



MEETING DATE: 11/06/06

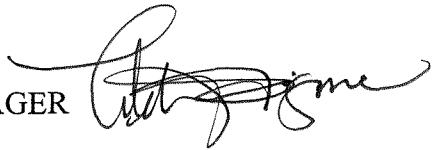
ITEM NO:

10

COUNCIL AGENDA REPORT

DATE: NOVEMBER 6, 2006

TO: MAYOR AND TOWN COUNCIL

FROM: DEBRA J. FIGONE, TOWN MANAGER 

SUBJECT: FY 2006/07 FIRST QUARTER BUDGET PERFORMANCE AND STATUS REPORT FOR THE PERIOD JULY 1, 2006 - SEPTEMBER 30, 2006.

A. ACCEPT 2006/07 FIRST QUARTER BUDGET PERFORMANCE STATUS REPORT.

B. AUTHORIZE BUDGET ADJUSTMENTS AS RECOMMENDED IN THE ATTACHED FIRST QUARTER BUDGET PERFORMANCE REPORT.

RECOMMENDATION:

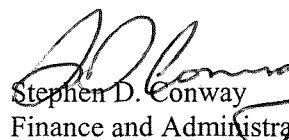
1. Accept FY 2006/07 first quarter budget performance and status report.
2. Authorize budget adjustments as recommended in the attached first quarter budget performance report.

BACKGROUND:

The attached Budget Performance Report covers the first three months of the fiscal year beginning July 1, 2006 and ending September 30, 2006. The report presents analysis and recommendations related to key General Fund revenues by category and expenditures by fund.

Staff provides to Town Council periodic updates on the status of the current year's adopted budget revenues and expenditures and the projected financial condition of Town funds, concentrating on the Town's General Fund. Though financial results are limited to the first three months, staff is able to provide an update based on early revenue trends for the current fiscal year, and to advise on potential future revenue and expenditure challenges which may materialize during the fiscal year.

PREPARED BY:


Stephen D. Conway
Finance and Administrative Services Director

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Reviewed by: PSJ Assistant Town Manager _____ Town Attorney
_____ Clerk Administrator _____ Finance _____ Community Development

MAYOR AND TOWN COUNCIL

SUBJECT: FY 2006/07 FIRST QUARTER BUDGET PERFORMANCE AND STATUS
REPORT FOR THE PERIOD JULY 1, 2006 - SEPTEMBER 30, 2006.

DATE: November 6, 2006

In recent years, as part of the state and local government budget agreement, changes to the local government revenue structure reduced two major revenues dedicated to the Town - Sales Tax and Vehicle License Fees (Car Tax), but incorporated replacement revenues (commonly referred as "backfills") to local governments. In addition, Proposition 1A passed by voters in November 2004 provides continuing protection to local governments by disallowing reductions to local sales tax rates, the shifting of local property taxes from cities, or reducing the vehicle license fee percentage (0.65%) without providing replacement revenues. However the local property tax share remains vulnerable because the constitutional protections under Proposition 1A also include provisions that would allow the state to reallocate the local property tax with a 2/3rds vote of both houses beginning in FY 2008/09. The effects of 2004's Proposition 1A, collectively with Propositions 1A&1B (*transportation funding*) and 90 (*government acquisition of property*), should they be passed by the voters on November 7th, may have future fiscal impacts (positive and/or negative) that are difficult to quantify at this time. Potential impacts will be discussed in future reports as further information becomes available.

DISCUSSION:

The first quarter budget report reflects a mix of positive news about last year's fiscal results, and a concern that the recovery in the Town's economically sensitive operating revenues such as the sales tax, transient occupancy tax, and property tax will be negatively impacted by the recent rise in energy costs (despite the current fall in gasoline prices from record highs) and by downturns in the local real estate market. National economists explain that as fuel prices rise, the buying power of consumers is eroded leaving fewer dollars available for discretionary spending. If this occurs, then the moderate recovery which appeared to be materializing in the Town's operating revenues last year and early this fiscal year may be stalled this fiscal year. In August 2006, the National Association of Realtors reported existing home sales were down 12.6 % from the prior year. Average home prices decreased 1.5% from the year before. Economists point out that declines in housing prices tend to have a dampening effect on consumer spending.

Despite the concern about the economy, many economic indicators remain positive. The *Sacramento Bee* reported recently that in discussing the upcoming holiday shopping season with national retailers and analysts, the phrase "cautious optimism" comes up early in every conversation.

In the FY 2006/07 "status quo" budget the Town conservatively forecasted continuing recoveries in local revenues, incorporating modest revenue growth in economically-sensitive revenues such as sales tax, franchise fees, business license and transient occupancy taxes. The FY 2006/07 budget continued funding at current service levels, which reflects prior year reductions due to budgetary down-sizing. Because of diminished resources and rising costs, staff continues to examine service level delivery strategies across all Town operations, mindful of the latest Five Year Financial Plan which forecasts potential revenue shortfalls that begin in FY 2009/10. Shortfalls are projected to occur if structural changes are not made, or revenues do not improve beyond their current estimates. Other budget adjustments beyond the forecasted shortfalls may be necessary in the future due to unanticipated State local revenue "takes" from local

MAYOR AND TOWN COUNCIL

SUBJECT: FY 2006/07 FIRST QUARTER BUDGET PERFORMANCE AND STATUS
REPORT FOR THE PERIOD JULY 1, 2006 - SEPTEMBER 30, 2006.

DATE: November 6, 2006

government or unexpected reductions in economically sensitive revenues such as sales tax or transient occupancy tax.

At the first quarter end of FY 2006/07, revenue trends are tracking in line with projections made at budget preparation time in the spring of 2006. Expenditures are trending in a manner similar to the pace set last year at the first quarter, which is good news in that last fiscal year the Town achieved overall budget expenditure savings of approximately \$1.0 million.

Service delivery in FY 2006/07

The current year status quo budget preserved vital Town services at the prior year's levels and provided a funding opportunity to make some improvements to service levels from the prior year. One example is the \$50,000 increase in the Library's ongoing collection budget (books, audio, video, and publications) from the \$135,000 appropriated in FY 2005/06, to a new ongoing collection budget of \$185,000. It should be recognized that the current year's "status quo" budget reflects service delivery levels which have been modified and/or reduced to meet reduced resources. This has occurred through a combination of operational efficiencies, salary savings from vacancies, strategic staffing defundings, and reductions in overtime, supplies, services, training, and postponement of equipment replacements.

While avoiding another consecutive year of service level reductions in FY 2006/07, the reductions carried over from the prior year continue to have effects on operations overall. Holding vacancies and reducing staffing and overtime results in the current workforce absorbing more of the workload, thus affecting the capacity to get the work done and limiting the flexibility to respond to new ideas and/or increased service demands. Response times associated with non-public safety requests have increased. Parks and public works related maintenance cycles have been extended or reduced, as well. Over the longer-term, the current service delivery model as funded in the FY 2006/07 budget strains the organization's capacity to deliver services to the community, and is not sustainable over the long run without incurring more significant impacts on services. New policies may need to be implemented to align resources with community demands for service.

Outstanding Issues for FY 2006/07 Mid-Year Review

Contributing to the positive fiscal results last year were Town-wide expenditure reductions and the cumulative effect of strategic defundings and restructurings that have been implemented in the past four fiscal years.

The FY 2006/07 budget reflects a current and prior year staffing reduction total of 33.10 defunded and deleted FTEs made across all Town departments. The Police Department continues to evaluate the viability of a new shift model, and expects to report its findings to Town Council at a future date. Also underway is an assessment of maintenance services in the Parks and Public Works Department. Under review with the department's participation is the ability of the department to meet the current demands for maintenance services under the current

PAGE 4

MAYOR AND TOWN COUNCIL

SUBJECT: FY 2006/07 FIRST QUARTER BUDGET PERFORMANCE AND STATUS
REPORT FOR THE PERIOD JULY 1, 2006 - SEPTEMBER 30, 2006.

DATE: November 6, 2006

level of resources and work methods. A goal of the assessment is to identify critical gaps in service which may need to be addressed in the FY 2007/08 budget process.

FY 2006/07 AND BEYOND: CONTINUING CHALLENGES AHEAD

As discussed in detail on page 3 of the attached Budget Performance Report, FY 2005/06 concluded favorably from a financial point of view. However, staff remains very attentive to the goal of preserving the Town's economic vitality. The most recent update to the Town's five-year General Fund financial operating plan presented on the following page continues to project potential revenue shortfalls that may develop in future years. However, the current update does indicate two important points. The first is that the efforts the Town has accomplished in the past four years have generated positive fiscal results in spite of a lingering soft local economy and the closing of two automobile dealerships in FY 2005/06. Secondly, if recoveries continue in economically sensitive revenues and service delivery costs are contained, the projected shortfalls will be reduced accordingly. However, at this time in approximately three years downward adjustments to the Town's operating budget are expected to be necessary to avoid the future shortfalls forecast for FY 2009/10.

The updated Five Year Plan uses assumptions based upon estimated costs of labor and benefits which represent approximately 70% of General Fund operating costs, and modest increases in revenues associated with a gradual economic recovery from the downturns experienced in recent years. The plan currently projects revenue shortfalls ranging from \$485,000 to \$606,000 in future years that must be managed pro-actively by the Town. To address this, the Town is continuing its multi-prong efforts to achieve operational efficiencies, cost reductions, reductions in non-vital services, and revenue enhancement efforts to balance ongoing revenues with expenditures in future years. As the budget tightens each fiscal year, the ability to reduce operational expenditures without service impacts becomes increasingly challenging. Departments review their operations on an ongoing basis for operating efficiencies, cost containment, and overall best practices to meet the public's need for service. An analysis of fees for cost recovery levels will also be undertaken as in years past. This information will be used to develop the FY 2007/08 proposed budget for Council's consideration in Spring 2007.

The Five Year Forecast assumes that the State property tax swap or "back-fill" of approximately \$1.2 million in Car Tax for local property tax will continue to be implemented "permanently" in each annual budget bill as promised by the State. Revenues are presented optimistically with varying growth rates, on average 5% for tax revenues and 3% for charges for services. Expenditures are derived from a database using actual costs and adjusting for future known increases in labor costs if multi-year labor agreements are in effect, and actuarial updates for retirement and other benefit costs as provided by PERS or other information sources available to the Town.

Each of the years presented in the plan assume that adjustments made to the budget to eliminate the revenue shortfall in FY 2006/07 and beyond are "permanent" adjustments, thereby reducing the level of shortfall in the following fiscal years. It is possible to make some adjustments

MAYOR AND TOWN COUNCIL

SUBJECT: FY 2006/07 FIRST QUARTER BUDGET PERFORMANCE AND STATUS
REPORT FOR THE PERIOD JULY 1, 2006 - SEPTEMBER 30, 2006.

DATE: November 6, 2006

through one-time solutions or prudent use of bridge funding on a year-to-year basis. However, problems that are truly structural should be addressed eventually with new revenue sources or reduced expenditures in an ongoing way.

TOWN OF LOS GATOS - GENERAL FUND
Five Year Financial Plan FY 2007/08 Through FY 2011/12

Revenue Summary	ACTUAL 2004-05	ACTUAL 2005-06	ESTIMATED 2006-07	PROJECTED 2007-08	PROJECTED 2008-09	PROJECTED 2009-10	PROJECTED 2010-11	PROJECTED 2011-12
Sales Tax	\$7,904,129	\$8,655,566	\$7,646,000	\$7,875,300	\$8,114,026	\$8,354,900	\$8,605,600	\$8,863,800
Property Tax	5,302,061	5,831,822	\$6,369,900	\$6,614,200	\$6,868,000	\$7,131,900	\$7,405,200	\$7,624,100
Charges for Services	2,920,356	3,006,634	\$3,178,490	\$2,889,400	\$2,928,200	\$2,970,000	\$3,014,400	\$3,061,200
Business Licenses	1,056,814	1,019,386	\$1,000,000	\$1,015,000	\$1,030,200	\$1,045,700	\$1,061,400	\$1,077,300
Car Tax/VLF Prop Tax Swap	1,554,932	2,096,704	\$2,032,200	\$1,935,900	\$1,994,000	\$2,053,800	\$2,115,400	\$2,178,900
Intergovernmental Rev.	2,316,962	2,606,356	\$1,937,080	\$2,111,585	\$2,148,263	\$2,191,350	\$2,236,075	\$2,282,576
Other Lic. and Permits	1,360,390	1,584,662	\$1,522,500	\$1,643,400	\$1,675,000	\$1,707,300	\$1,740,200	\$1,773,800
Investment Earnings	905,704	1,385,266	\$1,205,700	\$1,350,000	\$1,404,000	\$1,460,160	\$1,518,566	\$1,579,309
Franchise Tax	942,648	1,130,190	\$1,013,500	\$875,850	\$902,700	\$930,400	\$959,000	\$988,600
Hotel/Motel Tax	868,908	1,028,664	\$930,000	\$957,900	\$986,600	\$1,016,200	\$1,046,700	\$1,078,100
Fines & Forfeitures	580,937	210,888	\$125,900	\$464,500	\$466,500	\$468,500	\$470,600	\$472,800
Transfers & Use of Reserves	494,165	430,839	\$972,385	\$838,275	\$838,275	\$838,275	\$838,275	\$838,275
Miscellaneous	247,958	2,738,297	\$188,700	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000
Total Revenues	26,455,964	31,725,274	28,122,355	28,671,310	29,455,764	30,268,485	31,111,416	31,918,760
Town Expenditures								
Salary	11,415,065	11,439,231	12,521,800	12,960,063	13,413,665	13,883,143	14,369,054	14,871,970
Elected Officials	22,590	23,340	23,300	24,116	24,960	25,833	26,737	27,673
Temporary Employees	353,871	437,250	467,700	484,070	501,012	518,547	536,697	555,481
Overtime	494,170	542,624	391,500	405,203	419,385	434,063	449,255	464,979
Other Salary	572,258	571,011	193,700	200,480	207,496	214,759	222,275	230,055
Benefits	4,101,626	4,764,717	5,115,000	5,294,025	5,479,316	5,671,092	5,869,580	6,075,015
Supplies, Materials, & Services	3,256,678	3,287,777	4,257,820	4,385,555	4,517,121	4,652,635	4,792,214	4,935,980
Grants & Awards	177,578	178,359	181,415	186,857	192,463	198,237	204,184	210,310
Utilities	409,610	428,744	352,880	363,466	374,370	385,602	397,170	409,085
Fixed Assets	-	192,343	-	-	-	-	-	-
Internal Service Charges	2,820,428	2,849,969	3,057,900	3,149,637	3,244,126	3,341,450	3,441,693	3,544,944
Debt Service	930,710	932,122	931,080	931,800	931,850	931,850	929,050	932,100
Operating Transfers Out	182,876	67,673	309,550	-	-	-	-	-
GFAR Capital Transfers Out	75,000	475,000	318,710	150,000	150,000	150,000	150,000	150,000
Total Expenditures	24,812,461	26,190,160	28,122,355	28,535,270	29,455,764	30,407,211	31,387,909	32,407,593
Net Revenues Less Expenditures	1,643,503	5,535,114	-	136,040	-	(138,726)	(276,493)	(488,833)

Post Retirement Benefits - Governmental Accounting Standards Board Statement #45

Effective FY 2008/09, the Town will be required to fully accrue its actuarial determined liability for post retirement benefits (the Town's contribution to retiree health care premiums) under the provisions of the Governmental Accounting Standards Board (GASB) Statement #45. The Town has historically budgeted and expensed these benefits on a "pay-as-you-go" basis, a standard procedure for most local governments under generally accepted accounting principles.

Under GASB's new accounting standard, the Town is required to accrue a liability for the cost of post-retirement benefits, using actuarial methods to estimate expected future costs for a calculated portion of the current workforce that will retire under the Town's retirement benefit

PAGE 6

MAYOR AND TOWN COUNCIL

SUBJECT: FY 2006/07 FIRST QUARTER BUDGET PERFORMANCE AND STATUS
REPORT FOR THE PERIOD JULY 1, 2006 - SEPTEMBER 30, 2006.

DATE: November 6, 2006

program. Assumptions will be made about the level of benefits and the number of eligible employees who will eventually retire from the Town, offset by future accrued investment earnings expected to be earned in a separate trust account that is usually established by local governments to provide a funding account for these benefits.

Since the actuarial study is not yet completed, (the Town expects the study to be completed this fiscal year) the Five Year Financial Plan may not accurately reflect benefit costs. With the understanding there would be significant increases in future years, a 15% annual retiree benefit cost increase was built into the Five Year Forecast, however until the study is completed true liability estimates are unknown. Although accrued expenses will increase, actual cash payments to retirees are expected to trend much as they have in the "pay-as-you-go" basis. The difference between the accrued annual expense and the actual cash payments made annually by the Town will be amortized over a phase-in period of approximately 20 to 30 years until the full annual actuarial accrual of this expense is achieved. Until then, the difference between amounts set aside by the Town and the actuarial liability will be booked at year-end either as a liability or asset on the Town's financial statements. As a result of GASB 45, the Five Year Plan's future updates will include potential increases to the annual expenditures for cash payments made to the post retirement trust account used to fund post retirement benefits.

Conclusion

The Town has managed very effectively through the budget challenges in recent years. Shortfalls were dealt with, priority services maintained, and General Fund contingency reserves are intact. However, with the most current update to the Town's Five Year Financial Plan indicating projected shortfalls beginning in FY 2009/10 the need to remain fiscally viable continues to be a high priority for Town staff. The Town continues to communicate with residents, staff, and the employee labor units to increase understanding of the Town's ongoing fiscal challenges in order to engage all stakeholders on a continuous basis in seeking creative solutions to delivering service in the context of our fiscal reality. Key goals are to minimize the impact on Town services, maintain the community's quality of life, and remain a competitive employer while sustaining the Town's fiscal health.

FORMAT OF THE REPORT

The attached Budget Performance Report includes a financial overview comprised of: a brief discussion of the Town's financial condition; the FY 2006/07 financial outlook; a summary of the performance of the Town's primary General Fund revenue sources and necessary budget adjustments; and a look ahead at the FY 2007/08 budget process.

ENVIRONMENTAL ASSESSMENT:

This budget report is not a project defined under CEQA, and no further action is required.

PAGE 7

MAYOR AND TOWN COUNCIL

SUBJECT: FY 2006/07 FIRST QUARTER BUDGET PERFORMANCE AND STATUS
REPORT FOR THE PERIOD JULY 1, 2006 - SEPTEMBER 30, 2006.

DATE: November 6, 2006

FISCAL IMPACT:

The attached First Quarter Budget Performance Report includes a section providing a detailed list of recommended expenditure and revenue budget adjustments recommended for the first quarter of FY 2006/07. Upon approval of the recommended budget adjustments by Town Council, the adopted appropriations for the fiscal year will be adjusted accordingly.

Attachments:

Budget Performance Report for the Three Months Ended September 30, 2006