CITY OF SEBASTOPOL CITY COUNCIL
AGENDA ITEM REPORT FOR MEETING OF: March 19, 2024

To:	Honorable Mayor and City Councilmembers
From:	Don Schwartz, City Manager
Subject:	Sebastopol's Financial Situation

RECOMMENDATION: Receive report on the City's long-term financial situation.

EXECUTIVE SUMMARY: The City of Sebastopol has serious financial problems. These include the City's General Fund, which is the primary source of funding for functions include police, fire, land use planning, housing, and operations and maintenance of parks, facilities, and other infrastructure. Staff project an on-going deficit of $2.9 million/year without adjustments. There will be a detailed presentation at the City Council meeting by Bob Leland of Baker Tilly.

BACKGROUND: The City recently hired Baker Tilly to develop a model and forecast for the City's General Fund. This model will allow us to update the forecast as needed, and thus provides an important tool to support managing the City's finances. Some of the key findings from the model include:

1. Consistent with prior long-range forecasts, the City faces an on-going structural deficit. Baker Tilly estimates this deficit at $2.9 million/year when including current operating revenue sources and expenses, as well as $900,000/year for maintenance, repair, and replacement of items such as buildings, parks, technology, vehicles, and other infrastructure. This excludes $1.4 million/year needed to repair and improve City streets.
2. The City faces these challenges despite having the third highest per capita General Fund revenues in the County (behind Sonoma and Healdsburg), with the second highest General Fund expenses per capita (behind Sonoma).
3. As with many other cities, Sebastopol faces significant increases in employee retirement costs. These are expected to peak in approximately 10 years after increasing from about $1.7 million currently to $2.6 million. The City has set aside $2.9 million (mostly in a section 115 pension trust) to mitigate these coming increases.
4. Without changes, the City is on track to deplete our fund balance in FY 26-27, or approximately three years.
5. Options to mitigate the problem include an increase in sales taxes dedicated to the City and substantial reductions in expenses and services. We can also draw from the PERS trust or continue to defer maintenance and replacement expenses; these actions will result in higher costs in the long run.
6. The City can also pursue economic development, particularly the attraction of visitors to the City including hotels.

ANALYSIS: The presentation during the Council meeting will include further details and analysis.

COMMUNITY OUTREACH:
This item has been noticed in accordance with the Ralph M. Brown Act and was available for public viewing and review at least 72 hours prior to schedule meeting date.

FISCAL IMPACT: There is no fiscal impact from receiving this report. The impact of direction that the Council provides will depend on the nature of the direction.

OPTIONS: Staff did not consider options other than presenting this information to the Council. We did consider developing the information in house but lack the staff time and expertise to do so as well as Baker Tilly does this work. We also considered engaging prior consultants who have done this work for the City but chose Baker Tilly both because they are more cost effective and because their work includes a tool that we can continue to use.

ATTACHMENTS: Presentation by Bob Leland of Baker Tilly

City of Sebastopol
Long-Range Fiscal Model

Bob Leland, Special Advisor
Baker Tilly US, LLP

March 19, 2024

Model version 1.5, 3/12/24

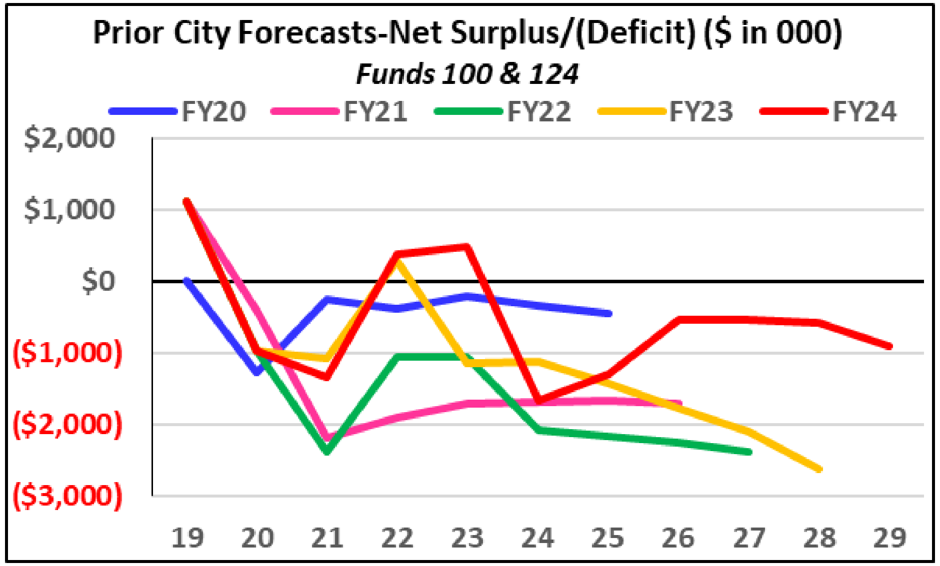
Extensive Experience in Forecasting

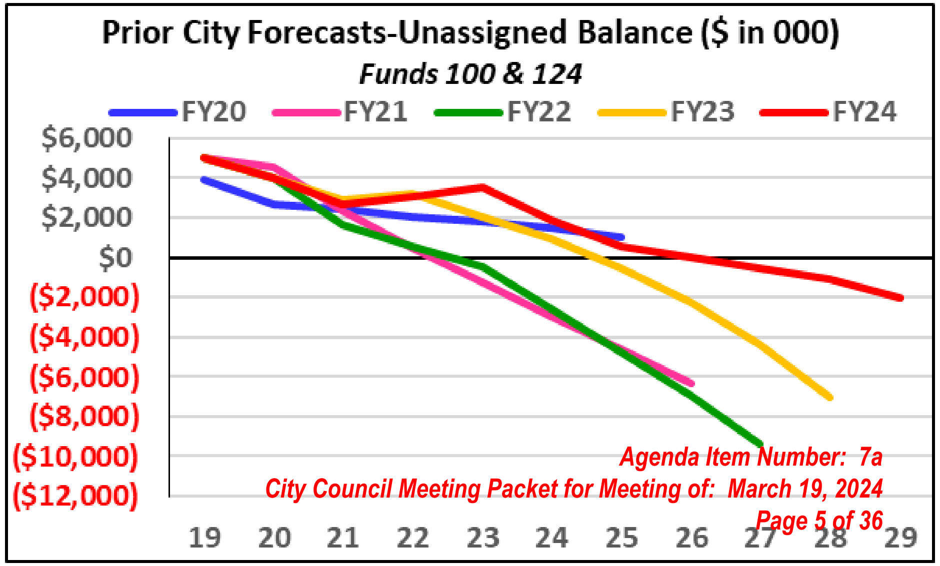
- Our Firm's Experience
  - Baker Tilly is the 10th largest accounting/consulting firm in U.S.
  - Public Sector practice works exclusively with local governments nationwide, including all the 20 largest California cities
  - We've developed long-range fiscal models for over 40 California cities in the last 10 years
  - Basis for our modeling approach was developed during the extensive bankruptcy litigation in City of Stockton's Chapter 9 proceeding

- Our Consultant's Experience
  - 49 years in state and local government finance
  - Finance Director for City of Fairfield (26 years)
  - Consultant with Management Partners and Baker Tilly (12 years)
  - Major projects include Stockton bankruptcy, Paradise recovery
  - 42 years of hands-on experience with long-range forecasting (created fiscal models for 45 different local agencies involving 126 separate forecasts)

Background

- Background
  - City prepares a 5-year forecast for the annual budget document
  - Trends have been generally downward since the forecast done in 2020 (see charts), showing a persistent structural revenue shortfall
- City hired NHA Advisors in 2023 to prepare a forecast and a range of options for balancing the budget
  - NHA projections confirmed the structural shortfall
- City hired Baker Tilly to prepare a long-range forecast model to demonstrate impact of various financial scenarios on the General Fund, for ongoing use by the City

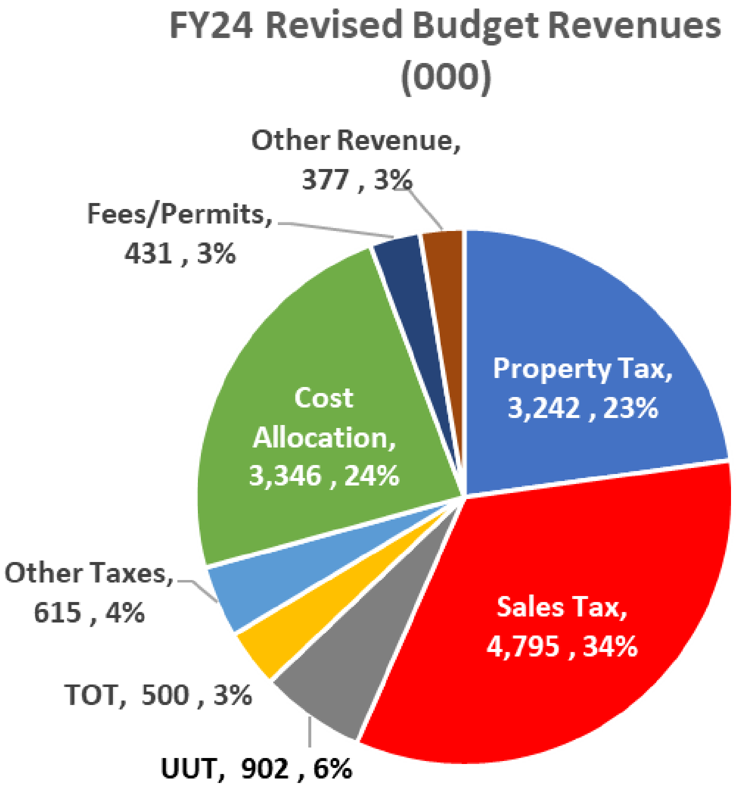


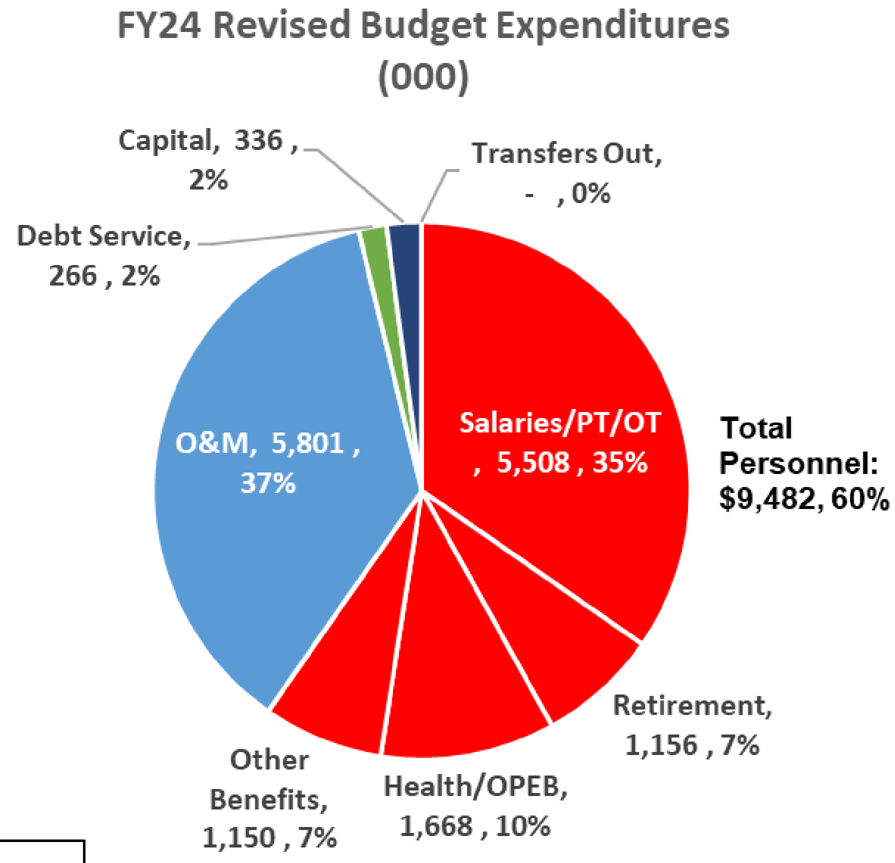


FY24 Budget – Change in CAP Treatment

Funds 100+124 ($ in mil.)	FY24 Adopted	FY24 Revised
Property Tax	3.24	3.24
Sales Tax	4.79	4.79
UUT	0.90	0.90
TOT	0.50	0.50
Cost Plan	0.00	3.35
Other Rev/Tfr In	1.42	1.42
Total Revenue	10.86	14.21
Personnel (ex WC)	9.00	9.00
O&M	5.17	5.17
Liability Ins/WC	1.11	1.11
CAP Exp Credits	(3.35)	0.00
Debt Service	0.27	0.27
Capital	0.34	0.34
Transfer Out	0.00	0.00
Total Expense	12.54	15.88
Net Rev/(Exp)	(1.68)	(1.68)
Fund Balance	5.55	5.55
Assigned	1.42	1.42
Unassigned*	4.13	4.13
Unassign % of Exp	32.9%	26.0%

*Reflects updated balance per 6/30/23 ACFR (budget showed $1.85M)





Unassigned Balance (Funds 100+124) (mil.)	FY21	FY22	FY23	FY24
Est Bal[1]	2.69	3.06	3.53	1.85
Act Bal[2]	2.94	3.45	5.81	4.13
Variance	0.26	0.39	2.28	2.28

[1]Per page 42 of FY24 Adopted Budget
[2]Actuals per ACFR, estimated for FY24

FY24 Revised Budget shows Cost Allocation Plan as it will be in future budgets

Change in Annual General Fund Shortfall

Combined Funds 100 & 124 ($ in mil.)

Adopted Budget Shortfall for FY24		(1.68)
Improved property tax revenue projected for FY24	0.22	
Reduced sales tax revenue projected for FY24 by Avenu	(0.07)	
Net projected change in other revenue for FY24	0.01	
Personnel cost savings in FY24 due to high position vacancies	0.92 [1]	
Net change in projection for all other expenses	(0.50) [2]	
Revised Budget Shortfall for FY24		(1.09) [3]
FY25 revenue assuming 2.5% overall growth above FY24 levels	14.72	
Reduction in Cost Plan revenue per latest plan update	(0.71)	
FY25 personnel costs with 6% vacancy rate	(8.63)	
FY25 O&M costs at 2.5% growth	(6.76)	
Year 1 of 3-yr phase-in to $900K replacement/maint costs[4]	(0.30)	
Added cost above 2.5% growth for Liability/Workers Comp[5]	(0.17)	
FY25 debt service & capital costs	(0.47)	
Projected Budget Shortfall for FY25		(1.97)

[3] $1.04M transfer of an assigned balance to Flood Control Fund 127 is excluded from this annual deficit calculation as it has no net impact on unassigned balance

[4] City does not adequately budget these costs to support current service levels and facilities; based on annual depreciation of depreciable governmental assets

[5] JPA expects 10% Workers Comp growth & 20% liability insurance growth

[1] **FY24 Personnel Savings (net):**

0.09	Police Sergeant
0.17	Fire Engineer
0.28	Fire Chief
0.12	Police Officer
0.12	Police Sergeant
0.08	Dispatcher
0.14	Accountant
0.99	Totals
(0.07)	Added OT/PT
0.92	Net Cost Savings

[2] **FY24 O&M Increase:**

(0.31)	Contract labor
(0.03)	Forecast contract
(0.35)	Transfer Police donation
0.17	Capital tied to donation
0.02	Insurance/Work Comp
(0.50)	Net Cost Increase

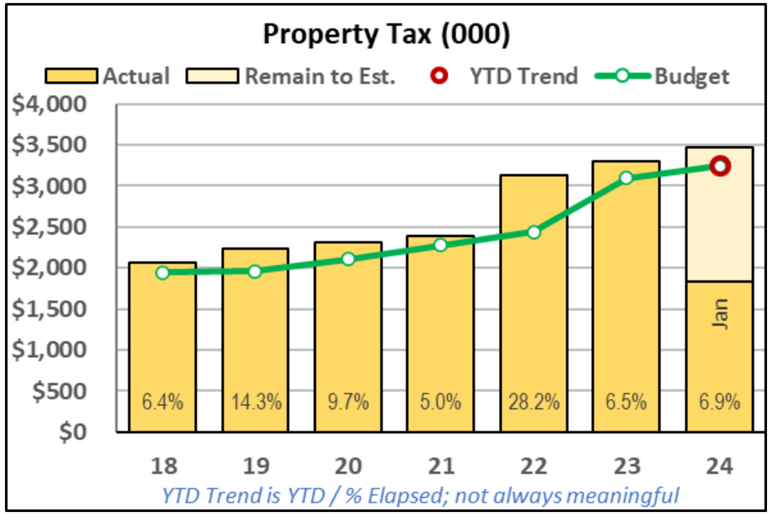
Black increases resources, Red reduces resources

Comparison of Estimates for FY24 & FY25

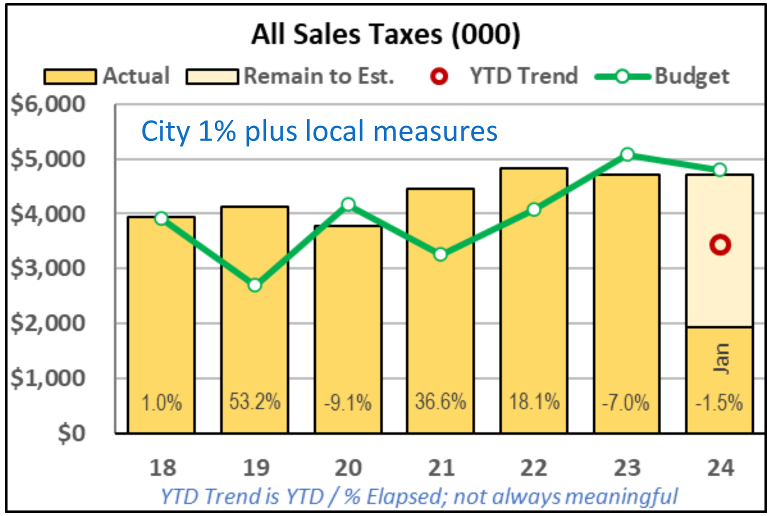
Funds 100+124 ($ in mil.)	FY24 Adopted	FY24 Revised	FY24 Estimate	FY25 Projected	FY25 Comments
Property Tax	3.24	3.24	3.46	3.62	4.25% projected growth
Sales Tax	4.79	4.79	4.72	4.68	FY24 & FY25 per Avenu Insights' projection
UUT	0.90	0.90	0.90	0.92	2.5% growth per past experience
TOT	0.50	0.50	0.51	0.52	2.75% growth (higher growth from private rentals)
Cost Plan	0.00	3.35	3.35	2.78	FY25 cost plan reflects recent CAP update, treated as revenue
Other Rev/Tfr In	1.42	1.42	1.43	1.49	
Total Revenue	10.86	14.21	14.37	14.01	
Personnel (ex WC)	9.00	9.00	8.07	8.63	Assumes 6% vacancy rate in FY25
O&M	5.17	5.17	5.51	5.60	FY25 adds $300K for replacement/maintenance
Liability Ins/WC	1.11	1.11	1.09	1.29	assumes Workers Comp up 10% & Liability up 20% in FY25
CAP Exp Credits	(3.35)	0.00	0.00	0.00	
Debt Service	0.27	0.27	0.27	0.27	continues FY24 budget from fund 124
Capital	0.34	0.34	0.16	0.20	2.5% growth on fund 124 FY24 budget
Transfer Out	0.00	0.00	0.35	0.00	assumes no transfers in FY25
Total Expense	12.54	15.88	15.46	15.98	
Net Rev/(Exp)	(1.68)	(1.68)	(1.09)	(1.97)	improvement in FY24 shortfall, but shortfall grows in FY25
Fund Balance	5.55	5.55	6.14	4.17	
Assigned	1.42	1.42	0.38	0.38	assumes no change in assigned balance in FY25
Unassigned*	4.13	4.13	5.76	3.79	FY25 unassigned balance drops by 34%
Unassign % of Exp	32.9%	26.0%	37.2%	23.7%	FY25 balance is above 15% minimum reserve, but will continue to drop

*Reflects updated balance per 6/30/23 ACFR (budget showed $1.85M)

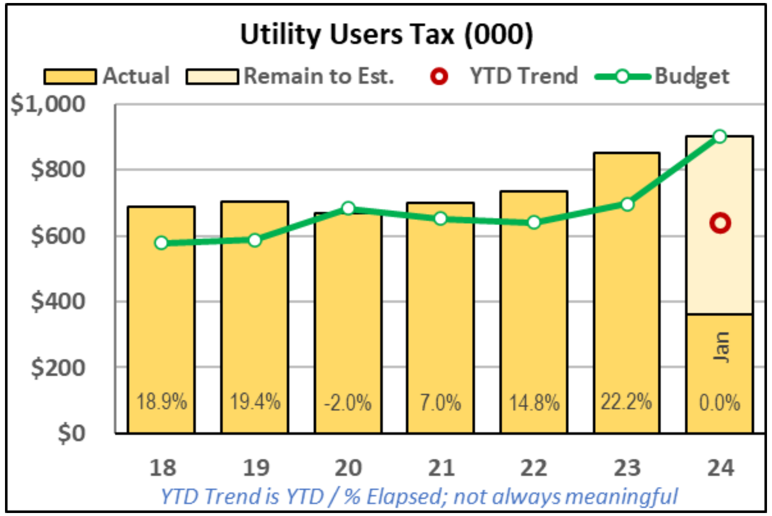
FY24 Revised Budget reflects the way Cost Allocation Plan (CAP) impact will be shown in future budgets, for comparison to FY25 projection



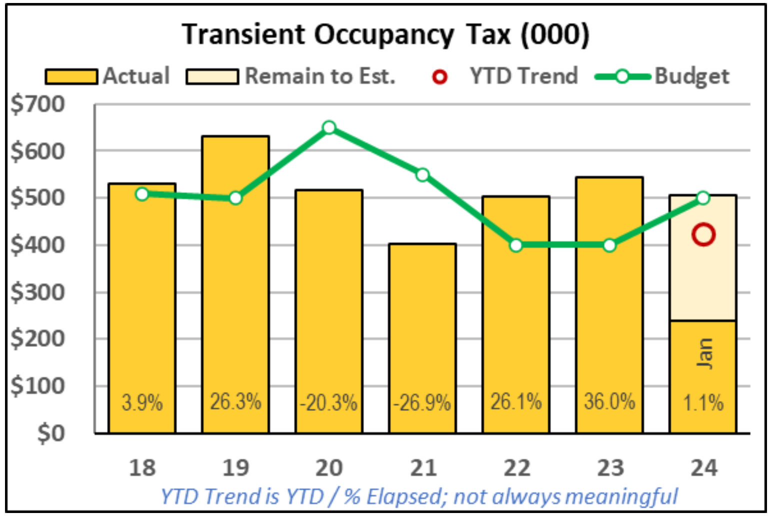
RDA residual revenue boost starting FY22



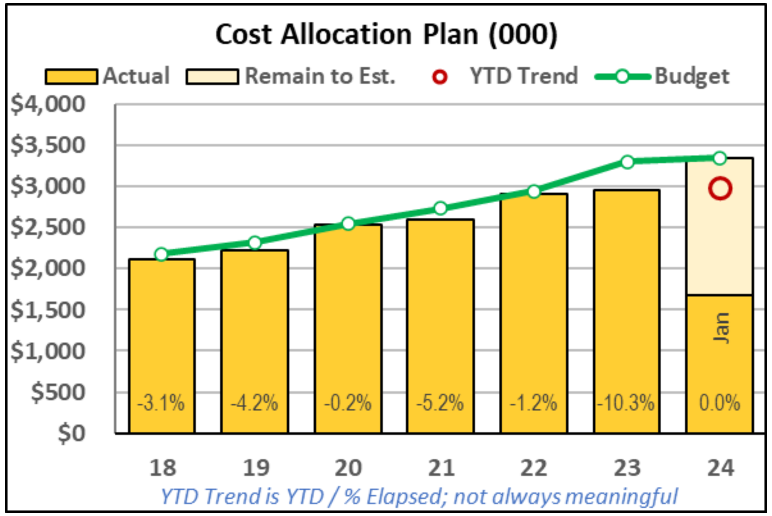
Pandemic led to lower budgets for FY21 & FY22



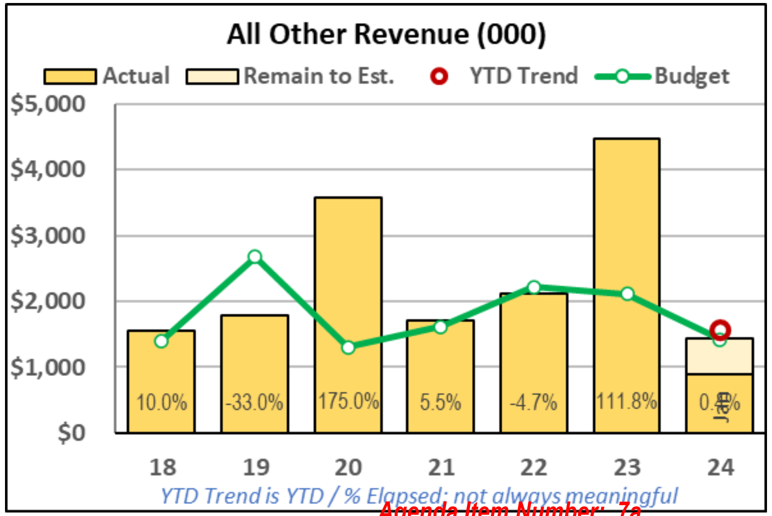
Budget too conservative until FY24



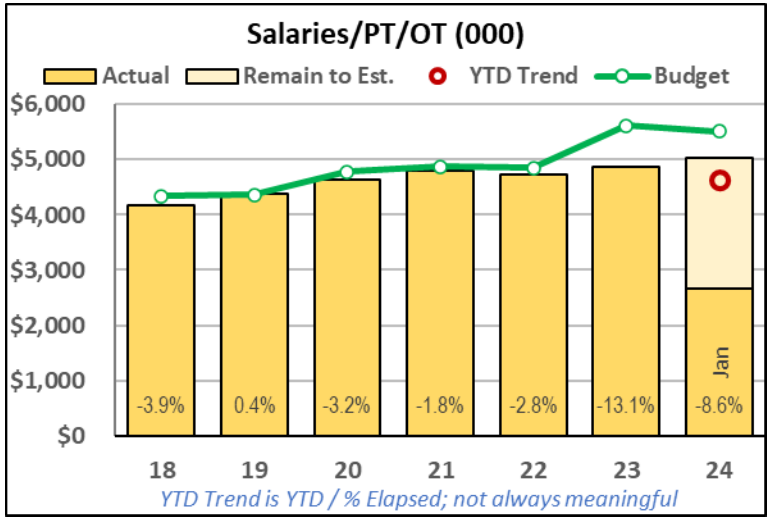
Pandemic led to lower budgets for FY21-FY23



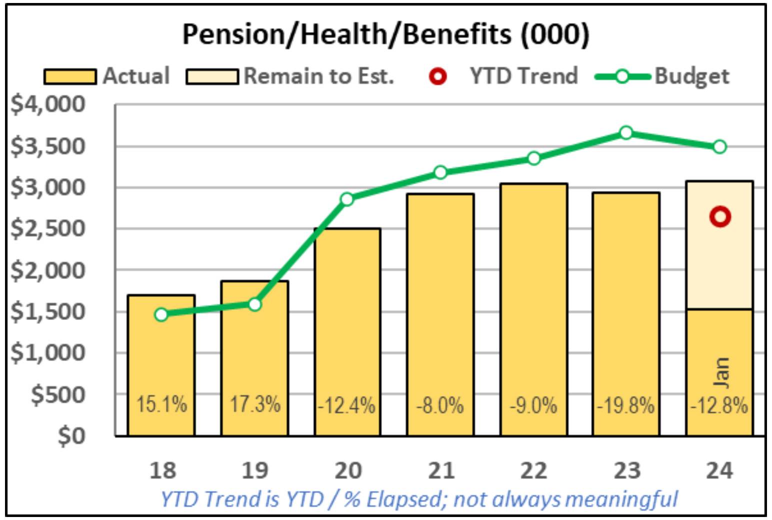
Budget generally on target



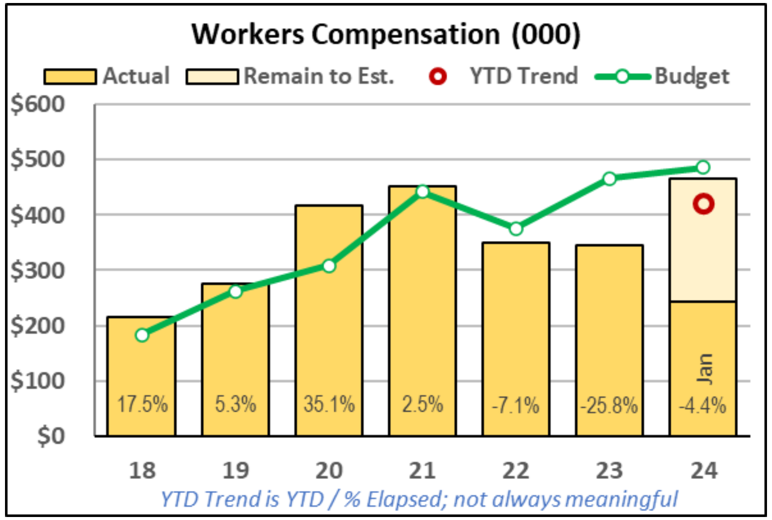
Large one-time revenues unanticipated in budget



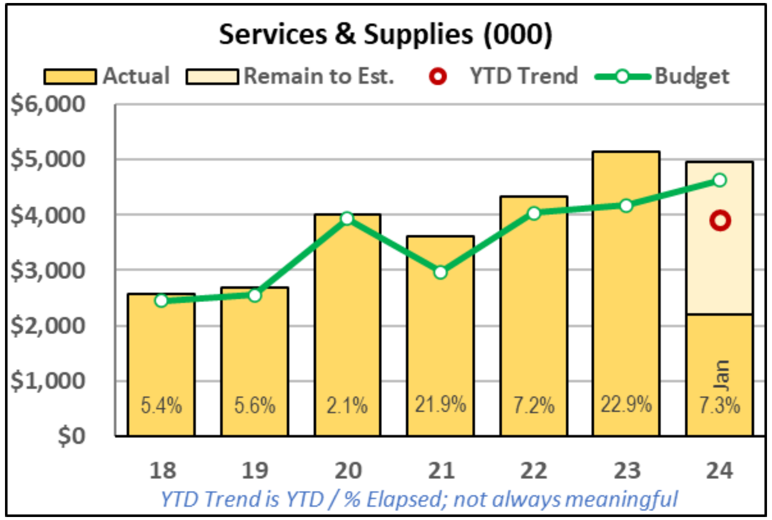
Significant vacancies over past 2 years



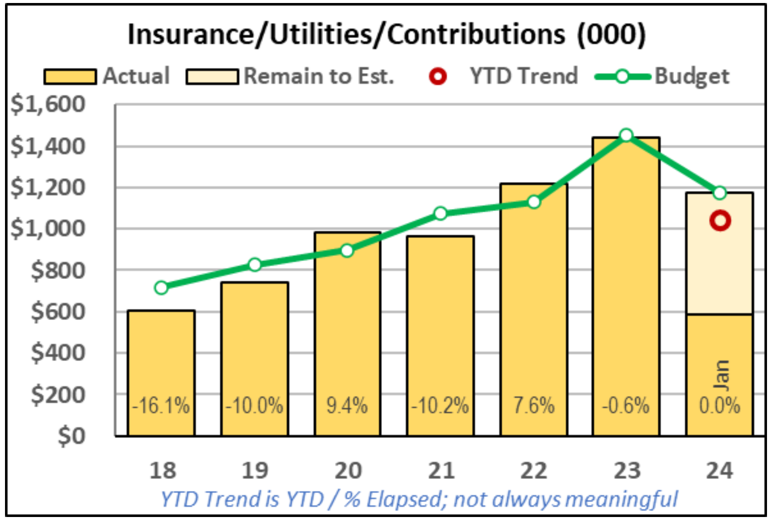
Savings from vacancies, despite UAL costs being fixed



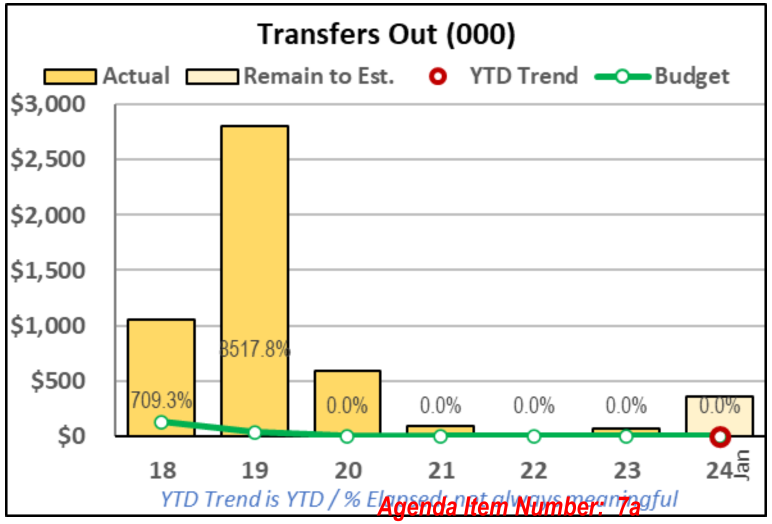
Savings from vacancies, over past 2 years



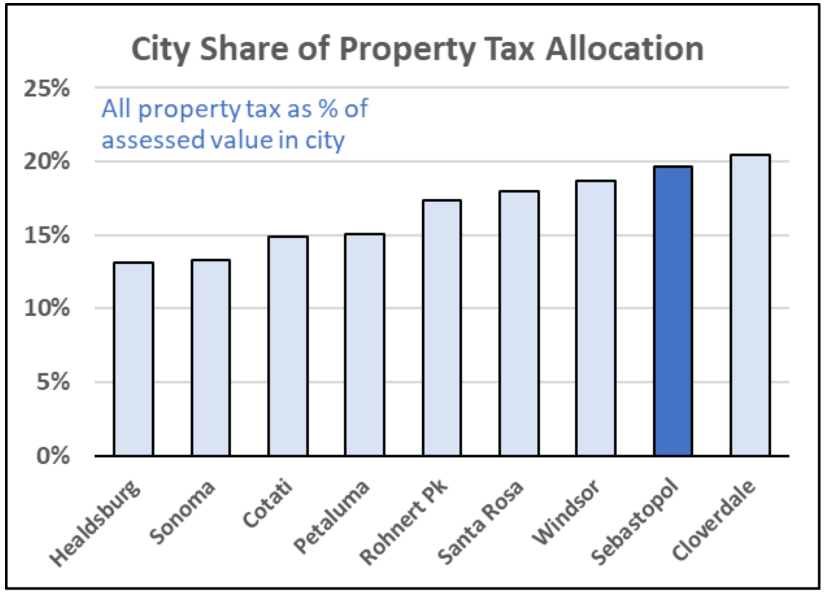
Spending has generally exceeded budget

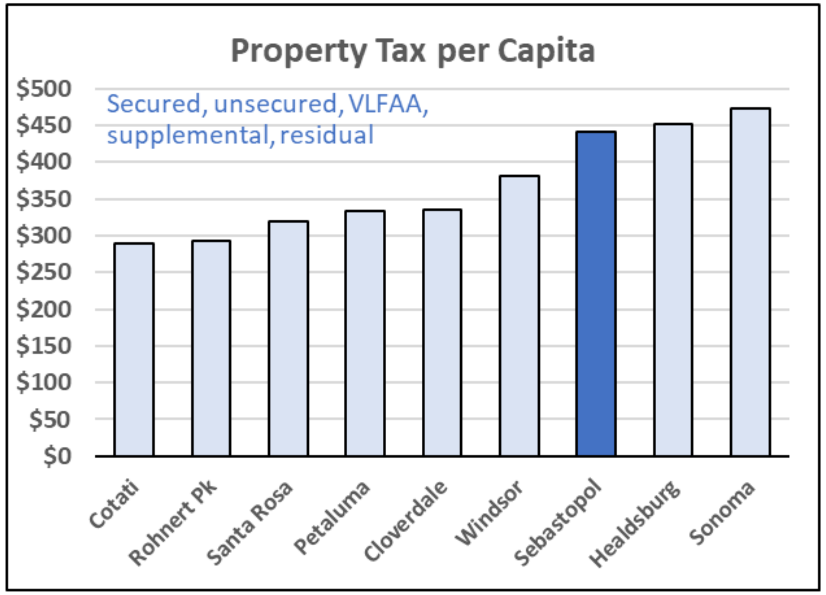


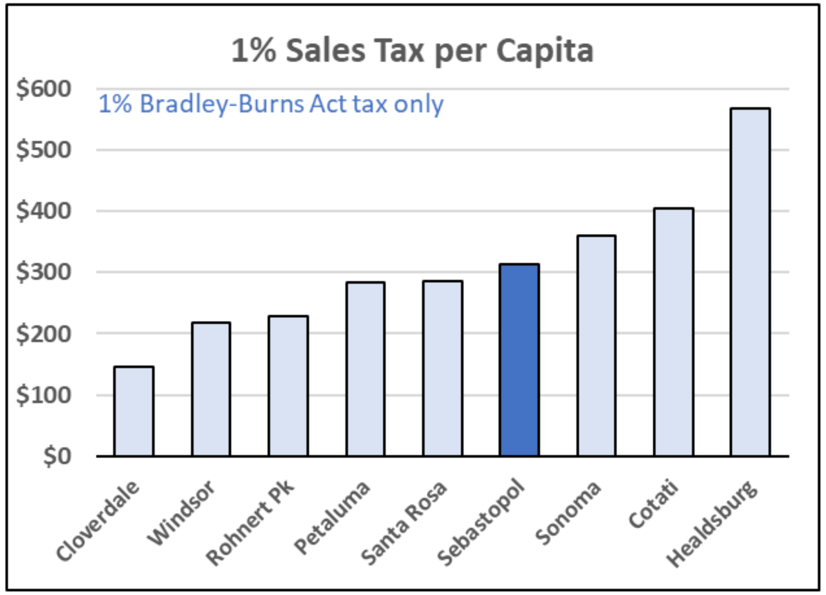
Mixed bag, budget generally close to actual

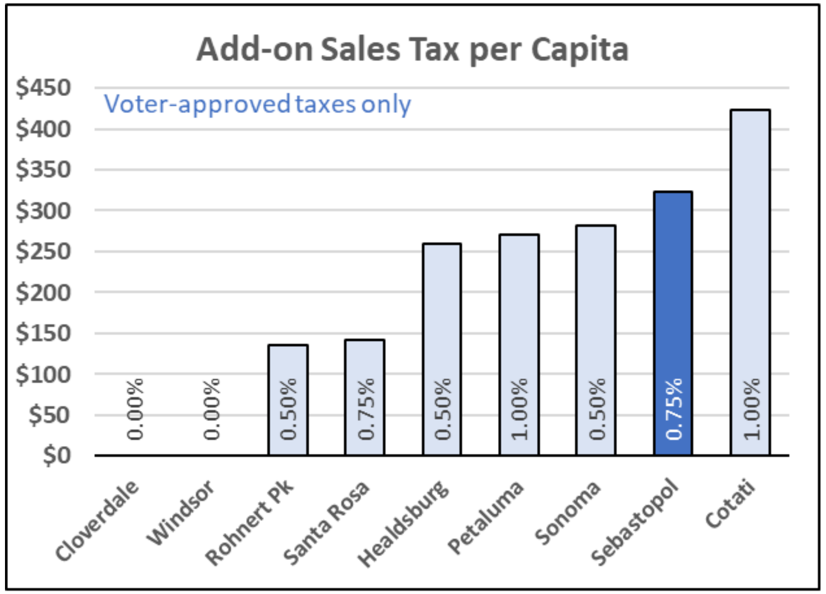


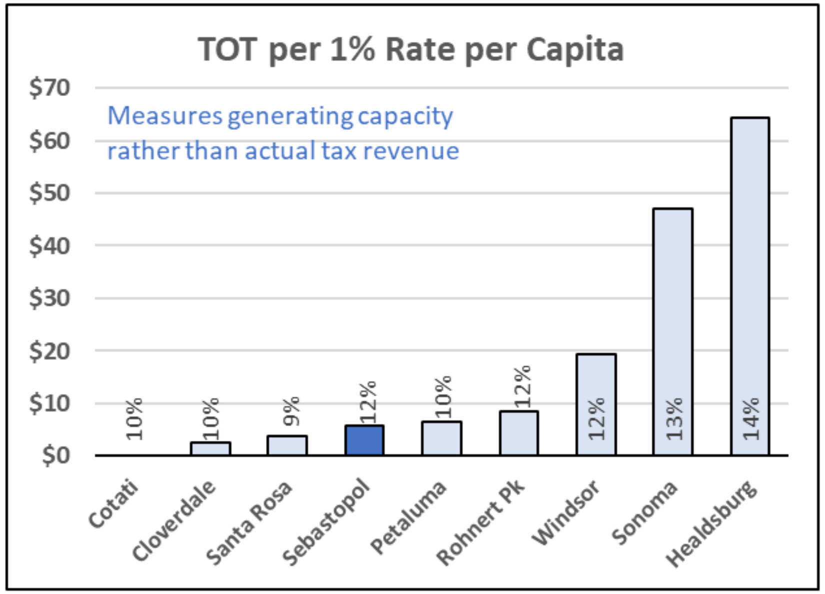
Transfers often not budgeted; FY24 excludes shift of $1.04M flood control assigned balance to new fund 127

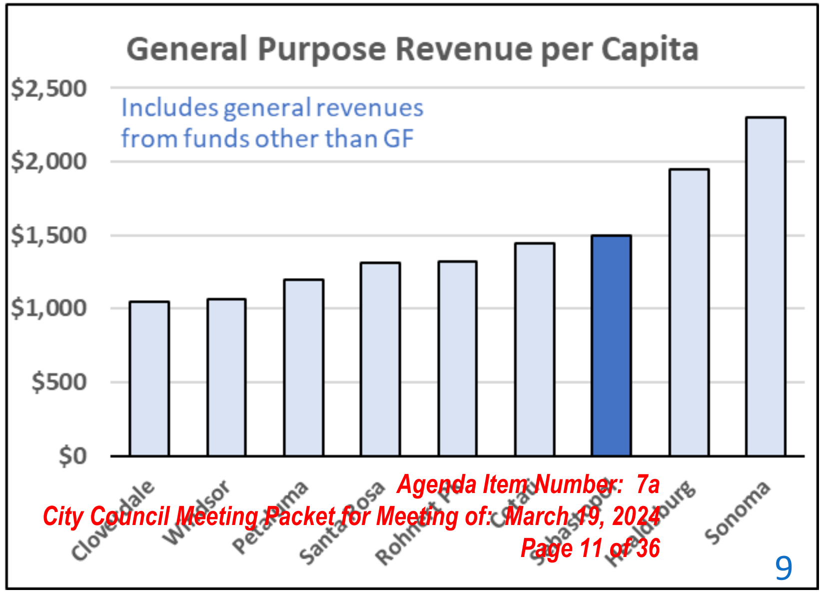












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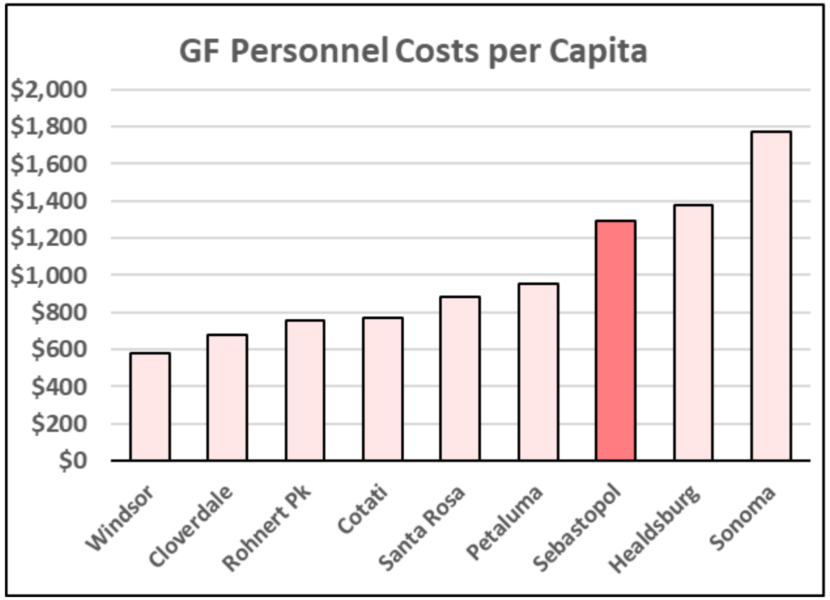
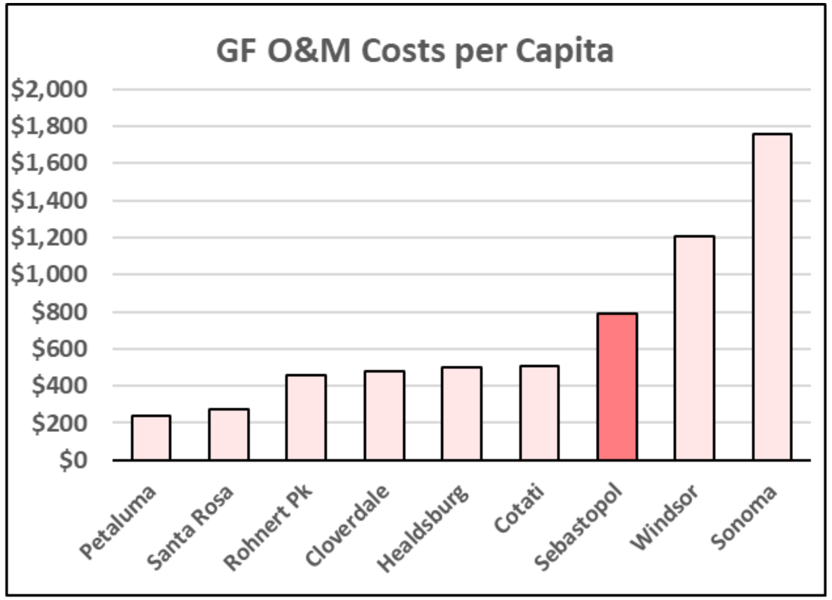
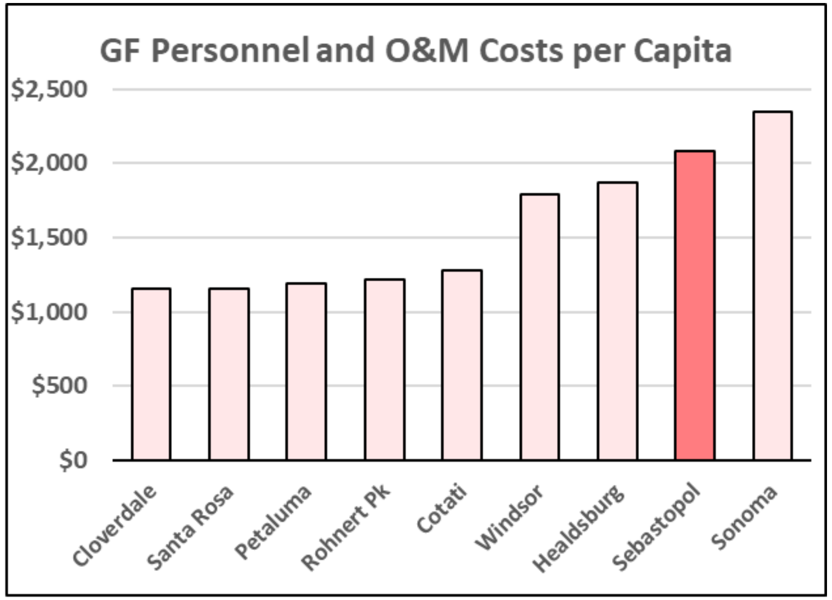
- Since Sebastopol ranks above the median for all revenue measures except TOT revenue generation, its current financial condition is likely influenced by the expense side of the equation, as the City does rank above the median of General Fund personnel and operating costs per capita

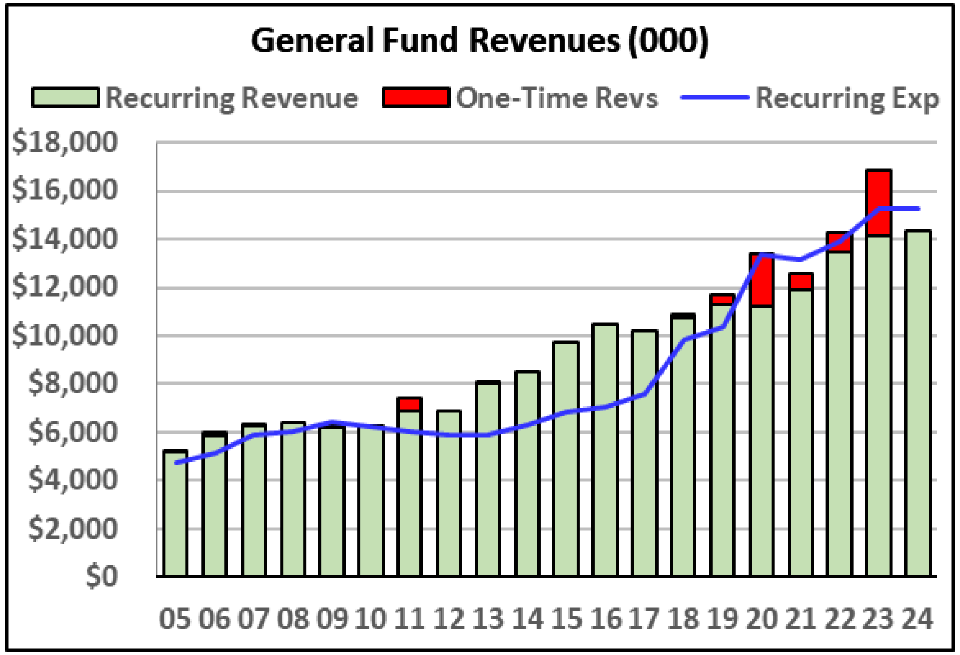




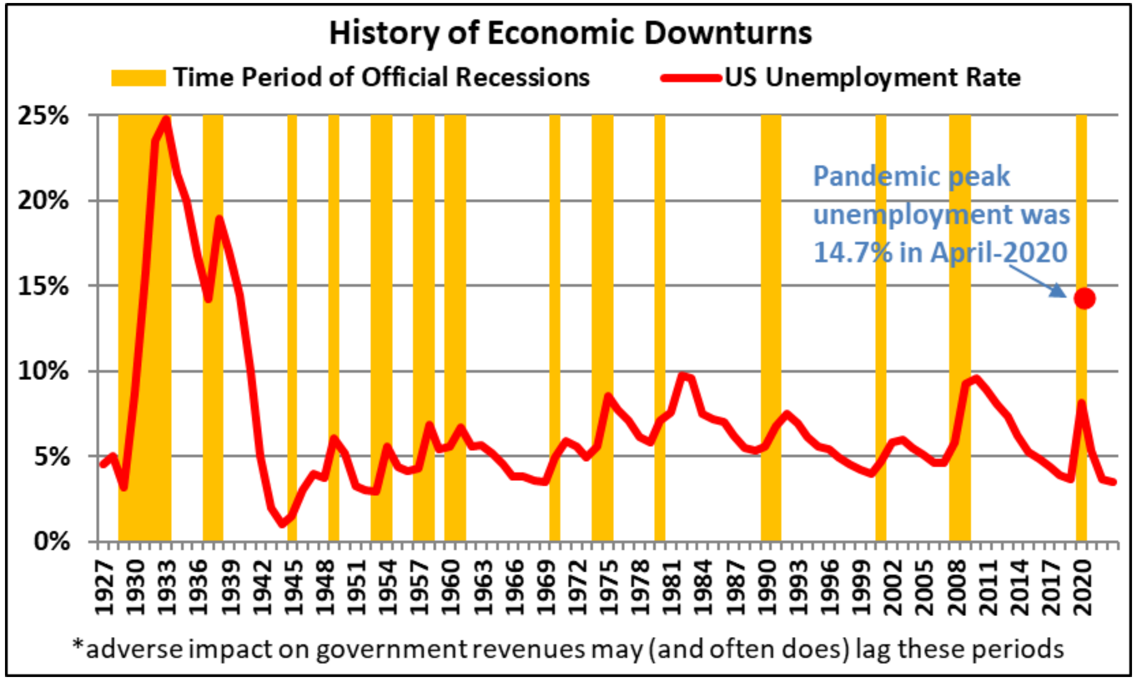


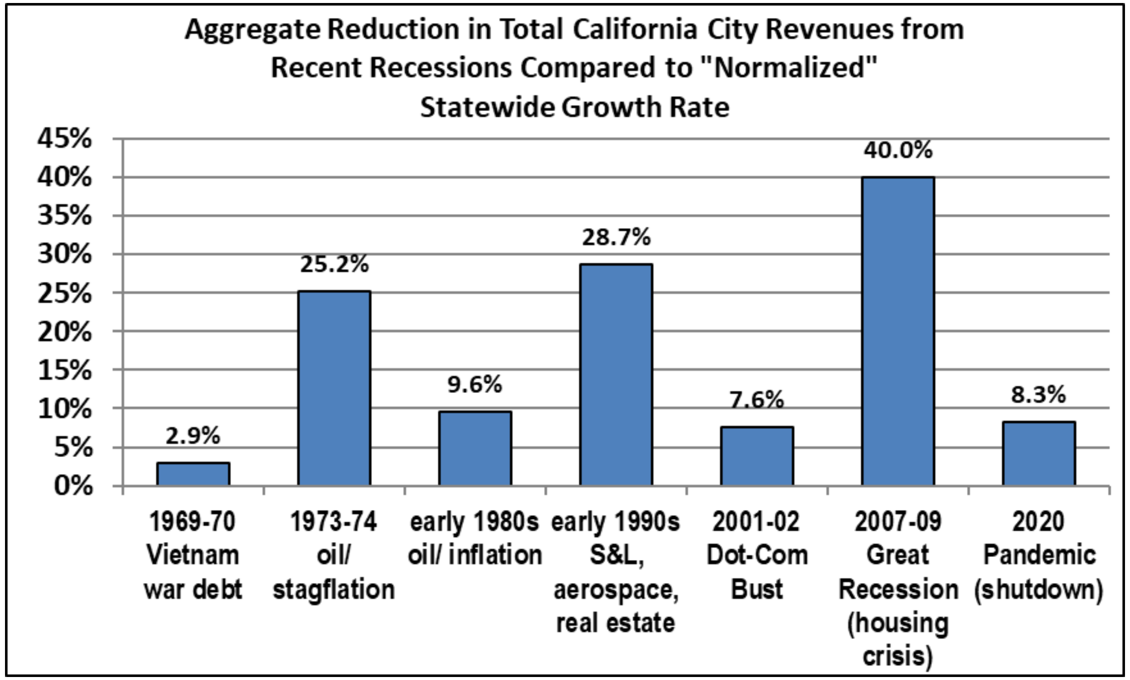
Caveat: This comparison is based on budget information available online. Since staffing levels, organization, and allocation of costs by fund can vary significantly among cities, additional research would be required to fine-tune these cost comparisons.

- Baseline revenues show what City can rely on to meet ongoing expenses at current level of service
- Forecast includes reasonable assumptions of revenue growth, in context of both long-term and recent experience
- Includes economic cycles over time to realistically portray stress on finances (assumes moderate recession in FY27 and every seven years thereafter)
- Recurring revenues exceeded recurring expenditures FY11-19, but not in recent years



For comparison purposes, shows CAP as revenue for all years





- Recessions have occurred on average every 6.8 years since 1927
- High correlation between recessions and unemployment rate
- Adverse budget impacts to local governments often lag term of "official" recession period

- Recession causes vary but key issues are timing and magnitude
- Impacts estimated using CA State Controller data on city taxes, permits, licenses
- Covid pandemic was shortest recession at 2 months, but very sharp impact due to shutdown

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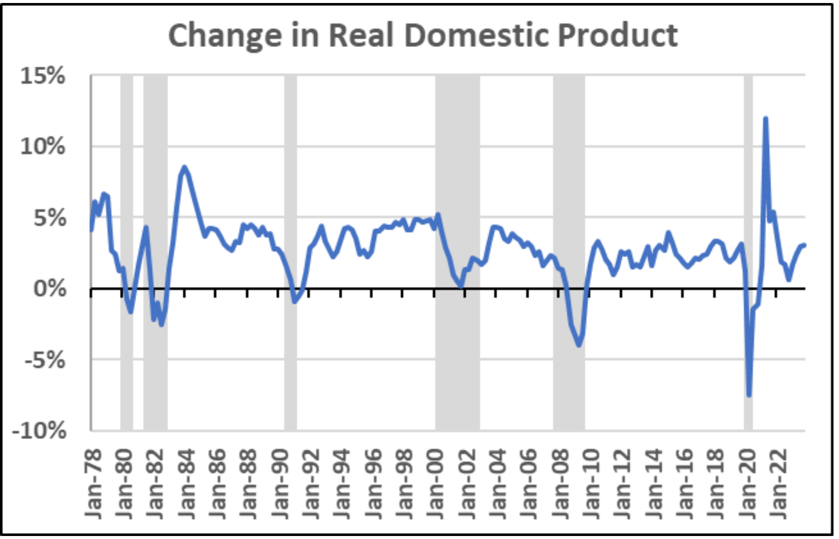
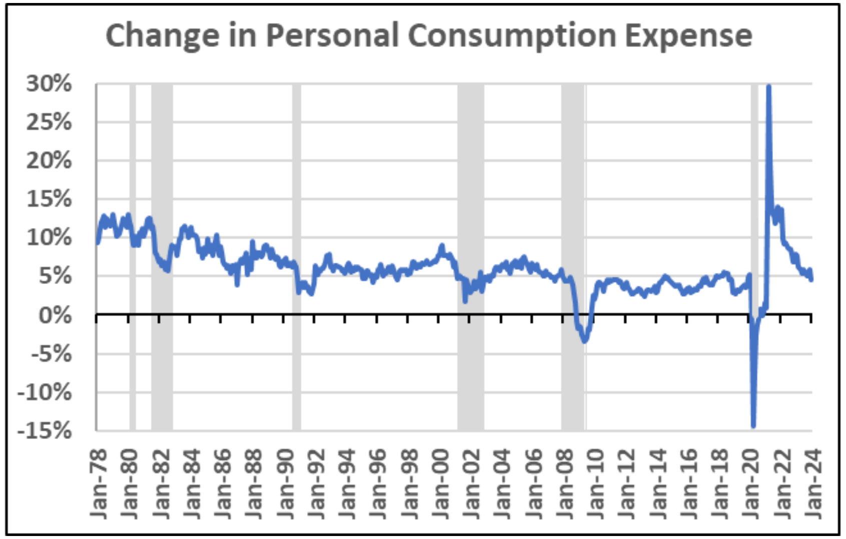
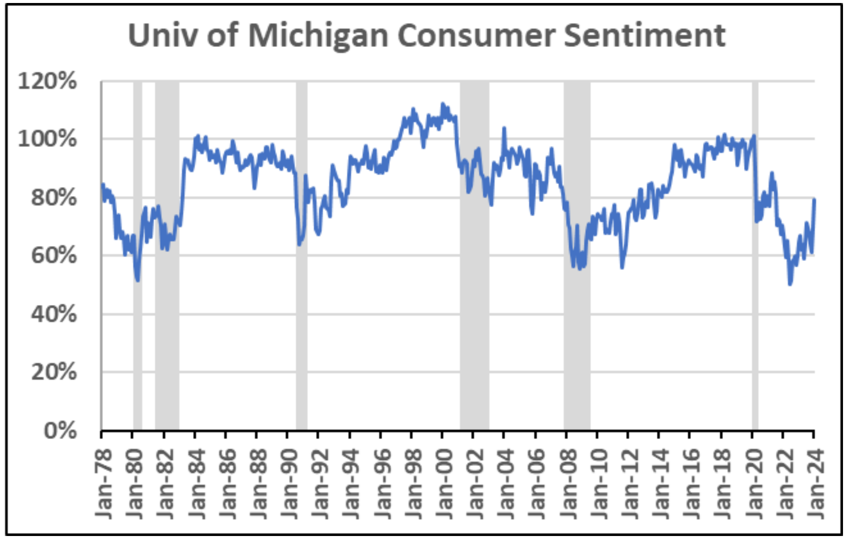


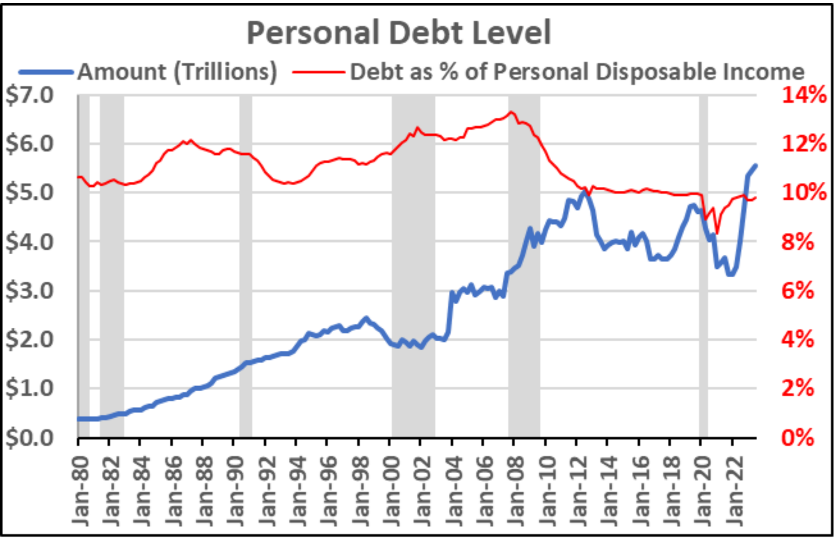
Back to pre-pandemic growth level



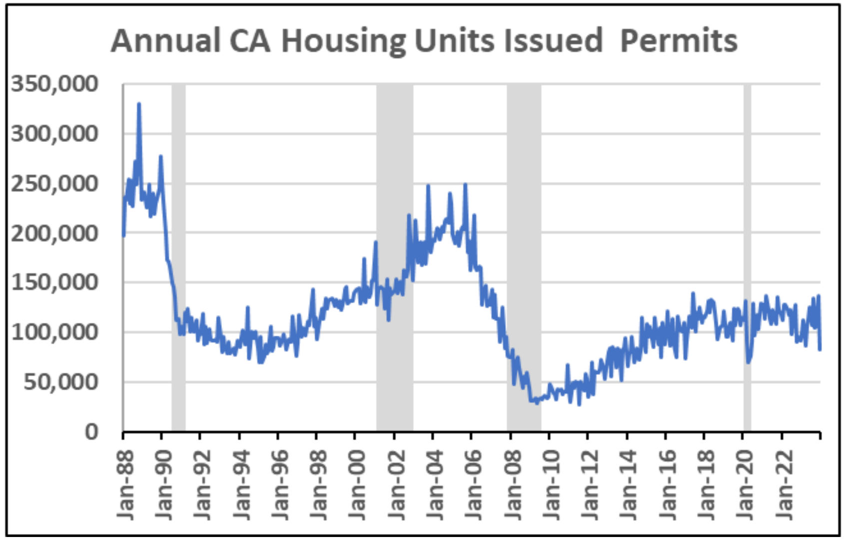
70% of economy, growth rate slowing, but still high



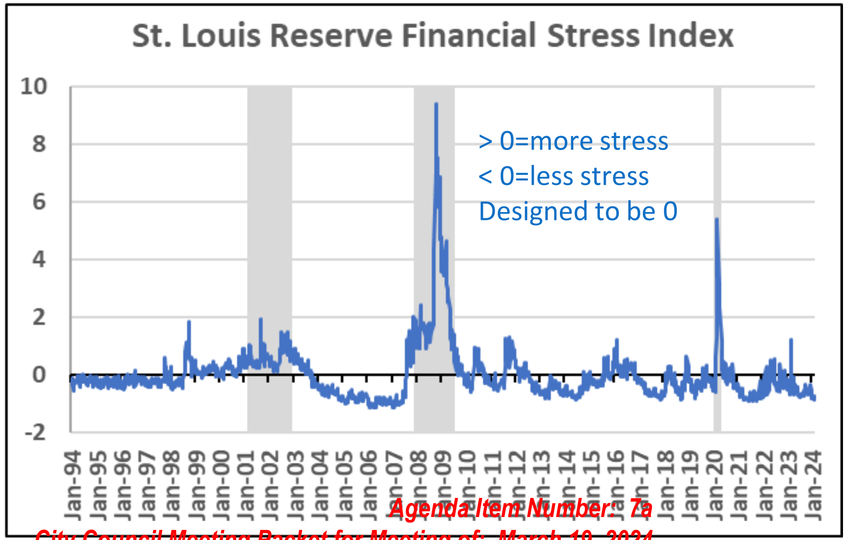
Low in 2022, but climbing in past year



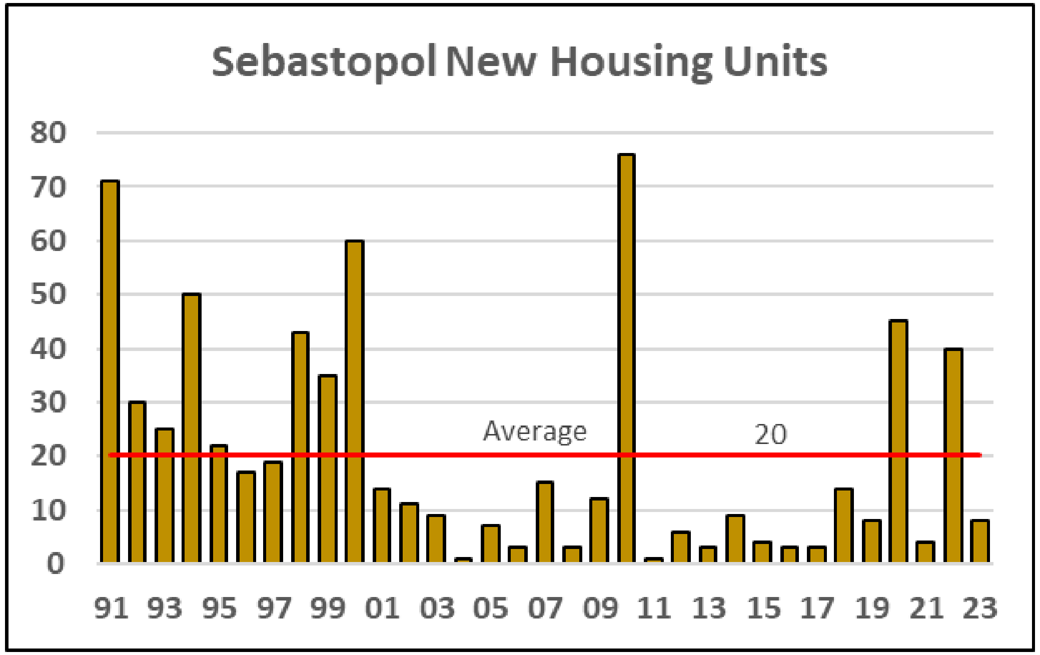
Large jump after pandemic savings, but low as % of income

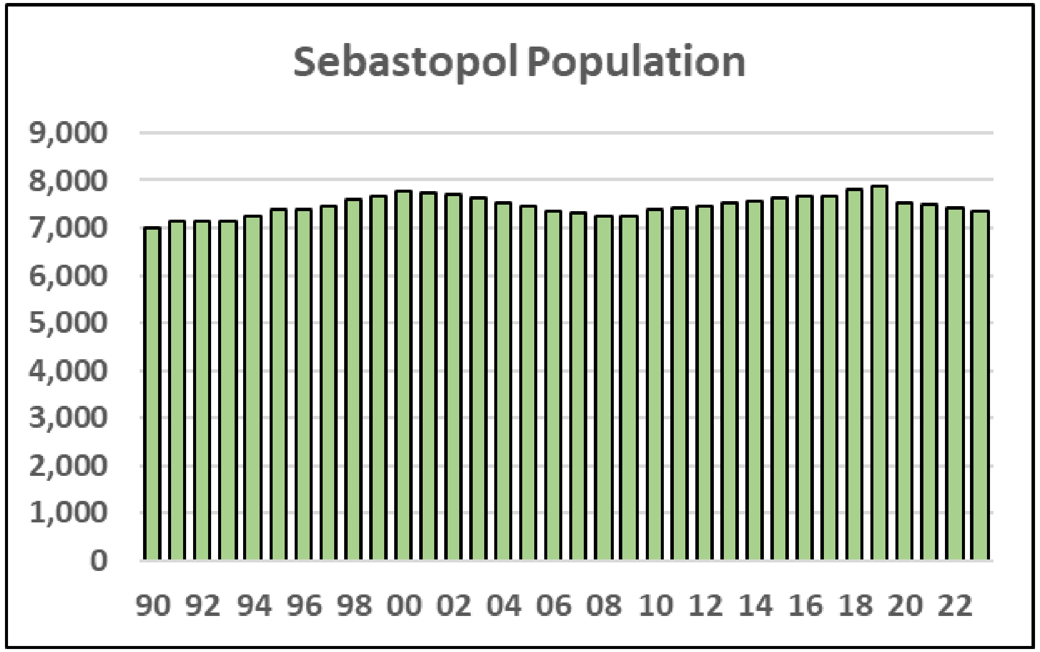


Up from Great Recession lows, but leveling off



Multi-indicator index currently shows less stress on economy

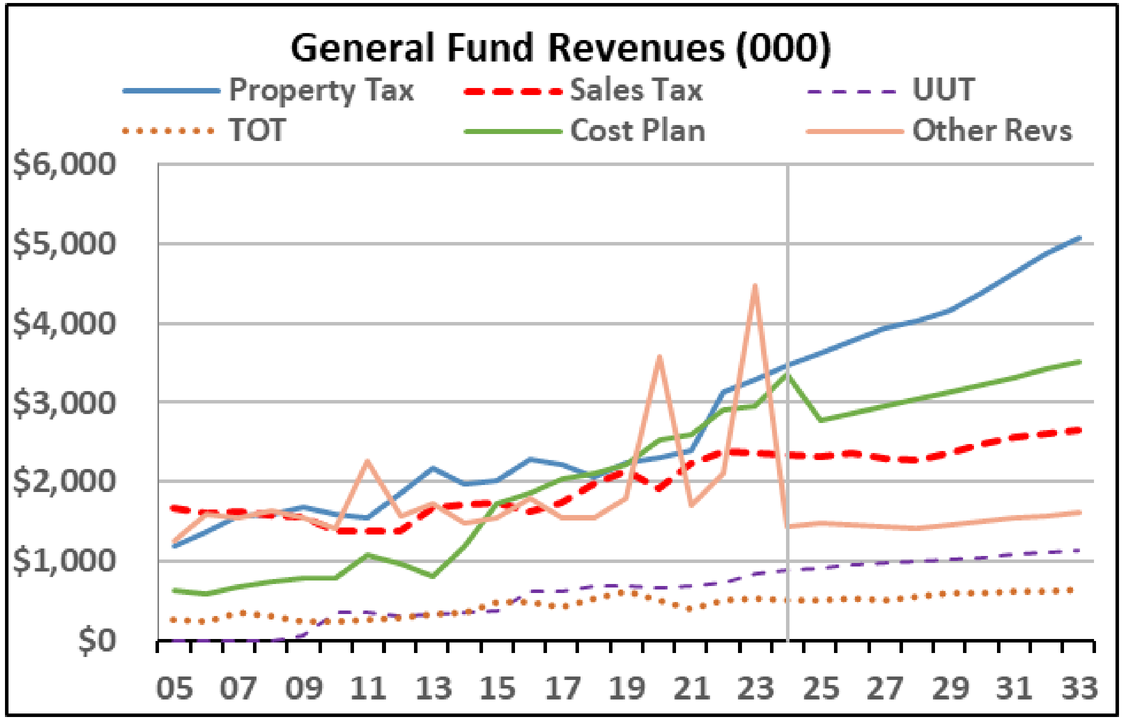




- Chart shows new housing units per CA Dept of Finance
- Average of only new units (SF+MF) added per year
- Average annual growth of 0.6%
- RHNA is 25 units/year

- Population has been generally stable except in early 2000's and post-Pandemic (2020-2022)
- Average annual growth of 0.2%

Major Revenue Trends



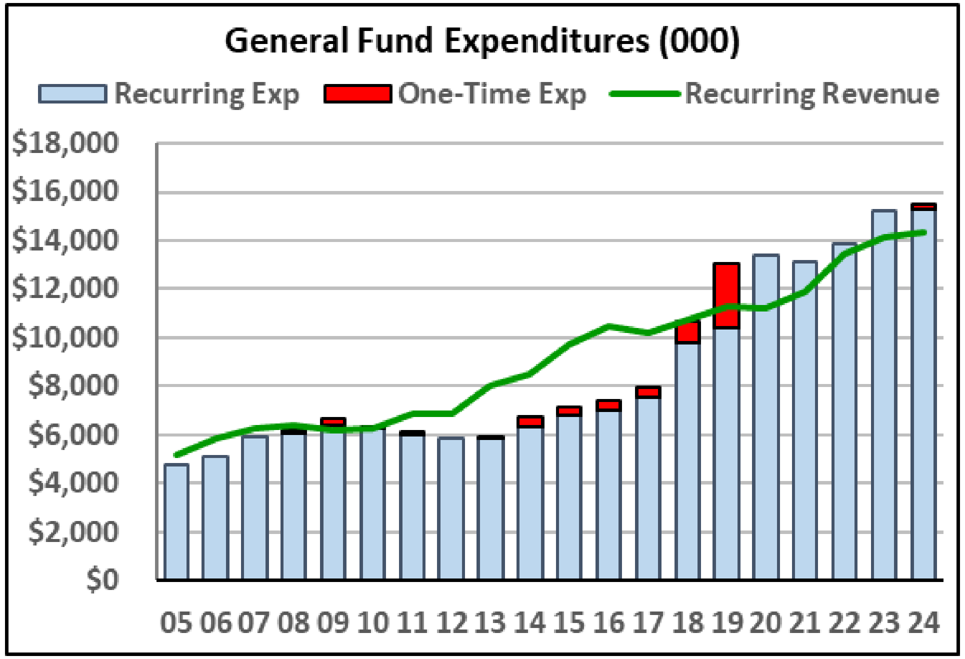
Combines funds 100 & 124

FY24 based on estimate

For comparison purposes, shows CAP as revenue for all years

- 96% of existing parcels grow 2%, 4% grow average of 40% (for ownership transfers), 20 new housing units plus $4M non-res value; grows at 4.3%; Residual revenue increase with end of RDA starting FY22
- 2nd largest GF revenue source, amount based on recent CAP update
- Near-term trend from Avenu, then 1.7% growth including moderate recession starting FY27; FY20 hit by pandemic, then increase in online sales over next 2 yrs
- No new hotels (two are in planning stages, one since 2015); 2% growth for hotel, 5% private
- Other taxes, franchises, fees, intergovernmental, interest, other

- Baseline forecast is ongoing trend by type of expenditure based on current workforce and service levels
- Includes reasonable assumptions as to compensation and inflation growth
- How spending is allocated by department or program is based on City budget priorities
- Major forecast risks:
  - adding FTE
  - COLAs higher than 2.5%
  - long-term inflation higher than 2.5%
  - lower CalPERS returns increasing pension costs
- Most likely potential forecast improvement:
  - Higher than projected employee vacancy rates



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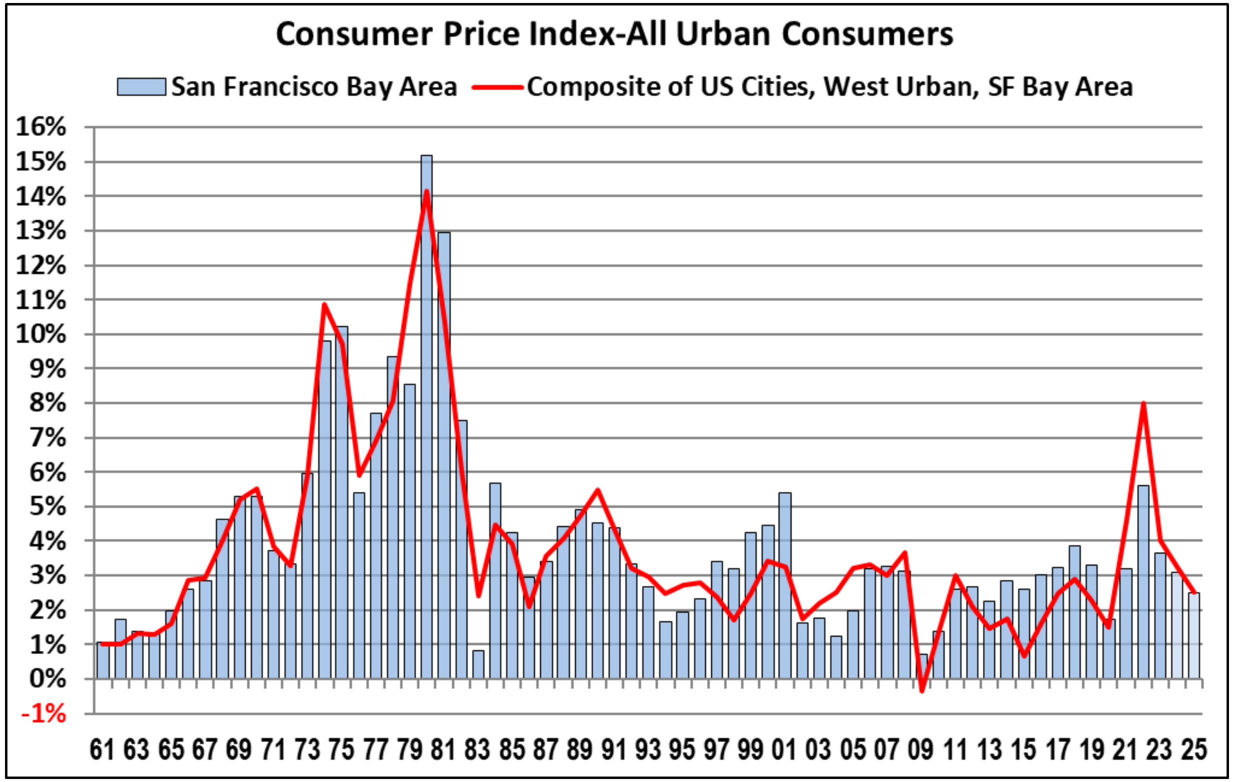

- Chart compares SF Bay Area to a composite inflation measure; results vary some, but move in same direction
- High inflation from 1973-1982, but relatively stable from 1982-2021
- Jump in 2022 related to post-pandemic supply-chain issues; inflation higher in rest of country compared to Bay Area; CPI has dropped by half in 2023 under both measures
- In 20 years prior to 2022, average annual growth was 2.48% for SF Bay Area and 2.25% for the composite measure
- Model assumes 2.5% ongoing inflation

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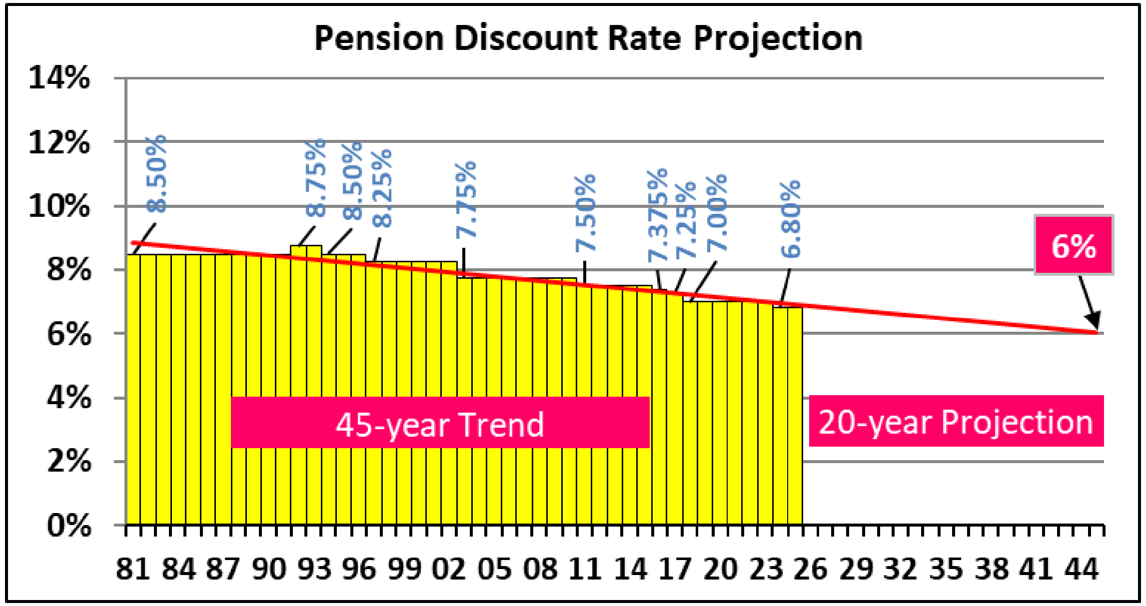
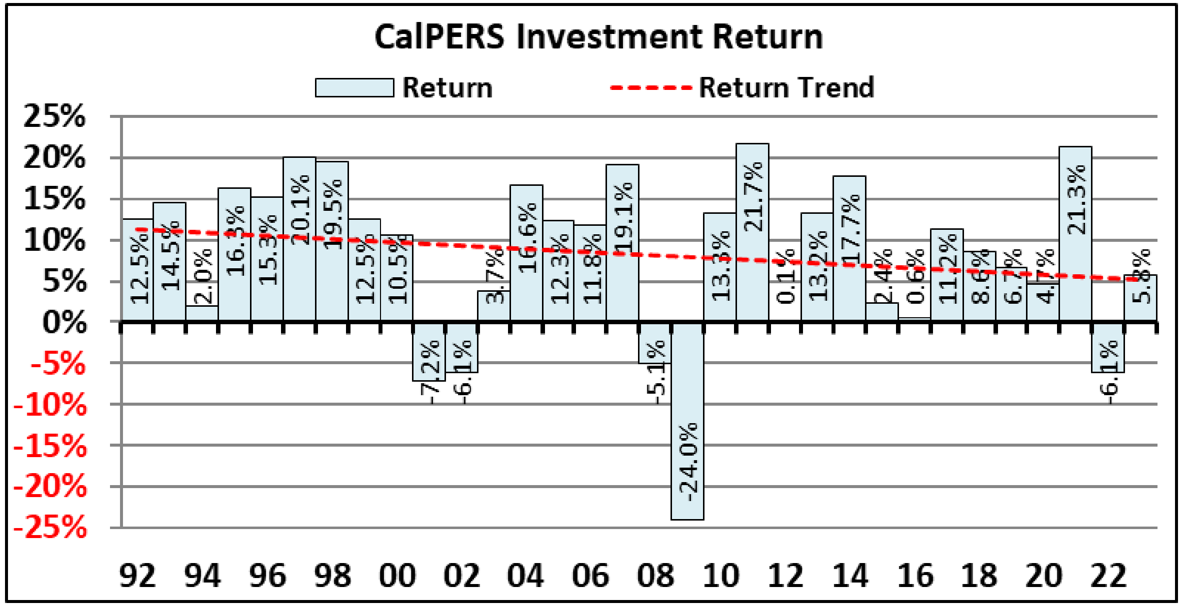


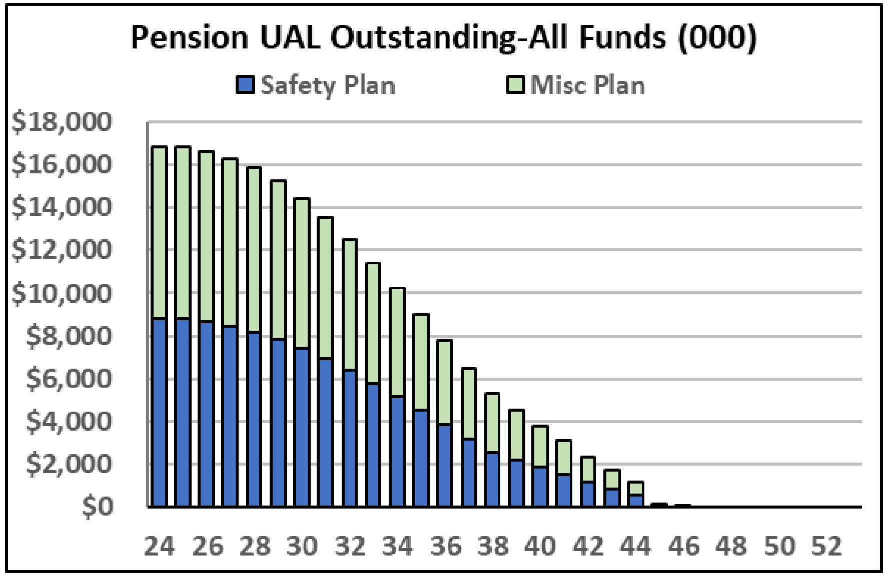


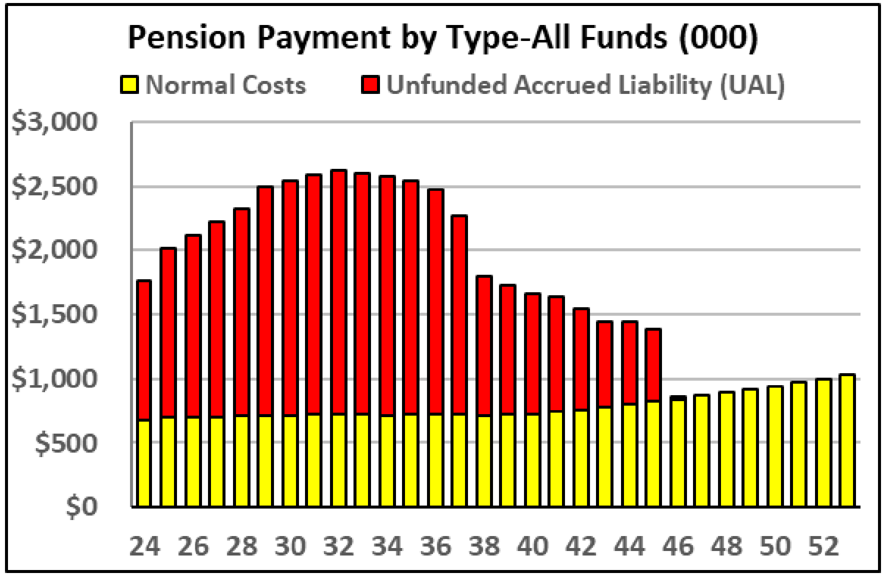
- Discount rate is investment rate of return assumed by CalPERS
- Discount rate has been lowered several times over past 45 years, from high of 8.75% to current 6.8%
- Following the 45-year linear trend of discount rates, in 20 years discount rate would theoretically be 6.0%
- However, forecast assumes the current 6.8% rate is maintained; if discount rate is lowered, City costs will be higher in near-term, and lower in long-term

- CalPERS investments are volatile, and have been on slow overall downward trend over past 30 years
- CalPERS plans to leverage its investments in private equity (carries greater risk & volatility of return) to achieve 6.8% return (forecast assumes 6.2% returns)
- When returns are lower, unfunded accrued liability (UAL) costs increase to compensate for the loss; when returns are higher, UAL costs are reduced over time; rates are recomputed annually by CalPERS

CalPERS Actuarial Assumptions

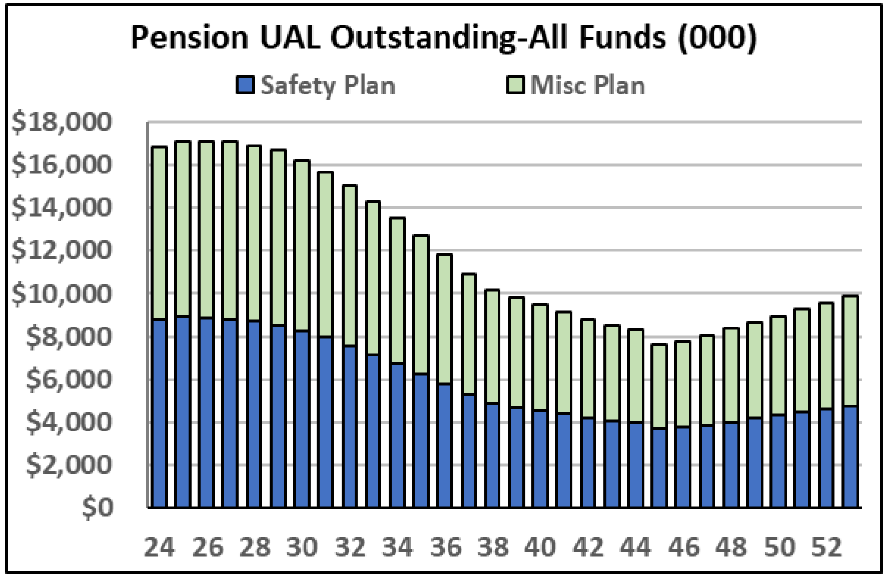
- 6.8% discount rate & returns
- UAL paid off by FY46

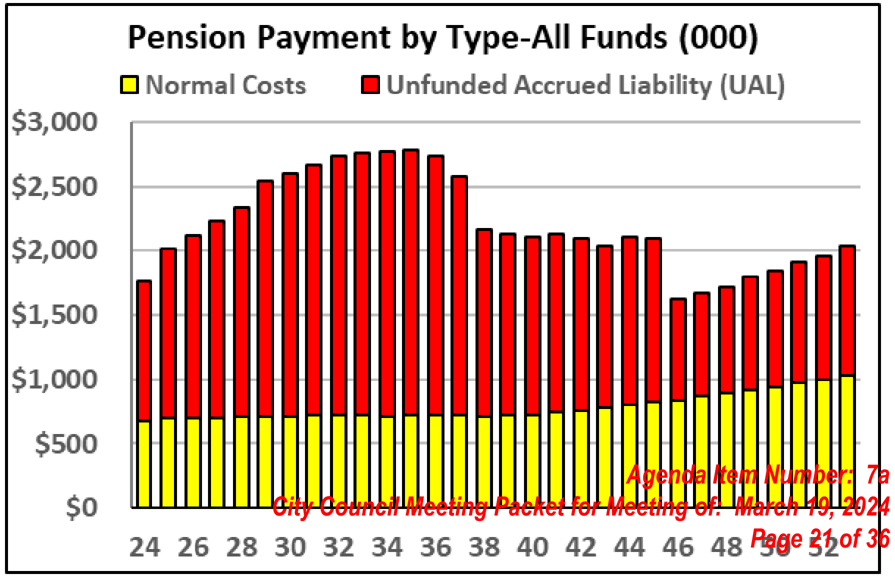




Model is More Conservative

- 6.8% discount rate & 6.2% returns
- UAL continues





Fire Service Needs

- City currently has 3.5 full-time employees with 3 reserves and 29 volunteers
- Measure H could provide the City with $1.08M annually starting early 2025, sufficient to support one three-person crew using 7 full-time employees and reserves/volunteers per the Matrix Report (Jan 2023)
- Measure H requires the City to maintain a $1.2M maintenance of effort for Fire funding; the FY24 budget for Fire operations is $1.5M
- The City is also exploring options for fire station improvements
- If the City merged with an adjacent fire district, that would allow the District's property tax to be levied within the City; another ~$1.1M could be generated
- If all the new revenue from these two sources is dedicated to improving fire services, then none of it would be part of a solution to the City's existing structural revenue shortfall

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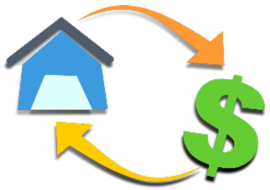
Maintenance and Replacement Needs



- Based on the useful life of the City's governmental assets (non-utility), their values are depreciating at ~$900K per year, which is approximately what the City should be spending annually in maintenance & replacement (5.3% increase in GF expense) to maintain these assets sustainably over time:

Estimated Annual Need: ($ in 000)	6/30/2022 Assets	FY22 Audit Depreciation	
Buildings/Structures	$7,851	$202	
Machinery/Equipment	2,752	103	*includes Technology*
Vehicles	2,718	143	
Infrastructure	8,857	453	*includes Streets, but backlog is greater than this amount*
Total	22,178	901	

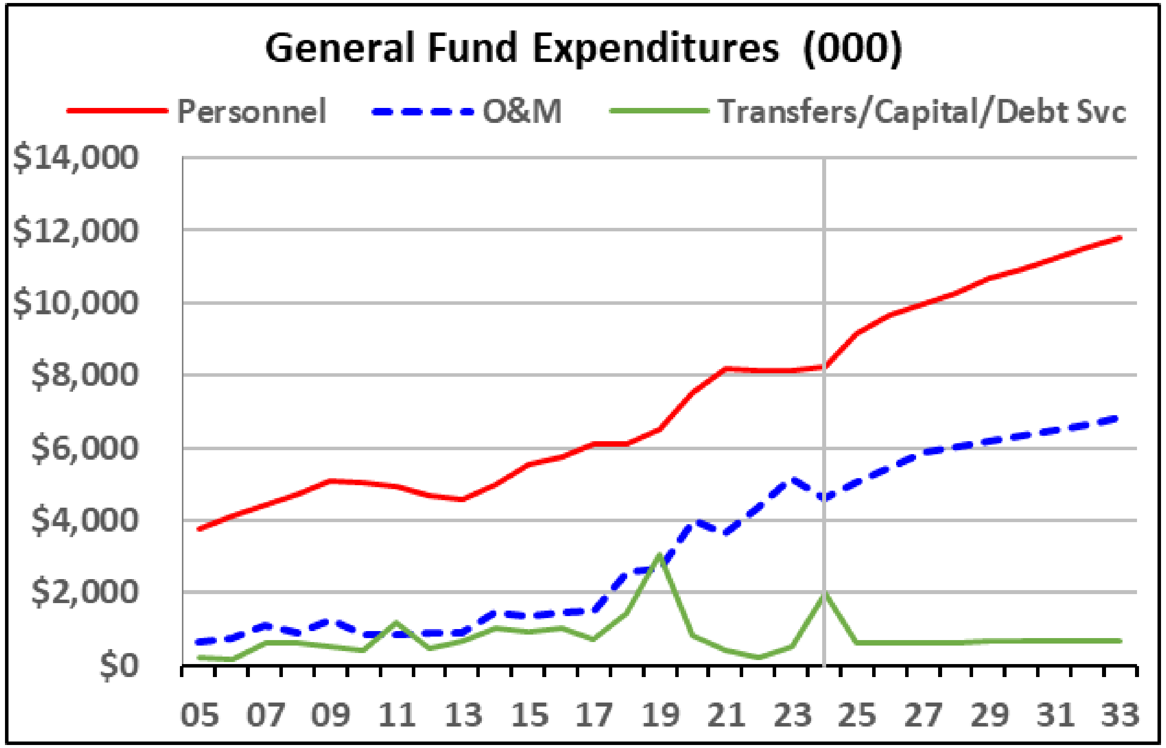
- It would take $7.13M over the next 5 years to increase the City's current Pavement Condition Index (PCI) of 55 (out of 100) to 60 (55-75 is considered "fair" condition)
- Additional City funding would be required for what realistically would be an additional $7M every 5 years on an ongoing basis; this is equivalent to a $500 per parcel tax with a minimum 2% annual inflator

Summary of Key Expenditure Assumptions

___ include

any funds to improve level of street PCI

Major Expenditure Trends



Combines funds 100 & 124

FY24 based on estimate

For comparison purposes, shows CAP as revenue for all years

- Major impact from cutbacks caused by Great Recession revenue losses
- Pandemic in FY20, with significant vacancies during past 3 years; assumes current authorized positions with vacancy rate down to 4% by FY26
- Consistent with overall trend since FY13 driven by PERS and benefit costs & no new positions

- Significant growth past 4 years
- Includes increase for deferred maintenance & replacement costs

- FY24 transfer is $1.039M to new Flood Control fund (127), assumes $0 after
- Debt & Capital from fund 124 continues

- Fund balance is the "bottom line" for City finances
- Not all fund balance is available
  - Restricted, assigned, nonspendable, and committed elements of fund balance are omitted as they are already earmarked for specific purposes, and thus unavailable to support other operations or new obligations
- Available balance in forecast combines:
  - General Fund Unassigned Balance (fund 100)
  - Local Sales Taxes (fund 124), because revenues are general taxes
- Pension Trust (fund 105) is also available because it can reimburse General Fund pension costs
- Forecast model can run numerous alternative scenarios to show impacts on fund balance

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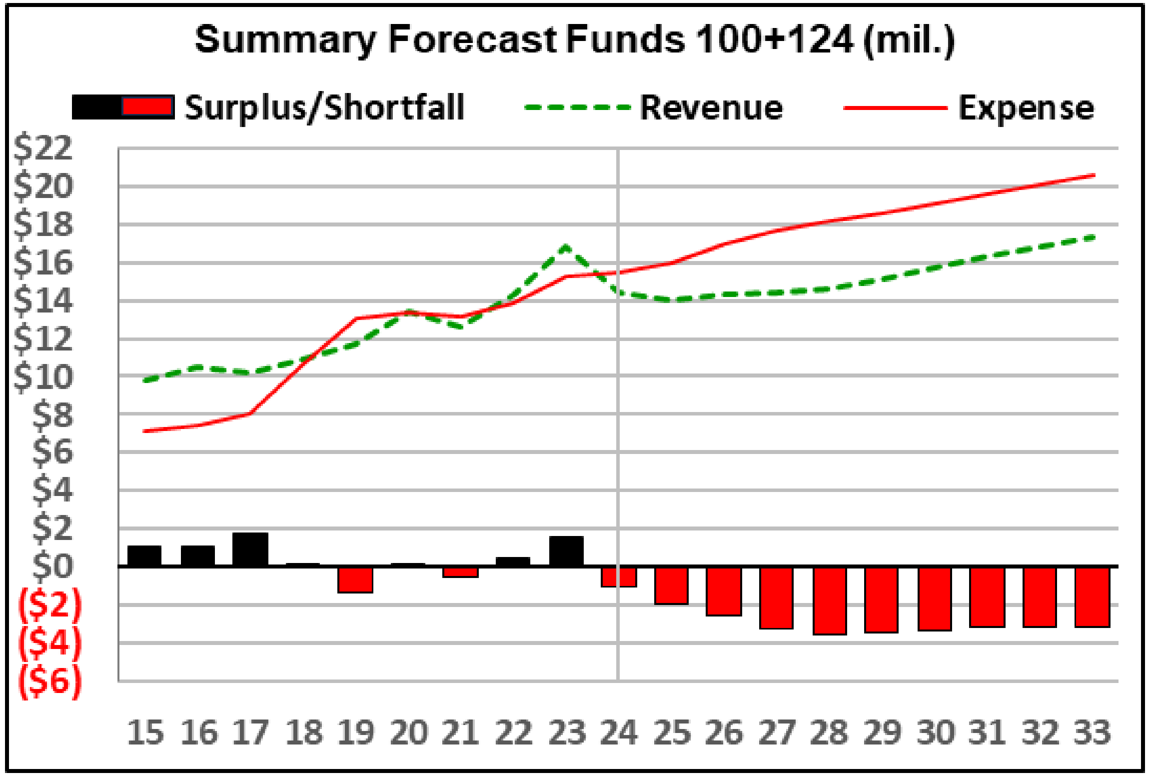
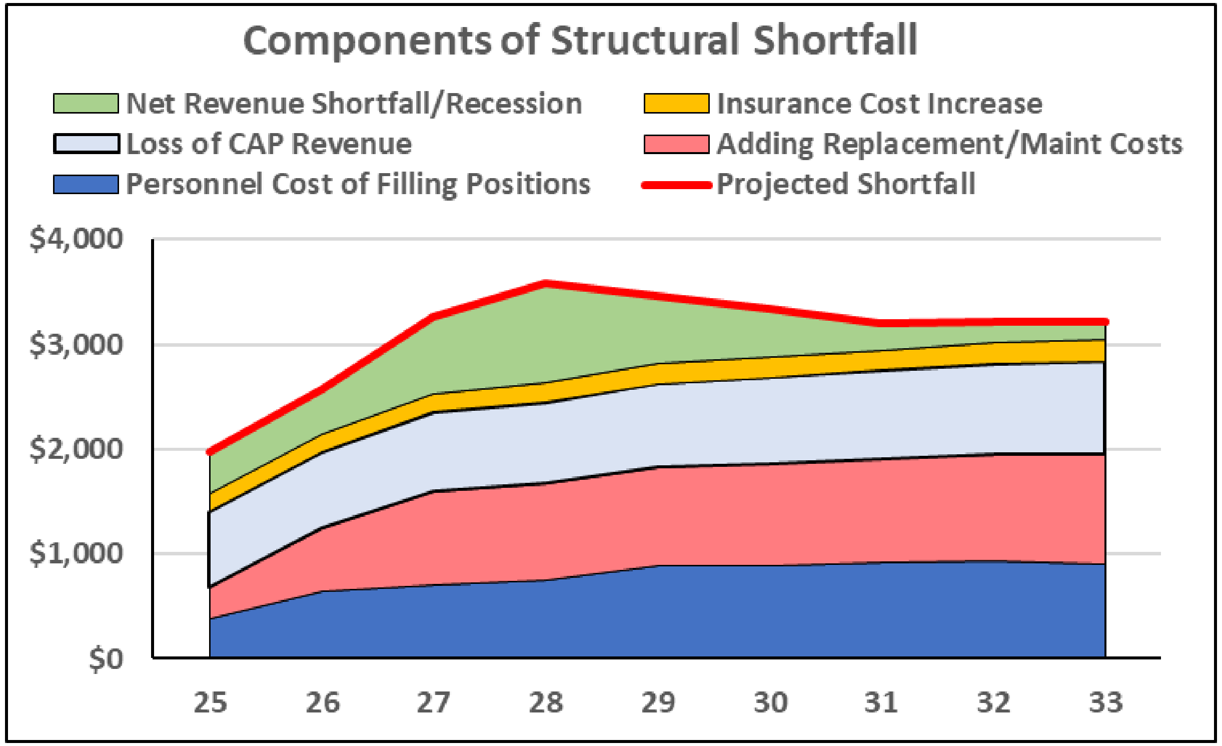
Baseline Forecast Before Corrective Actions



(000)	FY24 Bud	FY24 Est	FY25 Est	FY26 Est	FY27 Est	FY28 Est
Revenue	$14,206	$14,368	$13,998	$14,352	$14,420	$14,616
Expense	15,884	15,460	15,983	16,933	17,698	18,194
Net	(1,678)	(1,092)	(1,985)	(2,581)	(3,278)	(3,578)

CAP treated as revenue in all years

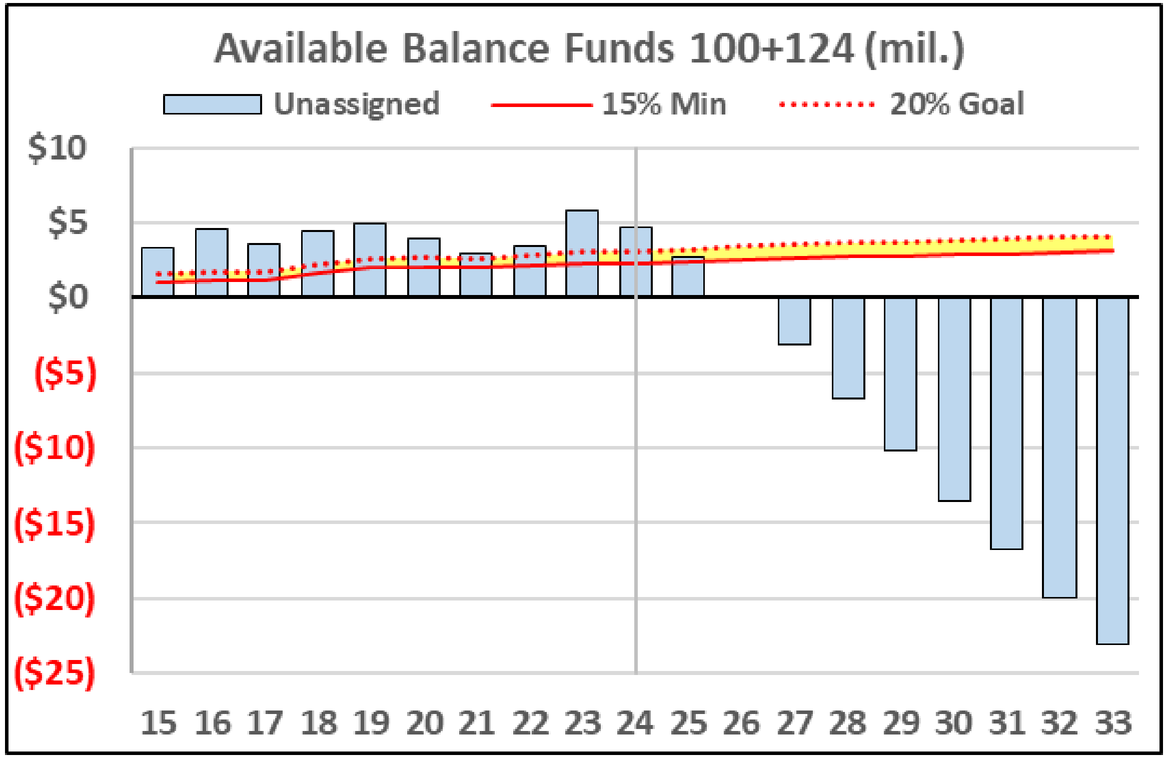
Major Components of Structural Shortfall



- If FY24 vacancies are filled, personnel cost increase grows to $900K annually
- City is not investing what it needs to sustain current facilities & service levels over time (ramps up to $900K/year)
- Reduced by $714K/year under recent CAP update (lower contribution by utilities)

- Insurance Costs
  - Workers Comp up 10% & Liability Insurance up 20% in FY25, adds $210K above inflationary growth
- Net Revenue Shortfall/Recession Impact
  - Moderate recession assumed to start FY27 adds to existing revenue gap; revenues eventually recover, and as pension costs drop, this factor eases over time

Baseline Forecast Before Corrective Actions



______ any corrective budgetary actions

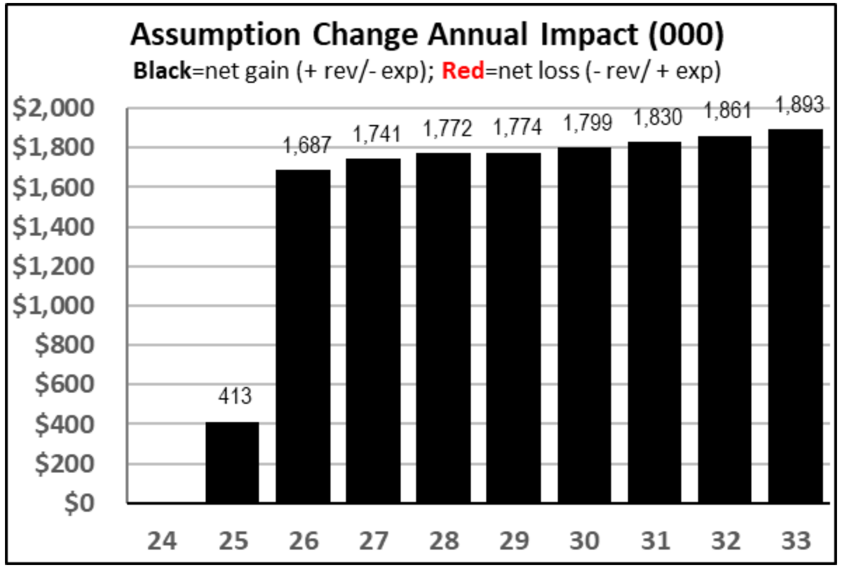
Goal is to get unassigned balance back to between 15-20% of total expenditures

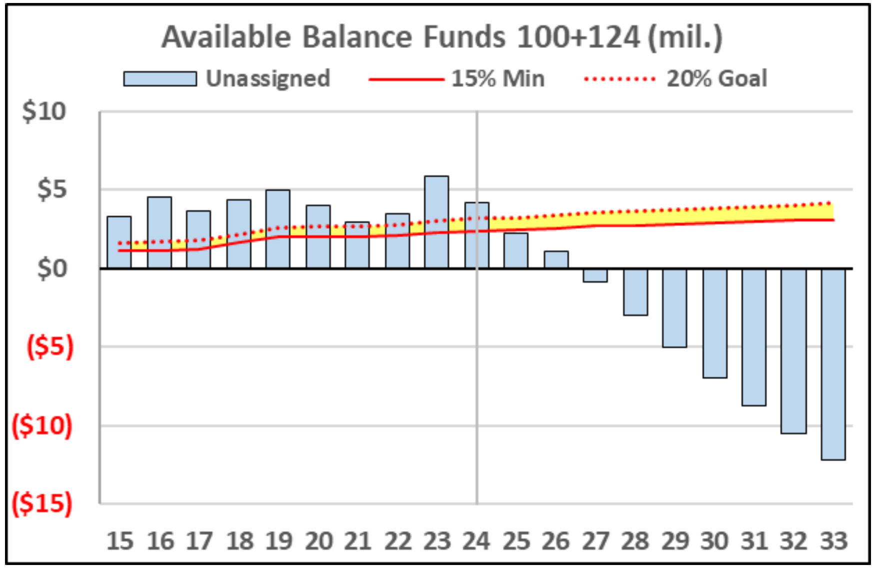
Scenario: Increase Local Sales Tax Rate

- Assumes approval on Nov 2024 ballot
- Raises ~$1.7M
- Leaves $1.4M average annual shortfall

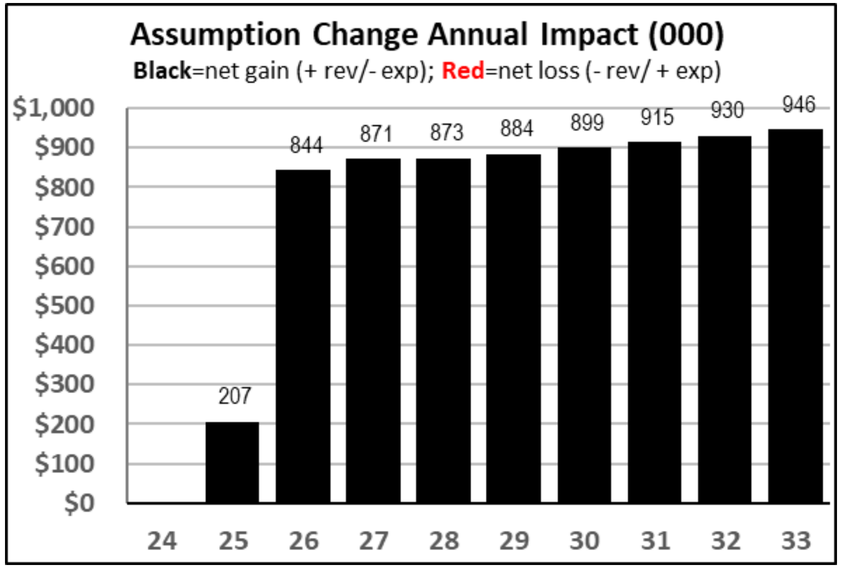
- Assumes approval on Nov 2024 ballot
- Raises ~$850K
- Leaves $2.2M average annual shortfall

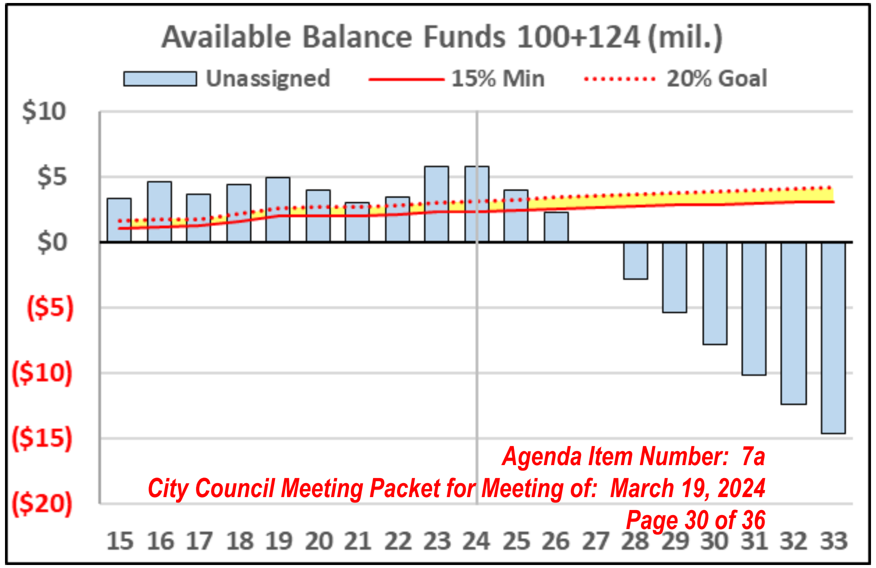
½ cent Added Sales Tax Rate



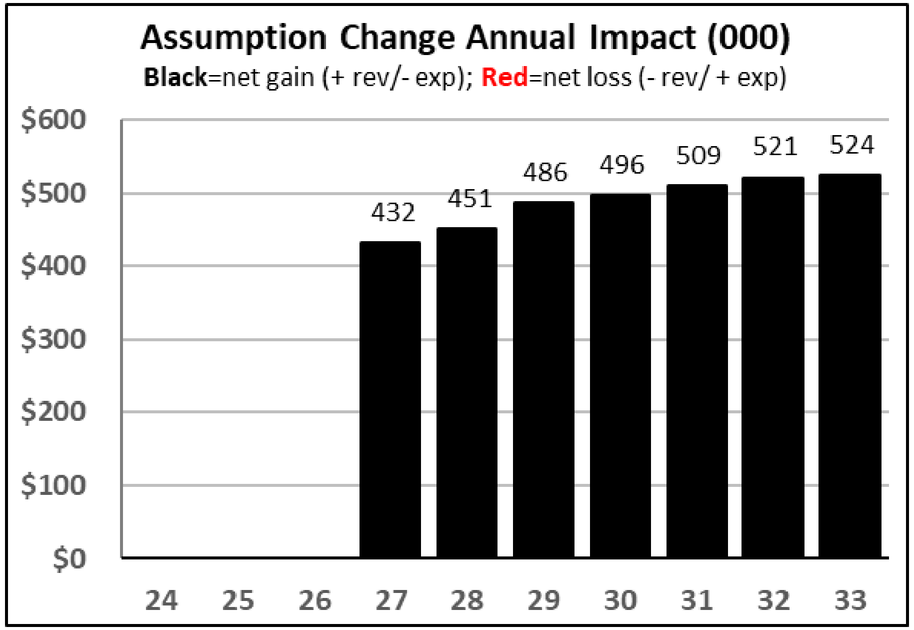


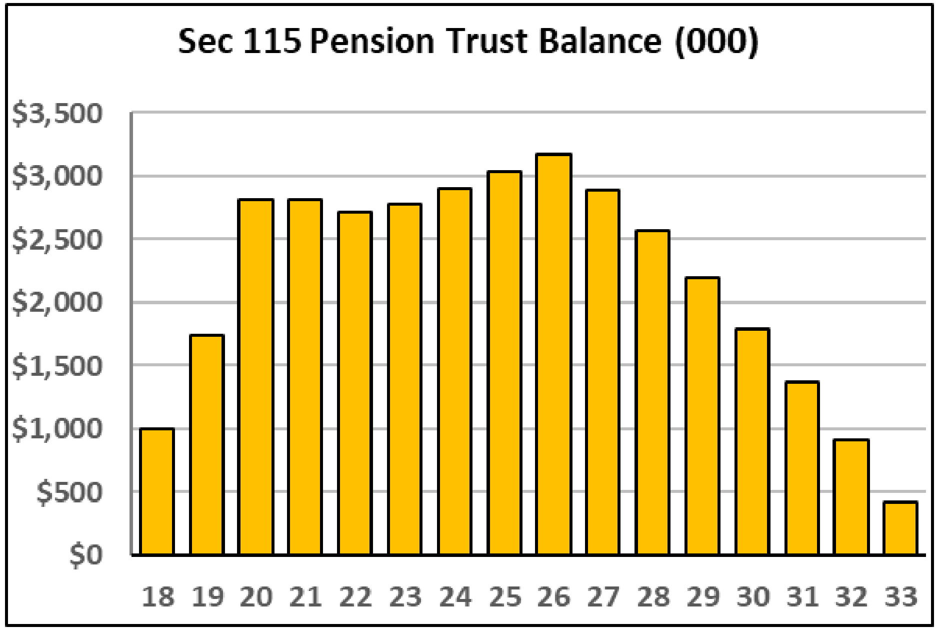
¼ cent Added Sales Tax Rate



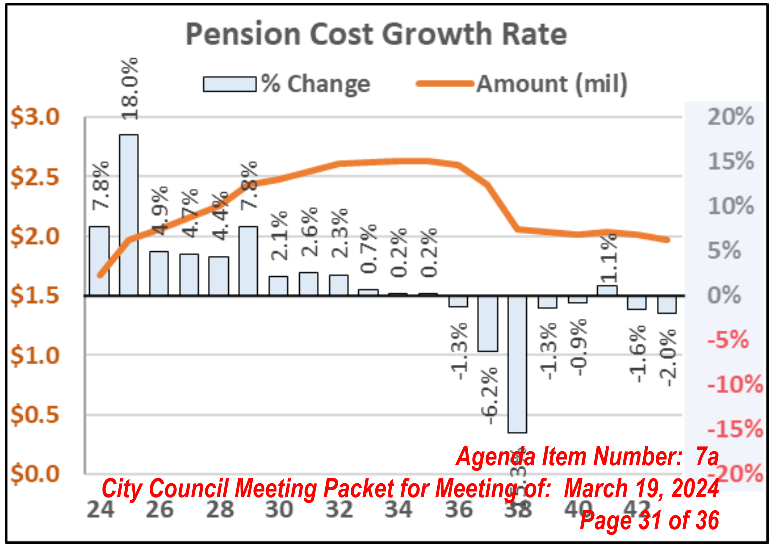


Scenario: Draw Down Pension Trust





- This example reimburses 20% of annual pension costs starting in FY28, which draws down pension costs by FY34 (timing and rate of drawdown are at discretion of the City)
- Pension costs to flatten out in early 2030's and reach a peak in FY35, which reduces need for a pension trust over the long-term
- Used in combination with budget reductions, a lower level of cuts would be required than without the pension trust drawdown

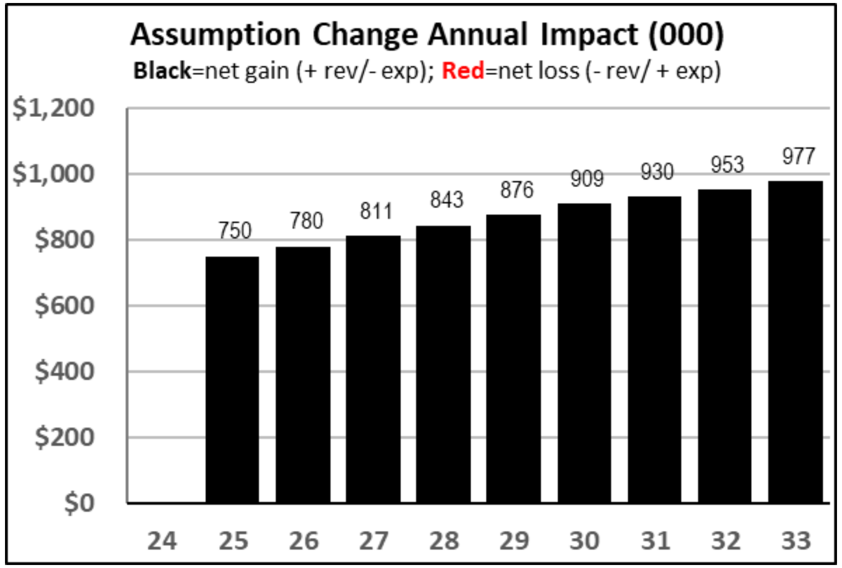


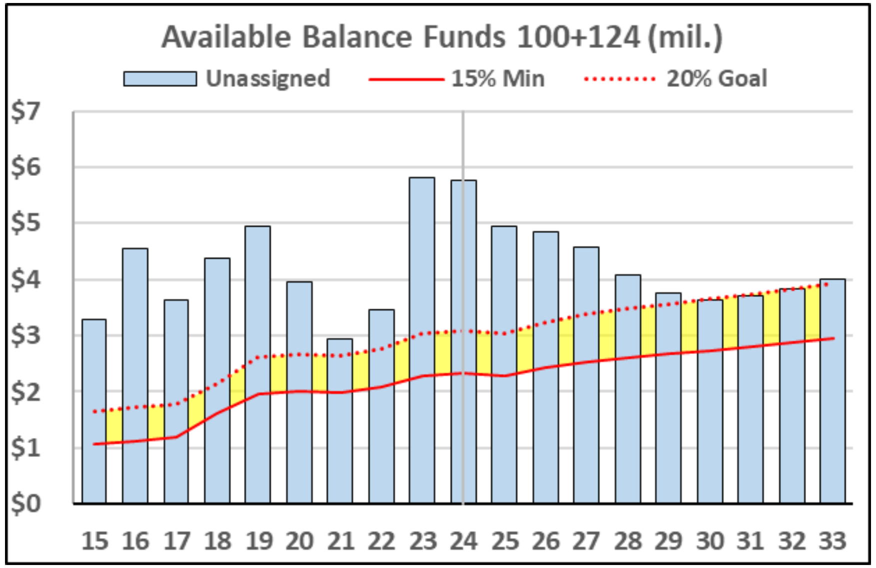
Scenario: Close Remaining Gap With Budget Reductions

- $750K in ongoing expenditure reductions (-4.5%) required starting FY25, results in 20% reserve

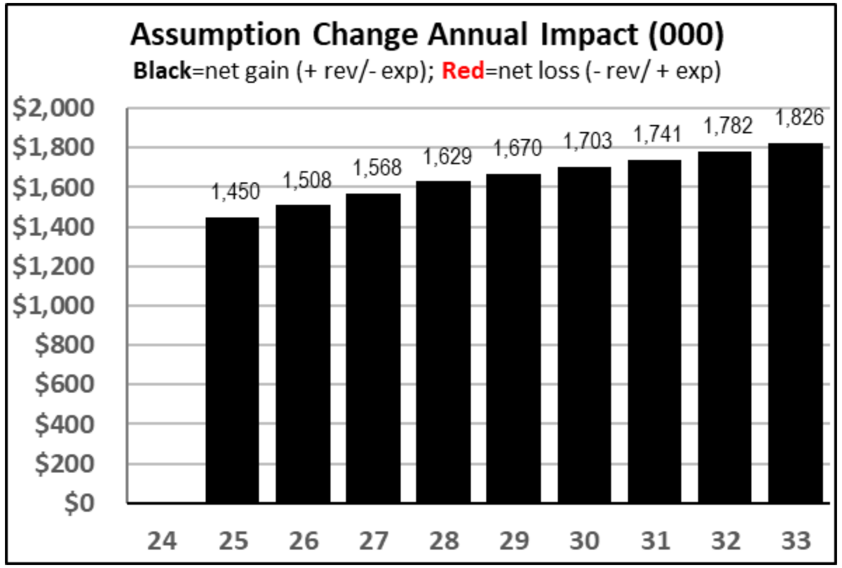
- $1.4M in ongoing expenditure reductions (-8.7%) required starting FY25, results in 20% reserve

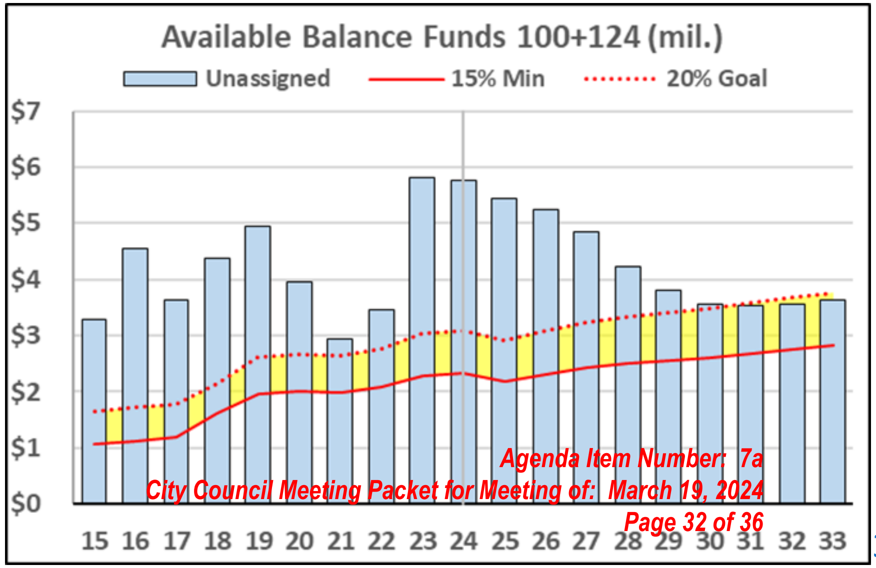
½ cent Added Sales Tax Rate





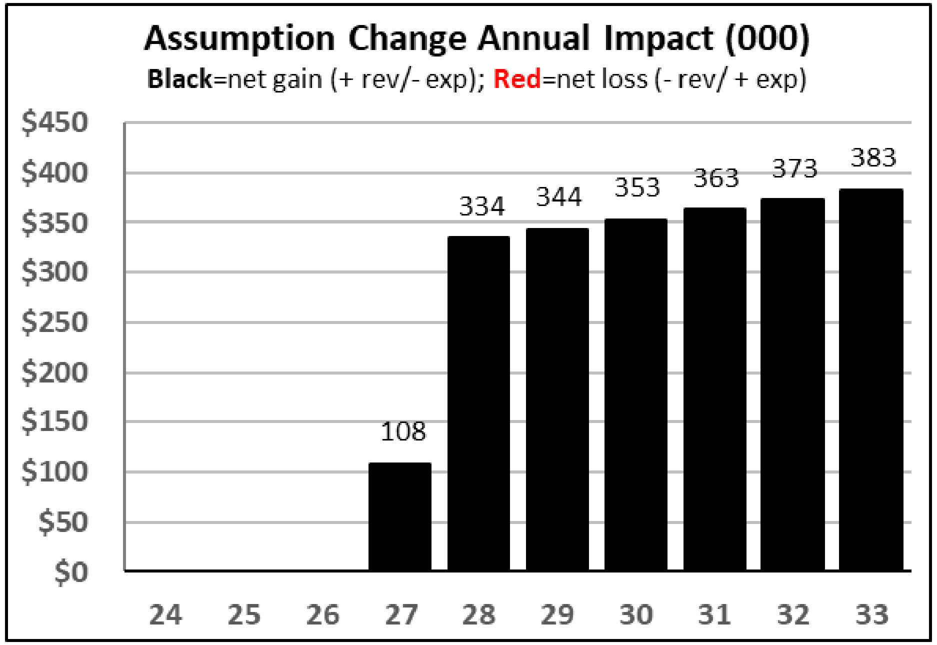
¼ cent Added Sales Tax Rate



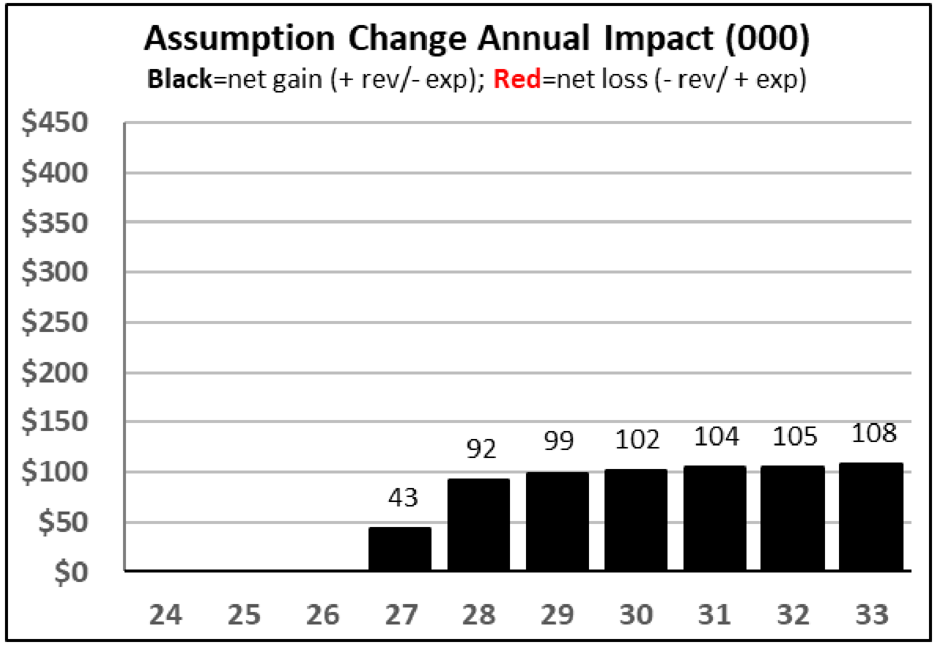


Other Potential Tax Increases to Support Operating Costs

Utility User Tax Increase



Transient Occupancy Tax Increase



- An increase in the 12% TOT rate to 14% on the Nov 2026 ballot would generate ~$90K annually (based on current hotel plus private rentals)

Recap: Change in Annual General Fund Shortfall

Combined Funds 100 & 124 ($ in mil.)		
Adopted Budget Shortfall for FY24		(1.68)
Improved property tax revenue projected for FY24	0.22	
Reduced sales tax revenue projected for FY24 by Avenu	(0.07)	
Net projected change in other revenue for FY24	0.01	
Personnel cost savings in FY24 due to high position vacancies	0.92 [1]	
Net change in projection for all other expenses	(0.50) [2]	
Revised Budget Shortfall for FY24		(1.09) [3]
FY25 revenue assuming 2.5% overall growth above FY24 levels	14.72	
Reduction in Cost Plan revenue per latest plan update	(0.71)	
FY25 personnel costs with 6% vacancy rate	(8.63)	
FY25 O&M costs at 2.5% growth	(6.76)	
Year 1 of 3-yr phase-in to $900K replacement/maint costs[4]	(0.30)	
Added cost above 2.5% growth for Liability/Workers Comp[5]	(0.17)	
FY25 debt service & capital costs	(0.47)	
Projected Budget Shortfall for FY25		(1.97)

[3]$1.04M transfer of an assigned balance to Flood Control Fund 127 is excluded from this annual deficit calculation as it has no net impact on unassigned balance

[4]City does not adequately budget these costs to support current service levels and facilities; based on annual depreciation of depreciable governmental assets

[5]JPA expects 10% Workers Comp growth & 20% liability insurance growth

[1]**FY24 Personnel Savings (net):**	
0.09	Police Sergeant
0.17	Fire Engineer
0.28	Fire Chief
0.12	Police Officer
0.12	Police Sergeant
0.08	Dispatcher
0.14	Accountant
0.99	Totals
(0.07)	Added OT/PT
0.92	Net Cost Savings

[2]**FY24 O&M Increase:**	
(0.31)	Contract labor
(0.03)	Forecast contract
(0.35)	Transfer Police donation
0.17	Capital tied to donation
0.02	Insurance/Work Comp
(0.50)	Net Cost Increase

Black increases resources, Red reduces resources

Next Steps

- $900K added for deferred maintenance/replacement, 2.5% COLAs, zero FTE growth
- ¼ cent versus ½ cent tax rate makes significant difference in City's fiscal capacity going forward
- Start with instructions to departments for FY25 budget

Questions & Answers