grant and Home Investment Partnership funds are no longer sufficient to fund the two-person housing unit staff. Staff recommended and the City Council

approved use of the Affordable Housing Trust Fund (AHTF) for administration, up to a maximum of 20 percent of Housing and Community Development administrative costs. This use of the AHTF will be revisited every year during the Annual Action Plan review.

The workload for permits and development review continues at a steady level, which is a challenge for Current Planning Division staff, considering the two vacant positions. This has constrained the division's ability to respond to code amendment requests and other special projects while performing our regular State-mandated time-sensitive work. The department has limited the Planning and Building counter hours, 7:30 a.m. to 12:00 noon every day, to allow staff the afternoons to work on projects.

Finance and Information Technology

Not only has the Finance Department experienced turnover in key positions, as was noted above, but it has been immersed in major system changes as well. The workload in the department has been unusually prodigious and intense for several years. The City owes a debt of gratitude to its Finance Department employees, who have served heroically in roles that are mostly taken for granted.

At this writing, the recruitment for a new Finance Director is underway. We are excited to have filled the Assistant Finance Director position with an in-house promotion. We expect to see additional promotions, as well as the appointment of new people to the department. We look forward to the increased use of electronic transactions, steps to streamline the budget process and the payroll function, and other improvements too.

Finally, the proposed budget includes a proposal to establish the Information Technology Division of the Finance Department as a separate City department. This was the final recommendation of our previous Finance Director before he left, and the first recommendation of our Acting Finance Director upon his arrival. It has long been under consideration, as information technology has become more and more central to all of the City's operations. Simply put, the information technology function is no longer a sub-set of the Finance Department; it is a citywide function critical to every department. In our judgment, the best way to meet the City's long-term information technology needs is to establish Information Technology as a department of the City.

Projects such as changing banks and the adoption of new technology for things like credit card processing, automated clearinghouse transfers, and web-based applications for banking do not attract much public interest. Nevertheless, they are essential aspects of the City's operations. Future plans include replacing the current utility billing system along with the obsolete HP3000 on which we still rely for many applications. We will then move on to upgrading City permit and parking citation systems.

Conclusion

While the proposed budget is far short of meeting the City's needs, especially in terms of general government services, it is the first since 2001 that does not feature painful cuts. That in itself is a measure of success, as well as a relief. The financial challenges ahead may be no less daunting than the ones behind us, but we can enjoy a "breather" while we contemplate the future.

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I want to express my thanks to the Mayor and to the Members of the City Council for your extraordinary dedication to the City's financial well-being. You have demonstrated unwavering leadership in guiding the City to its present position, and will no doubt continue to do so as you grapple with the issues ahead. It has been a pleasure for me, and for the City's staff, to prepare this budget for your consideration.

A handwritten signature in black ink, appearing to read "Richard C. Wilson". The signature is written in a cursive style with a vertical red line to its right.

Richard C. Wilson
City Manager