Atascadero

Comprehensive Financial Strategy
January 2013

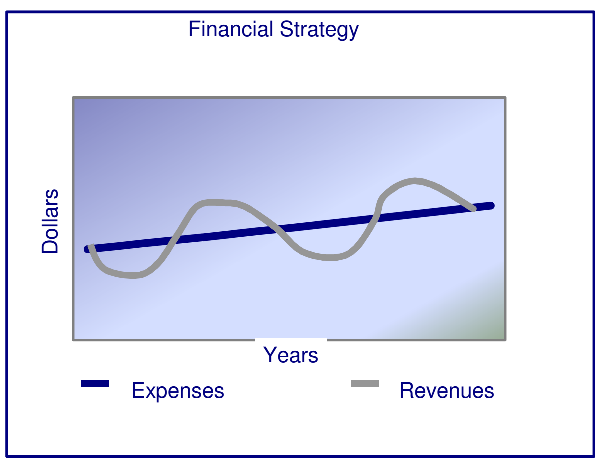
City of Atascadero
Financial Strategy – January 2013

Introduction:

The City of Atascadero has worked hard to maintain fiscal stability in these times of economic flux. The effects of the local, state, national, and worldwide financial environments have been felt by virtually all governmental agencies, companies, and individuals. The severity of the impact is often times directly related to the planning and preparation that was done in advance. Fortunately, through Atascadero's visionary leadership, appropriate policies and strategies have been put in place and continue to be used to help navigate the City as the economy recovers. The many tough decisions and sacrifices have worked to keep the organization strong and resilient.

The City of Atascadero has experienced its share of financial challenges over the last few decades. In the early 1990s, a sharp slow-down of the economy devastated the City's budget and brought the staff to a skeleton crew. In more recent years, the state budget crisis brought more challenges as the State sought to balance their budget on the backs of local government. This is even more severe now with the loss of redevelopment. The importance of a well-defined financial strategy to anticipate and conquer difficult issues cannot be understated. The responsibility to maintain a strong organization is shared community wide, but as the City Council and City employees, we agree to be the leaders in this effort. The Council has shown great leadership in its forward-thinking members and continues to look toward ensuring a sustainable future.

As with all successful organizations, the City needs to continue to revisit and update the long-term plan. A current yet fluid Fiscal Strategy is a key element of building a solid foundation upon which to move into the future. The City first adopted a Financial Strategy in 1998 and by focusing its resources, its financial condition has improved dramatically since that time.



The financial plan should outline general strategies and guidelines to mold the City's decisions. The plan should identify actions and describe the current belief of the organizational needs. However, it should also be flexible as the economy or situations change, direction and efforts can be modified to best suit the needs of the City and community. The plan requires periodic updates to ensure the City's financial strategy remains current and reflects the priorities of the citizenry.

The overall strategy has consistently been to maintain a conservative outlook by putting aside reserves in good times and then using those reserves during down periods to achieve stable operations. By employing this conservative strategy, the City can avoid the undesirable peaks and valleys in services due to revenue fluctuations and can better maintain its long-term financial vitality.

Comprehensive Financial Strategy:

The first section of this plan highlights some of the actions that Council and staff have taken in preparation of, and in response to, the current economic downtown.

The second section reviews some of the major revenues for the City. This section includes a description of these sources, how they've changed over the years, and what that means to the City now and into the future.

The third section analyzes ongoing operating costs. This includes employee and benefits costs, trends and assumptions. Additionally, this section reviews operating service costs, supplies, capital expenditures and upcoming insurance costs.

The forth section discusses long-term costs. These include discussion on long-term funding for maintenance and replacement of streets and bridges, storm drains, buildings, technology, vehicles, and equipment. Additionally, employee leave accruals are reviewed and analyzed.

The fifth section discusses reserves. The City has several different types of reserves to serve different purposes. The organization must retain some reserves to deal with cash flow issues, personnel, equipment, liabilities, and other unexpected expenses. Having a prudent plan to deal with ongoing operating costs and reserves will allow the Council and community to understand levels of risk in the City's financial operation.

The sixth and last section reviews the City's fiscal policies. These policies guide our budget process, projects, purchases and general City business. The City has taken a variety of steps over the years to maximize limited resources including economic development, strengthening of reserves, short- and long-term budget reductions, Strategic Planning, and revenue enhancement solutions. Staff continues to search for ideas to better the financial condition of the organization.

As we noted, all organizations must have a plan to succeed. This plan keeps the City's focus on the top priorities. The plan is dynamic and change is always expected. Improvements will occur and good ideas are invited from all sources. The underlying belief is that through the community's collective knowledge and teamwork, the City will continue to have a strong financial foundation that will withstand adversity.

Atascadero

Comprehensive Financial Strategy
January 2013

Section 1- Key Actions

Highlights of Key Actions

Council and staff have worked as a powerful team to maintain the organization as fiscally nimble as possible. Critical indicators and influences are continuously monitored and analyzed so adjustments and modifications can be made as new information is available. Detailed below are highlights of some of the key actions in the last several years that have been accomplished to help the City get through this economic downturn.

May 13, 2008 - Mid-Year and Mid-Cycle Budget Revisions
As a part of the Mid-Year and Mid-Cycle Budget review, staff prepared and analyzed a five-year projection to facilitate long-term planning. Council endorsed staff budget actions taken such as the reduction in operating expenses, emphasis on economic development, hiring chills, and operations monitoring. Additionally, Council adopted budget policies that have enhanced the City's fiscal position such as budget adjustments, no new or expanded programs, and pursuit of new and/or improved revenue sources.

November 22, 2008 – Special Public Workshop on Economic Development
Council hosted a special public workshop to receive the report from Applied Development Economics. The report identified the City's strengths and weakness, and proposed ideas for improvement.

January 13, 2009 – Budget Workgroup Initiated & Weekly Budget Update Memo
A workgroup was initiated in January to discuss budget strategies and come up with new ideas for cost reductions and revenue enhancements. The group met weekly and was comprised of staff from the different departments and representatives from all of the employee associations. Concurrent with meetings, weekly budget newsletters were distributed to Council and all City employees to provide information discussed at the budget workgroup meetings and on progress with the two-year budget, pertinent State legislative actions, and to generate new ideas for cost reductions or revenue enhancements. Staff received positive feedback on the newsletters and good ideas were brought forth.

January 13, 2009 - Fiscal Year 2007-2008 Audit
Council reviewed and accepted the audited financial statements for fiscal year 2007-2008. The report included information on the effects the economic downturn had on the 2007-2008 fiscal year. Also included were the projected effects the downturn would have on future years.

January 28th and 29th, 2009 – Council Strategic Planning
Council met for annual strategic planning to discuss key issues and prioritize goals. This process is fundamental to budget development and the success of ongoing operations.

March 24, 2009 - Budget Plan 2009-2011
Council received a budget update report which identified the $3.5 million gap that needed to be closed for the 2009-2011 budget. In an effort to close the gap, staff evaluated and/or implemented solutions including a hiring chill, a policy of no new or expanded programs, a critical analysis of budgets and operations, weekly staff budget meetings, Council/employee budget newsletters, employee cost cutting/revenue generating idea program, voluntary furlough and early retirement incentive programs, and a review of each department for services that could be reduced or eliminated.

April 14, 2009 - Budget Plan 2009-2011
Council received staff report on budget progress and current information. Data relating to key revenues, expenditure reductions, and reserves were presented and staff indicated that the budget gap was reduced to $700,000. Staff was working to close the gap completely but believed that wasn't possible without the consideration of layoffs.

April 28, 2009 - 2009-2011 Budget Update
Council received a budget update and authorized the City Manager to proceed with staff layoffs. The update included an analysis of critical revenue sources affirming that they were still projected to come in low, a review of reserves, and descriptions of expenditure cuts and layoffs proposed to close the budget gap.

May 26, 2009 – Special Budget Meeting
Council was provided a review of the preliminary budget and an opportunity to ask questions and voice concerns. Additional details and information was given by staff to address these concerns.

June 9, 2009 - Operating and Capital Budget Message for Fiscal Years 2009-2011
Council adopted the budget for fiscal years 2009-2011. Included in the budget were one-time special and capital project deferrals or eliminations, ongoing operational cost reductions, staff layoffs, hiring chills, and suspension of specific reserve funding among other gap-closing solutions. The budget was designed to implement the Council's top priorities of growing the City's economy and pursuing economic development, enhancement of public safety, and the continued stabilization of the City's finances.

June 23, 2009 – Business Stimulus Package Adoption
Council approved the Business Stimulus Plan in June of 2009. The goals of this plan were to increase revenue through economic development and to stimulate the City's economy. This package included a comprehensive marketing plan, fee relief, plans for improved relationships with local commercial brokers, support of buying local, promotion of shopping locally, streamlining of the permitting process, a new business website, and strategic downtown initiatives.

August 11, 2009 - Budget Amendment and Update
Council amended the 2008-2009 fiscal year budget in response to the State's intentions to raid City funds. Expecting that this would likely come to fruition, the organization was

prepared and pre-determined responses were identified including legal action against the State, expenditure reductions, borrowing, and shifting of funds were possible.

October 27, 2009 - Authorization to Participate in Proposition 1A Securitization
Council adopted a resolution and authorized the participation in the Proposition 1A Securitization Program that would effectively negate the State borrowing of $645,000 in property tax revenues, freeing up necessary liquid reserves.

December 8, 2009 – Strategic Planning, Phase II – Financial Information
Council received a budget update, affirmed staff's analysis of the City's risk areas, and accepted an update of the 7-year projections. The report included a comprehensive review of key revenues, labor costs, reserves, and the risks the City faced as a result of the State's budget crisis.

December 8, 2009 - Authorization to Execute Financing Agreement with Redevelopment Agency
Council authorized financing agreements with the redevelopment agency to fund several projects around the Zoo and the Lake Park. The financing agreements maximized the funding options for these priority projects.

January 30, 2010 – Council Strategic Planning
Council met for annual strategic planning to discuss key issues and prioritize goals. This process is fundamental to budget development and the success of ongoing operations.

February 23, 2010 – Investment Policy Update
The Investment Policy provides guidelines for the prudent investment of funds, outlines policies for maximizing the efficiency of the City's cash management system, protects pooled cash and ultimately enhances the economic status of the City. Council adopted an updated Investment Policy which reflected the changes in reporting frequency, consistency with modified State laws, changes to FDIC limits and other minor changes.

March 9, 2010 - Fiscal Year 2008-2009 Audit
Council reviewed and accepted the audited financial statements for fiscal year 2008-2009. The report included information on the effects the economic downturn had on the 2008-2009 fiscal year. Also included were the projected effects the downturn would have on future years.

March 9, 2010 – Strategic Planning 2010 - Council Goals and Action Plan
Council adopted the goals set forth in the Strategic Planning session on January 30, 2010, and approved the related action plans developed at the same meeting.

May 11, 2010 – Bond Finance Team
Council authorized the City Manager to execute agreements with Piper Jaffray and Quint & Thimmig for the October 2010 bond issue.

June 22, 2010 – Strategic Plan- Update on Goals
Council received a report of progress being made on the Council goals adopted in March 2010 and an opportunity to provide feedback and additional direction.

July 27, 2010 - Mid-Cycle Budget Revisions
Staff provided some information on anticipated results of the 2009-2010 fiscal year, and made one minor budget adjustment in the Wastewater Fund.

July 27, 2010 – City Hall Update – Bond Issue
Council approved the issuance and sale of Lease Revenue Bonds to finance improvements to the City's Historic City Hall and the acquisition and development of other capital improvements throughout the City.

October 26, 2010 – Strategic Planning 2010 – Update on Council Goals
Council received an update on the three key goals, including the two fiscal goals related to growth of the City's economy/economic development and stability of the City's finances.

November 3, 2010 – Budget Workgroup Reinitiated & Budget Update Memo
The budget workgroup that was initiated in 2009 was reconvened beginning in November. This purpose of this group is to discuss budget strategies and come up with new ideas for cost reductions and revenue enhancements. The group met semi-monthly through the end of 2010, and met weekly or as needed. The group is comprised of staff from the different departments and representatives from all of the employee associations. Concurrent with meetings, budget newsletters were distributed to Council and all City employees to provide information discussed at the budget workgroup meetings and on progress with the two-year budget, environmental/economic influences, and to generate new ideas for cost reductions or revenue enhancements.

December 14, 2010 - Fiscal Year 2009-2010 Audit
Council reviewed and accepted the audited financial statements for fiscal year 2009-2010. The statements indicated that while the City was effectively managing resources, difficult times remained ahead.

December 14, 2010 – Redevelopment Agency Restaurant Stimulus Program
Council acting as the Agency Board approved a Restaurant Loan Assistance Program designed to provide short-term financial assistance to people looking to open or expand restaurants in Atascadero's Downtown.

January 11, 2011 – Strategic Planning 2011- Finance Issues
Council reviewed and accepted a staff report regarding the City's financial picture as of December 2010 in preparation for the upcoming two-year budget preparation. The report included a ten-year history and a seven-year projection, a detailed analysis of key revenues, the potential effects on Atascadero of the state budget crisis, and a review of reserves.

January 28th and 29th, 2011 – Council Strategic Planning
Council met for annual strategic planning to discuss key issues and prioritize goals. This process is fundamental to budget development and the success of ongoing operations.

February 22, 2011 – Opposition to Abolish Redevelopment Agencies
Council adopted a resolution in opposition to the Governor's proposal to abolish redevelopment agencies in California.

April 21, 2011 – Strategic Planning 2011 - Council Goals and Action Plan
Council adopted the goals set forth in the Strategic Planning session on January 28-29, 2011, and approved the related action plans developed at the same meeting.

May 10, 2011 – Atascadero Tourism Initiative Update
Council received a report and provided direction regarding the Tourism Action Plan for 2011. In 2009, the City commissioned a tourism study by SMG. Later, the City hired Steve Martin from SW Martin & Associates to work as the Tourism, Events and Marketing Director. Mr. Martin reported on past progress and Action Plans for future tourism activities.

June 14, 2011 – 2011-2013 Operating and Capital Budget
Council adopted the budget for fiscal years 2011-2013, and amended the budget for fiscal year 2010-2011. Included in the budget were one-time special and capital project deferrals or eliminations, ongoing operational cost reductions, hiring chills, and suspension of specific reserve funding among other gap-closing solutions. The budget was designed to implement the Council's top priorities of growing the City's economy and pursuing economic development, enhancement of public safety, and the continued stabilization of the City's finances.

June 28, 2011 – 2011-2013 MOUs, Two-Tier Pension System, and Employee Contributions to PERS
Council approved two-year Memorandums of Understanding with all of the employee groups. The groups and the City worked together to agree to the two-year contract terms, additional employee contributions to PERS, voluntary salary reductions for the Executive Management Team, and a two-tier PERS pension system.

July 12, 2011 – Strategic Planning 2011 – Update on Council Goals
Council received an update on the three key goals, including the two fiscal goals related to growth of the City's economy/economic development and stability of the City's finances.

August 9, 2011 – Urgency & Regular Ordinance for ABx1 27 Voluntary Alternative Redevelopment Program
Council adopted an urgency ordinance and introduced the first reading by title only of a draft ordinance related to Assembly Bill X1 27. This was necessary to comply with the

Voluntary Alternative Redevelopment Program in order to avoid dissolution of Atascadero's Redevelopment Agency.

August 25, 2011 – Discussion of Continuation of Redevelopment Agency Projects
Council discussed and provided direction to City staff on the continuation of redevelopment projects and activities during the period of Supreme Court review of legal challenges of ABX1 26 and 27.

September 27, 2011 – Remittance Agreement Between City and Redevelopment Agency
Council adopted a draft resolution approving a remittance agreement whereby the Agency would transfer a portion of the tax increment to the City to cover the cost of redevelopment agency projects, programs and activities performed by the City. This mechanism was authorized by Assembly Bill X1 27.

October 25, 2011 –Strategic Planning 2011 – Update on Council Goals
Council received an update on the three key goals, including the two fiscal goals related to growth of the City's economy/economic development and stability of the City's finances.

January 10, 2012 – Resolution establishing the City of Atascadero as the Successor Agency to the Redevelopment Agency
Council adopted a resolution naming the City as the Successor Agency to the redevelopment agency and electing that the City retain the housing assets and functions previously held by the agency. The California Supreme Court's December 29, 2011 decision to uphold ABX1 26 and find ABX1 27 unconstitutional required that the City name a Successor Agency for the redevelopment agency that was to dissolve as of February 1, 2012.

February 24, 2012 – Strategic Planning 2012
Council met for annual strategic planning to discuss key issues and prioritize goals. This process is fundamental to budget development and the success of ongoing operations.

March 27, 2012 – Fiscal Year 2010-2011 Audit
Council reviewed and accepted the audited financial statements for fiscal year 2010-2011. The statements indicated that the City ended the year better than anticipated as a result of the focus on the Council's top three priorities of economic development, continued enhancement of public safety and the stability of the City's finances.

April 24, 2012 – Strategic Planning 2012 - Council Goals and Action Plan
Council adopted the goals set forth in the Strategic Planning session on February 24, 2012, and approved the related action plans developed at the same meeting.

May 8, 2012 – Promotions Roundtable Study Session
Council held a roundtable study session to discuss tourism and promotions of the City and established an Ad Hoc Promotions Committee.

May 22, 2012 – Fall Special Pavilion on the Lake Rental Rate
Council approved a special Fall rental rate for private rentals of the Pavilion on the Lake in order to maximize facility use and increase revenues.

June 12, 2012 – Interim Promotions Services Agreement
Council authorized a contract with S.W. Martin & Associates for an Interim Promotions program.

June 26, 2012 – Public Hearing Regarding Del Rio Road Commercial Area Specific Plan
Council held a public hearing to discuss the Del Rio Road Commercial Area Specific Plan (Walmart).

July 10, 2012 – Adoption of Ordinances for Del Rio Road Commercial Area Specific Plan
Council adopted three ordinances necessary for the Del Rio Road Commercial Area Specific Plan (Walmart) to continue moving forward.

July 17, 2012 – Promotions Roundtable Study Session
Council's continuation of the Promotions Roundtable held in May to discuss tourism and promotions of the City.

August 14, 2012 – Promotions Request for Proposals
Council approved the Promotions Request for Proposals and appropriated funding for the Promotions Program.

August 14, 2012 – Business Friendly Update – Enhancements to City's Permit Process
Council received a report on the current progress of streamlining the City's permit process and additional improvements that will be implemented in the next 12-month period. Enhancing the City's Permit Process helps to continue to promote Atascadero's Business Friendly reputation, which ultimately develops the Council's number one priority of economic development.

August 14, 2012 – Potential Hotel Development – Development Fee Deferral
Council approved the proposal to defer payment of development fees for a hotel and banquet facility at the Home Depot Center in order to encourage the development.

October 23, 2012 – Hotel Development – Agreement for Deferred Fees
Council approved the agreement and related documents for deferred payment of development fees for a 130-room suites hotel and banquet facility at the Home Depot Center in order to encourage the development.

October 23, 2012 – Public Relations and Marketing Program
Council authorized negotiation and execution of a contract with Mental Marketing and TJA Advertising for the Public Relations and Marketing Program.

November 13, 2012 – Atascadero Road Program Update
Council reviewed status, policies, funding and progress achieved on the Atascadero Road Program

November 15, 2012 – Budget Workgroup Reinitiated
The budget workgroup that was initiated in 2009 and 2010 was reconvened beginning in November. This purpose of this group is to discuss budget strategies and come up with new ideas for cost reductions and revenue enhancements. The group is comprised of staff from the different departments and representatives from all of the employee associations.

December 14, 2012 – Promotions Program Study Session
A study session was held on the Promotions Program and the City's Promotions consultant gave an update on progress.

January 8, 2013 – 2013 Strategic Planning Update- Community Development / Economic Development
Council reviewed economic development and community development accomplishments, along with upcoming programs, projects and mandates

These actions are but a small sampling of the work that has been done, and continues to be done, to successfully position the City to respond to the ebbs and flows of the uncertain economy. In addition, the Office of Economic Development has been continuing efforts carry out Council's priority of encourage economic development throughout the City. There has been some terrific progress made in the last several years including Colony Square, other new businesses, and expansion of current businesses.

Seven Year Projections

In preparation of the two-year budget process, staff prepared a seven-year projection to more fully understand the long-term impacts of the two-year budget. The seven-year projection is an excellent planning tool to get a broader perspective of how the organization will fare and to ensure that the level of reserves currently available will last through the downturn. Similar to the planning horizon for Strategic Planning purposes, the seven-year view is generally believed to be a reasonable time frame for projecting the future. However, as anticipated, the return to an average growth period looks to be exceptionally long and slow. Staff has updated the projection's key revenues and expenses and extended them out to seven years.

A nine-year history and a seven-year forecast are displayed below and will be referenced throughout the following staff report.

GENERAL FUND HISTORY & PROJECTIONS
Fiscal Years 2002/2003 through 2010/2011

	Actual 2002/2003	Actual 2003/2004	Actual 2004/2005	Actual 2005/2006	Actual 2006/2007	Actual 2007/2008	Actual 2008/2009	Actual 2009/2010	Actual 2010/2011
Taxes									
Property Tax (Current Secured & VLF)	$ 2,979,616	$ 3,239,232	$ 3,208,666	$ 5,436,497	$ 6,482,216	$ 7,117,679	$ 7,275,963	$ 7,003,657	$ 6,859,675
RDA Dissolution Distributions	-	-	-	-	-	-	-	-	-
Other Property Taxes	275,234	290,138	337,300	563,937	624,786	394,205	378,524	229,906	188,426
Sales Tax	3,682,751	3,501,198	3,646,009	3,989,425	3,982,903	3,547,696	3,019,522	2,583,899	2,862,255
Franchise Fees	657,873	739,985	766,769	811,195	855,132	956,931	1,091,097	1,019,174	990,037
Transient Occupancy Tax	282,988	321,008	386,164	479,547	478,593	407,609	418,631	409,177	525,530
Other Taxes	289,280	332,067	373,472	398,172	321,864	255,935	229,770	222,396	219,319
Permits	622,434	558,834	816,853	958,044	650,057	275,622	206,490	180,111	209,569
Intergovernmental	1,737,451	1,418,237	1,774,933	744,238	399,383	223,917	168,576	167,829	231,270
Grants	221,817	187,419	689,241	359,735	556,897	625,044	65,078	141,687	179,167
Service Fees									
Safety Fees	153,642	178,126	181,399	183,037	185,902	182,671	295,007	245,243	254,876
Mutual Aid	38,536	98,931	73,470	65,908	742,963	861,597	887,899	518,053	133,051
Development Fees	536,673	511,113	1,255,604	1,088,046	1,064,772	714,421	599,957	345,766	696,318
Recreation Fees	220,091	223,268	184,219	193,191	204,486	218,779	196,773	215,925	246,156
Administrative Fees	7,118	44,825	68,841	92,548	76,805	69,381	62,380	36,786	37,621
Pavilion & Other Rental Fees	117,109	92,869	96,418	95,925	153,244	139,155	147,628	149,348	137,022
Parks Fees	16,427	19,241	15,399	23,305	17,181	22,034	24,998	42,305	50,375
Zoo Fees	157,969	153,593	204,838	192,303	204,182	210,638	200,308	185,612	196,506
Fines	82,897	103,107	90,558	103,029	169,259	127,765	137,375	104,328	90,655
Interest Income	308,094	171,484	251,040	324,636	622,337	467,963	311,177	171,216	160,435
Other									
Interfund Charges	468,650	504,727	651,989	1,018,692	968,930	1,043,102	1,020,251	1,240,420	1,215,906
Donations	106,615	96,658	94,119	99,291	163,353	74,170	53,279	63,619	47,377
Other	440,236	357,625	326,538	77,532	119,917	96,031	69,884	71,508	70,950
Transfers	-	-	-	49,766	57,552	289,760	302,952	267,130	412,320
Total Revenues	13,403,501	13,143,685	15,493,839	17,347,999	19,102,714	18,322,105	17,163,519	15,615,095	16,014,816
Employee Services	(7,267,628)	(8,010,348)	(8,705,412)	(9,984,537)	(11,212,722)	(13,321,050)	(13,169,188)	(12,013,133)	(11,988,656)
Operations	(3,740,915)	(4,129,822)	(4,368,782)	(4,842,365)	(5,031,226)	(5,561,493)	(5,282,445)	(4,040,370)	(3,981,802)
Special Projects & Community Funding	(832,568)	(591,536)	(420,886)	(402,558)	(722,462)	(182,411)	(292,450)	(270,042)	(583,826)
Capital Outlay	(1,012,706)	(427,294)	(496,141)	(976,504)	(1,583,236)	(363,231)	(31,082)	(7,369)	(57,617)
Debt Service	(111,636)	(41,436)	(41,269)	(41,307)	(41,499)	(41,300)	(42,138)	-	-
Total Expenses	(12,965,453)	(13,200,436)	(14,032,490)	(16,247,271)	(18,591,145)	(19,469,485)	(18,817,303)	(16,330,914)	(16,611,901)
NET INCOME / (LOSS)	438,048	(56,751)	1,461,349	1,100,728	511,569	(1,147,380)	(1,653,784)	(715,819)	(597,085)
Fund Balance Beginning of Year	7,579,569	8,017,617	7,960,866	9,422,215	10,522,943	11,034,512	9,887,132	8,233,348	7,517,529
FUND BALANCE END OF YEAR	$ 8,017,617	$ 7,960,866	$ 9,422,215	$ 10,522,943	$ 11,034,512	$ 9,887,132	$ 8,233,348	$ 7,517,529	$ 6,920,444
Fund Balance as % of Expenses	61.8%	60.3%	67.1%	64.8%	59.4%	50.8%	43.8%	46.0%	41.7%

GENERAL FUND HISTORY & PROJECTIONS
Fiscal Years 2011/2012 through 2018/2019

	Actual 2011/2012	Budgeted 2012/2013	Estimated 2012/2013	Estimated 2013/2014	Estimated 2014/2015	Estimated 2015/2016	Estimated 2016/2017	Estimated 2017/2018	Estimated 2018/2019
Taxes									
Property Tax (Current Secured & VLF)	$ 6,721,593	$ 6,738,140	$ 6,722,200	$ 6,839,830	$ 7,045,020	$ 7,256,360	$ 7,510,330	$ 7,773,190	$ 7,967,520
RDA Dissolution Distributions	41,254	-	2,117,810	57,370	70,130	83,760	97,070	114,590	120,000
Other Property Taxes	168,673	245,070	156,400	176,400	207,660	229,570	252,160	274,800	276,150
Sales Tax	3,149,612	3,131,670	3,311,070	3,381,000	3,491,400	3,887,000	4,228,000	4,429,000	4,569,000
Franchise Fees	989,527	1,004,670	993,110	995,320	998,300	1,001,460	1,004,350	1,010,660	1,017,770
Transient Occupancy Tax	638,113	479,400	675,000	691,880	905,720	932,890	951,550	961,070	970,680
Other Taxes	242,315	223,330	235,000	240,000	243,000	251,000	251,000	251,000	251,000
Permits	219,517	293,120	417,440	341,760	410,710	378,970	432,080	453,910	476,870
Intergovernmental	81,288	94,920	80,840	82,120	83,470	85,360	87,040	95,270	67,550
Grants	235,598	166,880	106,880	20,510	8,410	-	-	-	-
Service Fees									
Safety Fees	325,023	270,440	258,280	260,380	262,520	268,300	275,100	281,180	291,360
Mutual Aid	229,371	392,420	497,000	199,420	199,420	199,420	199,420	199,420	199,420
Development Fees	510,106	591,350	565,610	340,090	294,500	294,290	322,440	342,000	363,150
Recreation Fees	308,076	242,290	267,600	273,510	277,810	282,620	287,520	292,010	296,510
Administrative Fees	36,422	46,230	39,150	39,760	39,080	39,080	41,400	42,470	43,900
Pavilion & Other Rental Fees	138,271	154,900	138,900	138,700	138,800	139,850	139,950	141,030	142,030
Parks Fees	28,555	45,260	35,690	35,700	35,700	36,650	36,650	37,620	37,620
Zoo Fees	254,729	242,200	219,700	236,900	242,200	244,370	245,370	245,370	245,370
Fines	80,309	94,950	81,220	81,220	81,430	81,430	83,940	83,940	84,160
Interest Income	121,565	170,500	45,200	45,200	45,200	45,200	45,200	45,500	46,000
Other									
Interfund Charges	1,048,925	1,231,360	1,034,180	1,043,460	1,046,930	1,069,120	874,470	884,250	902,300
Donations	178,219	59,500	61,420	29,500	29,500	28,000	28,000	28,000	28,000
Other	63,133	61,600	62,800	62,550	62,550	62,550	22,750	22,750	17,550
Transfers	480,443	452,500	452,500	345,420	362,690	380,820	399,860	419,850	440,840
Total Revenues	16,290,637	16,432,700	18,575,000	15,958,000	16,582,150	17,278,070	17,815,650	18,428,880	18,854,750
Employee Services	(12,095,049)	(12,772,550)	(12,772,550)	(12,480,300)	(12,736,530)	(13,006,350)	(13,131,940)	(13,328,930)	(13,595,510)
Operations	(4,096,833)	(4,204,590)	(4,204,590)	(5,131,000)	(4,331,000)	(4,461,000)	(4,461,000)	(4,595,000)	(4,595,000)
Special Projects & Community Funding	(335,824)	(469,630)	(469,630)	(190,120)	(193,900)	(197,780)	(203,700)	(209,810)	(216,100)
Capital Outlay	(216,813)	(17,050)	(17,050)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)
Debt Service	-								
Total Expenses	(16,744,519)	(17,463,820)	(17,463,820)	(17,901,420)	(17,361,430)	(17,765,130)	(17,896,640)	(18,233,740)	(18,506,610)
NET INCOME / (LOSS)	(453,882)	(1,031,120)	1,111,180	(1,943,420)	(779,280)	(487,060)	(80,990)	195,140	348,140
Fund Balance Beginning of Year	6,920,444	5,475,100	6,466,562	7,577,742	5,634,322	4,855,042	4,367,982	4,286,992	4,482,132
FUND BALANCE END OF YEAR	$ 6,466,562	$ 4,443,980	$ 7,577,742	$ 5,634,322	$ 4,855,042	$ 4,367,982	$ 4,286,992	$ 4,482,132	$ 4,830,272
Fund Balance as % of Expenses	38.6%	25.4%	43.4%	31.5%	28.0%	24.6%	24.0%	24.6%	26.1%

Overall, the current seven year projection is a more positive overall picture than was projected as part of the 2011-2013 budget process. While revenues are not expected to once again exceed expenses until 2017-2018, overall reserve balances are projected to remain higher than in previous projections. The projections show that if the City remains committed to the financial strategy, that reserves will not fall below the 20% reserve minimum called for in Council's policy.

GENERAL FUND RESERVE BALANCES

	Actual 2011/2012	Estimated 2012/2013	Estimated 2013/2014	Estimated 2014/2015	Estimated 2015/2016	Estimated 2016/2017	Estimated 2017/2018	Estimated 2018/2019
Estimated June 2011	$ 5,475,100	$ 4,575,100	$ 2,721,990	$ 2,720,350	$ 3,350,660	$ 4,551,140	$ 5,822,000	n/a
Fund Balance as % of Expenses	32.5%	26.8%	15.0%	15.7%	19.1%	25.7%	31.6%	n/a
Estimated January 2013	**$ 6,466,562**	**$ 7,577,742**	**$ 5,634,322**	**$ 4,855,042**	**$ 4,367,982**	**$ 4,286,992**	**$ 4,482,132**	**$ 4,830,272**
Fund Balance as % of Expenses	**38.6%**	**43.4%**	**31.5%**	**28.0%**	**24.6%**	**24.0%**	**24.6%**	**26.1%**

As discussed in the following sections of this report, the economic recovery is expected to be even longer and more drawn out than economists originally predicted. The seven year projection reflects this more shallow growth trend in revenues such as property taxes. A one-time influx of revenue as a result of the dissolution of redevelopment funds is projected to help bolster the reserve balance in 2012-2013; however the dissolution of redevelopment also brought with it, the transfer of specific program costs from redevelopment to the General Fund, for a cost of $450,000 annually. The current projections show that the City's General Fund will overcome the additional loss from the State's decision to eliminate redevelopment.

The uptick in the economy will bring with it pressure from both citizens and employees to increase service levels, staffing and compensation. The projections show that while things are better, that a continued conservative fiscal policy is essential. The City has a financial strategy to use reserves in good times for use in bad times in order to maintain service levels. The current projections show that we need to continue with this strategy to use those reserves and that our revenues are not enough to pay for the service levels currently in place in the short-term. The projections also show us that revenues will eventually exceed expenditures and that the reserves on hand are enough to get us through until that time.

Projections are estimates that come from the information available at the time of the projections. Like all plans, the key to sustained fiscal health is to continually monitor and adjust as actual experience changes or new information comes to light. Council reviews the financial strategy as part of the strategic planning process and again as part of the budget process, setting forth the plan for the City's continued fiscal health. This course setting by Council, coupled with the consistent monitoring, analyzing and adjusting by staff has led the City through the worst economic downturn since the Great Depression. Continuing this teamwork on the path defined by the Council's

Comprehensive Strategic Plan will help effectively focus resources and will result in sustained financial health.

Atascadero

Comprehensive Financial Strategy
January 2013

Section 2- Significant Revenues

Significant Revenues

General Fund is the City's primary operating fund, providing resources for most of the City's ongoing activities including police, fire, parks, recreation and general government. It is this fund that the Council has the most discretion in directing expenditures and accomplishing Council priorities. For many years, the City's top three General Fund revenues were 1) Property Tax revenue, 2) Sales Tax revenue, and 3) Development Fee revenue, in that order. However, times have changed, and with the effects of the economy and the California State Legislature, Development Fee revenue is no longer one of the top three revenues sources in the City. Property Tax and Sales Tax, while they have evolved over the years, still maintain the top two positions for percentage of General Fund revenue. This section will review both of these income sources in detail, as well as other important, but smaller, revenue sources.

Property Tax Revenue

The City of Atascadero currently receives 40% - 45% of its general fund revenues from property tax revenues.

WHAT ARE PROPERTY TAX REVENUES?

Property tax revenues are taxes imposed on real property (land and permanently attached improvements) and tangible personal property (movable property). The tax is based on the value of the property rather than on a fixed amount or benefit to the property or person. Proposition 13 (Article XIIIA of the State Constitution) limits the real property tax rate to 1% of a property's assessed value, plus rates approved by the voters. The amount of the tax is based on an annually determined assessed valuation. The property tax is paid to the county tax collector and allocated to local taxing agencies pursuant to a statutory allocation formula. The property tax is guaranteed by placing a lien on the real property.

The City of Atascadero participates in the Teeter Plan. This means that the City of Atascadero receives its entire amount of the property tax levy regardless of whether or not the tax has been paid to the County. In exchange, the County is entitled to all future penalties and interest collected on the levy.

In order to understand property taxes, it is important to understand assessed value. Proposition 13 calls for a base year assessed value to be established when the property undergoes a change of ownership (typically a sale) or when new construction occurs.

After the base year value is established, the value is factored annually for inflation, which is the lesser of the change in cost of living or 2%. The assessed value may also be adjusted by a Proposition 8 factor. Proposition 8 requires the Assessor to value the property at the lesser of the base year value indexed by inflation or the fair market value. A significant number of property values were written down to market value over the past several years. As the housing market recovers, the assessed value is adjusted back up to the lower of the new fair market value or the original base value adjusted annually for inflation. The table below illustrates how assessed value would be calculated for a fictional property.

EXAMPLE OFASSESSED VALUE FOR FICTIONAL HOME

Date	Description of Changes in Assesssed Value	CCPI Factor	Inflation Factor	Base Value [1]	Fair Market Value (FMV)	Assessed Value	Percent Change[2]
1/1/X1	Market Value when Purchased	N/A	N/A	$ 300,000	$ 300,000	$ 300,000	N/A
1/1/X2	Annual 2% inflation applied	2.46%	2.00%	306,000	335,000	306,000	2.00%
1/1/X3	CCPI inflation rate applied	1.85%	2.00%	311,670	375,000	311,670	1.85%
1/1/X4	Declining Real Estate Market	2.10%	2.00%	317,904	290,000	290,000	-6.95%
1/1/X5	Slight Improvement in RE Market	4.37%	2.00%	324,262	300,000	300,000	3.45%
1/1/X6	Drastic Improvement in RE Market	2.08%	2.00%	330,747	350,000	330,747	10.25%
1/1/X7	Annual 2% inflation applied	2.08%	2.00%	337,362	360,000	337,362	2.00%
1/1/X7	Home addition adds $50,000 to base value	N/A	N/A	380,747	410,000	380,747	12.86%
1/1/X8	CCPI inflation rate applied	1.01%	2.00%	384,592	437,000	384,592	1.01%
1/1/X9	Annual 2% inflation applied	2.76%	2.00%	392,284	450,000	392,284	2.00%

[1] Base Value is calculated on lessor of CCPI or Inflation Factor

[2] Amount of Change from prior year assessment

The City receives various forms of property tax revenues each with its own distinct issues and trends as follows:

Current Year Secured - Current secured revenues make up 67% of the City's property tax revenues and are what most people think of when discussing property taxes. Assessed values are established as of January 1 of each year and taxes are paid to the Assessor in two installments, due on December 10 and April 10. As the Assessor receives the funds, they are then allocated and distributed to the various agencies, including the City. Amounts levied but not collected by the County are distributed to the City under the Teeter Plan at the end of the fiscal year.

Property Tax in Lieu of Vehicle License Fees - This revenue source grew out of a state-local budget agreement as part of the State 2004 budget package. Under this arrangement, the Vehicle License Fee (VLF) was reduced to Californians and the reduction in city and county revenues was replaced with a like amount of property taxes. Subsequent to the fiscal year 2004-2005 base year, the property tax in lieu of VLF fluctuates in proportion to the gross assessed valuation in the City.

Current Year Unsecured - Unsecured property tax is collected on items such as mobile homes that are not on a permanent foundation, machinery and equipment owned by businesses, and personal property such as airplanes and watercraft. Unsecured roll taxes are due on August 31.

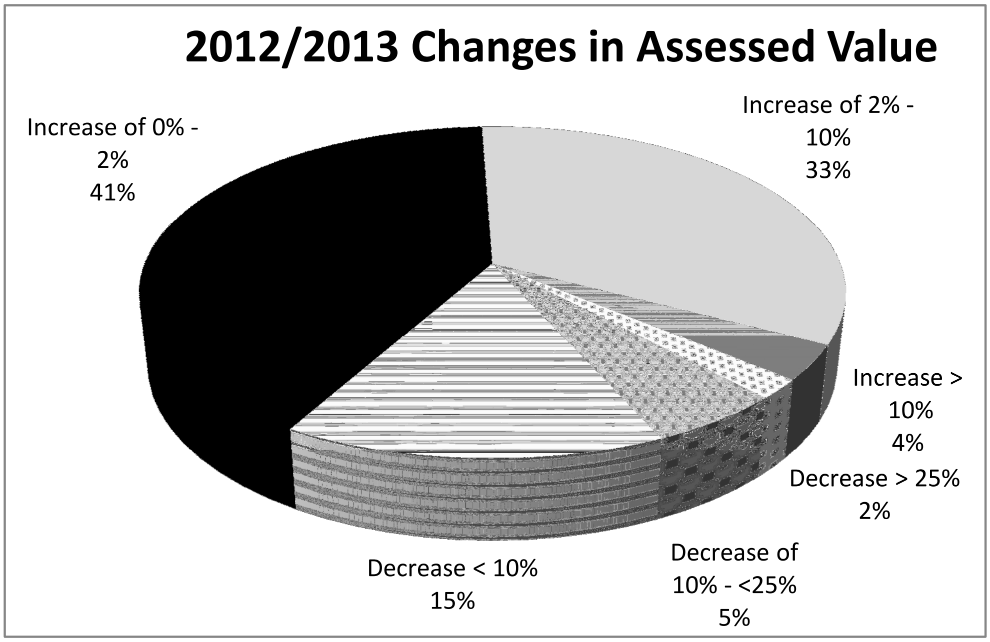
Current Year Supplemental - This property tax is an extra assessment that occurs when new construction is completed on real property or when a property changes ownership. The assessed value of the property is then increased to the current market value as of the date of the title transfer or completion of construction. Supplemental property tax is the amount due on the difference between the pre-event assessed value and the new market value of the property. Because there is a time lag between the change of ownership or completion of construction and the actual change of assessed value to the tax roll, supplemental property taxes are generally collected six months to a year or more after the event.

Redevelopment Property Tax Trust Fund (RPTTF) Distributions- This new revenue category was created as a result of the dissolution of Redevelopment. As part of the dissolution of redevelopment agencies, all revenues and assets of the former redevelopment agency that are not needed to pay to obligations of the former agency must be distributed to the taxing agencies. The City of Atascadero is a taxing agency within the former Atascadero Community Redevelopment Agency and thus is entitled to approximately 18% of the “excess” revenues and assets.

WHAT IS THE CURRENT STATUS OF PROPERTY TAXES?

Property taxes are a function of assessed value and assessed value is a function of the base year adjusted for inflation and/or the fair market value. Beginning in 2008-2009, the fair market value of many properties in the City of Atascadero had decreased below the base value adjusted by the inflation index. Each year the County Assessor examines each home or business property to determine if the market value of the home/business as of January 1st was less than the prior year assessed value adjusted for inflation. Because of the fall in market prices and as a result of this examination, the assessed values of many properties within the City have been written down.

A comparison of an assessed value database for 2011 versus the same database for 2012, shows that properties representing approximately 22% of 2011 assessed value were written down to some degree and another 41% had an increase less than the inflation factor. Analysis of the database also shows 10% were adjusted by the inflation factor and the remaining properties were increased due to change in ownership or new construction. Large decreases to commercial properties such as the Carlton, or residential subdivisions such as Woodridge, Dove Creek and Chalk Mountain brought down the assessed values and offset much of the inflationary increase. Overall the net effect to the City's assessed value was an increase of 0.13%. Although there are still adjustments downwards on some properties, the very modest increase seems to indicate that things are starting to turn around.



According to the County, median home prices in the County are up 4.4% over the same time last year. The median home price is the median price of homes being sold and is therefore a function of both the value of real estate and number of high end versus low end properties being sold. In discussing the real estate trends with local professionals, the consensus seems to be that residential values are remaining somewhat consistent; however the amount of inventory and the number of days on the market are both shrinking.

It appears that while the residential assessed values have stabilized, there are still some commercial property Proposition 8 write-downs that are still making their way through the system. In discussions with the County, they are currently assuming that commercial write-downs may reduce the assessed base by as much as 0.5%.

Atascadero Single Family Residence
Median Home Prices
SLOWatch.com

Date	Atascadero SFR Median Home Price
November 2012	$ 321,500
2011	302,500
2010	344,000
2009	375,000
2008	387,500
2007	520,000
2006	515,000
2005	520,000
2004	419,900
2003	359,000
2002	320,000

As stated before, assessed values are also a function of the inflation factor. The inflation factor for the 2013-2014 assessments has been released by the State Board of Equalization. The California Consumer Price Index (CCPI) increased by 3.081%, therefore the inflation factor to be used on the 2013-2014 tax roll will be 2%.

WHAT ARE PROPERTY TAX REVENUES EXPECTED TO BE FOR THE NEXT 7 YEARS?

Current Secured Property Tax

When projecting out future property taxes revenues, staff tried to consider the factors that go into assessed value: What will annual inflation factors look like? How much new construction can we expect? What will the real estate market look like?

While the inflationary factor has been published for 2013-2014, we are trying to predict what the next seven years will look like. Again economists disagree on what to expect in the coming years. While there appear to be fewer professionals touting the fear of hyper-inflation, there are still some that state it is a real fear. Others fear that yet another drop is coming, leading to a negative CCPI. The State Legislative Analyst's Office's (LAO's) California Fiscal Outlook (Attachment A) projects the state Consumer Price Index to increase between 1.7% - 2.0% in each of the next 5 years. While this is lower than the 3% CCPI that we have seen in the last two years, it is consistent with a long, slow climb out of the recession.

In large part due to the Dormant Permit Program, Atascadero is beginning to see more building activity. Projects that have been dormant such as Dove Creek, Los Lomas, Southside Villas, Oak Haven and Oak Grove 2 have all had recent building permit activity. Many of these dormant units have either recently pulled building permits or are in the process of getting permits approved. This construction activity should begin to show up in our property tax base beginning in 2014-2015. For every $1 million that we add in new construction, $10,000 a year is added in property tax.

Overall, the State's housing market is into its third year of recovery, but the recovery has been marked by a series of starts and stops. Housing trends are often difficult to predict because they are influenced by many factors including, income and employment growth, mortgage rates, affordability, tax policy and consumer confidence. That being said, the demand for housing across the State has picked up significantly from this time last year, and statewide rental rates have also picked up. These seem to indicate that this uptick in the real estate values may be more sustainable than previous false starts. While the market is beginning to turn upward, the key is still that it will be a long, slow recovery and will be years, if ever, before we see the types of markets we saw in 2007.

In its November 2012 California's Fiscal Outlook Publication, the LAO predicts that statewide assessed valuation will increase by 3.7% in 2013-2014, and an average of 5% in each of the following 4 years. Keep in mind, that the statewide average includes not just major metropolitan areas that are distinct in and of themselves, but also areas such as the Central Valley where huge decreases took place. In talking with SLO County representatives, they indicate that they are expecting much more modest growth in the San Luis Obispo County assessed values. While it is still very early in the process, County representatives suggest that a 1.5% increase for 2013-2014 with growing, but modest, increases for future years would be a reasonable yet conservative estimate.

When refining property tax for the budget and projecting what the real estate market may hold, staff will continue to consult with experts including; real estate professionals, mortgage banks, economists, and the Community Development Department.

RPTTF Distributions:

Although most of the discussion above has related to current secured property tax, the RPTTF distribution revenues will have a significant effect on 2012-2013 revenues. The original legislation required that tax increment amounts that were over and above the amounts needed to pay for obligations of the former RDA (pass-through, administration, debt service, enforceable contracts) would be distributed to the taxing agencies twice a year. Because of the debt service commitments of the former RDA, this is estimated to be around $300,000 a year and will grow as property tax within the former RDA grows. The City will receive over 18% of these funds.

In June 2012, AB 1484 was passed by the State. AB 1484 requires that cash, and other liquid assets that were on hand as of June 30, 2012, had to be distributed to the taxing agencies by specific deadlines. These deadlines, the estimated amounts to be paid by the former RDA, and the estimated amount to be received by the City are below:

DOF Review Due Date	Amount to be distributed to taxing agencies	Estimated **City** share of distribution
November 9, 2012	$ 3,947,024	$ 740,000
April 1, 2013	$ 6,152,801	$ 1,150,000
Total Due Diligence Review Distributions	$ 10,099,825	$ 1,890,000

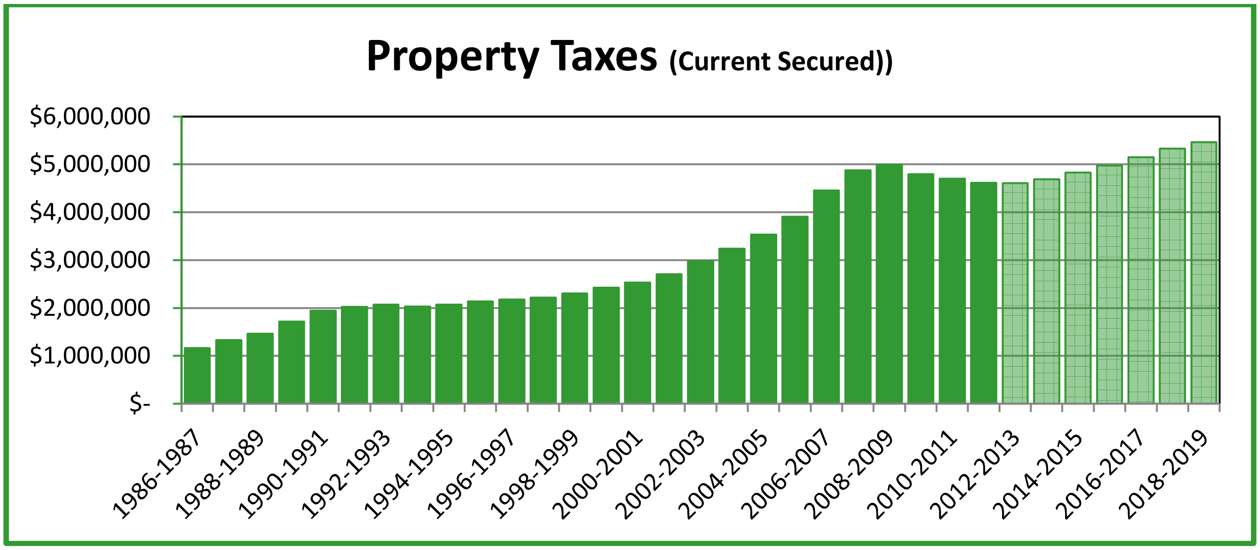
This means that in 2012-2013, the City will be receiving the estimated $1,890,000 in Due Diligence Review Distributions as shown above, plus its share of the annual distributions. While this is a significant amount of revenue, it is not unexpected. At last year's Council strategic planning session, the Council looked at all of the programs and projects that had been funded by the RDA, and the impact on the City's general fund of each of those programs/projects. Once Council had reviewed each program and decided which programs/expenditures to keep and which to eliminate, it was estimated that there would be a $459,000 annual net expenditure to the General Fund. It was also decided that distributions the City received from the former RDA would be banked (or put into reserves) in order to continue to fund these programs for the next 4-5 years. This would allow the City time to make slow adjustments for the loss of RDA funding.

Assumptions

Assumptions that went into the projected property tax revenues were as follows:

- 2012/2013- Assumed that Current Secured, Redevelopment Agency Pass-Through, and Property Tax in Lieu of Vehicle License Fees are equal to the amounts estimated by the County Auditor's Office in their letter dated September 14, 2012. Current Year Supplemental revenues are expected to come in below budgeted levels, while Current Unsecured revenues are expected to come in at budgeted levels. RPTTF Distributions are expected to come in at over $2.1 million.
- 2013/2014- Assumes that all properties are increased by the 2% annual inflation factor. Proposition 8 adjustments for residential properties are not expected to play a large factor in the tax base either upward or downward; however Prop 8 adjustments downward for commercial properties are expected. Because Atascadero has a smaller commercial base with lower assessed values, it is expected that the City will not be hit as hard as others in the County. Current Year Supplemental is expected to increase slightly as the real estate market continues to move, and Current Unsecured revenues are expected to be flat. RPTTF Distributions are expected to drop down to $57,000.
- 2014/2015- Assumes that a positive inflation factor of 2% is again applied to all properties. Also assumes that the new construction that the City is starting to see will add approximated $8,000,000 - $10,000,000 in assessed value. Current year supplemental will continue to grow with development and RPTTF will grow slightly with the tax base in the former RDA area.
- 2015/2016- Assumes a positive inflation factor with a modest bump up for properties written down due to Prop 8 adjustments. Assumes some continued growth due to new construction. Overall, current secured rolls are increased by 3% and supplemental rolls continue to recover.
- 2016/2017- Assumes a positive factor with a stronger adjustment for increases in fair market value of homes with remaining Prop 8 adjustments. New construction recovers to levels seen in the late 1990's and overall assessed values increase by 3.5%. As homes move, supplemental rolls continue to increase.
- 2017/2018- Very similar assumptions to 2016/2017. Assumes a positive inflation factor with more adjustment for increases in fair market value of homes with remaining Prop 8 adjustments. New construction remains good, but not booming. Overall assessed values increase by 3.5%.
- 2018/2019- Assumes a 1% inflation factor with adjustment for additional construction and increases in fair market value. Overall assessed values increase by 2.5%

	Actual 2011/2012	Estimated 2012/2013	Estimated 2013/2014	Estimated 2014/2015	Estimated 2015/2016	Estimated 2016/2017	Estimated 2017/2018	Estimated 2018/2019
Property Tax (Current Secured & VLF)	$ 4,614,425	$ 4,610,500	$ 4,691,180	$ 4,831,910	$ 4,976,860	$ 5,151,050	$ 5,331,330	$ 5,464,610
Property Tax In Lieu of VLF	2,107,168	2,111,700	2,148,650	2,213,110	2,279,500	2,359,280	2,441,860	2,502,910
RDA Dissolution Distributions	41,254	2,117,810	57,370	70,130	83,760	97,070	114,590	120,000
Other Property Taxes	168,673	156,400	176,400	207,660	229,570	252,160	274,800	276,150
TOTAL	$ 6,931,520	$ 8,996,410	$ 7,073,600	$ 7,322,810	$ 7,569,690	$ 7,859,560	$ 8,162,580	$ 8,363,670



Sales Tax Revenue

The City of Atascadero currently receives 15% - 20% of its general fund revenues from sales and use tax based revenues.

WHAT ARE SALES AND USE TAXES?

Under the California Sales and Use Tax Law, the sale of tangible personal property is subject to sales or use tax unless exempt or otherwise excluded. Sales tax is imposed on all retailers for the privilege of selling tangible personal property and is measured by the retailer's gross receipts. Use tax is imposed on the purchaser of tangible personal property from any retailer for storage, use or other consumption in California. Effective January 1, 2013, the base sales tax rate in California is 7.5% and is made up of the following:

Rate	Jurisdiction	Purpose	Authority
3.6875%	State	Goes to State's General Fund	R & T 6051, 6201
0.2500%	State	Goes to State's General Fund	R & T 6051.3, 6201.3 (Inoperative 1/1/01 – 12/31/01)
0.2500%	State	Goes Towards State's Fiscal Recovery Fund, to pay off Economic Recovery Bonds (2004)	R & T 6051.5, 6201.5 (Operative 7/1/04) ("Triple Flip")
0.5000%	State	Goes to Local Public Safety Fund to support local criminal justice activities (1993)	Section 35, Article XIII, State Constitution
0.2500%	State	Goes to State Education Protection Account	Section 36, Article XIII, State Constitution (Operative 1/1/13 to 12/31/16)
0.5000%	State	Goes to Local Revenue Fund to support local health and social services programs (1991 Realignment)	R & T 6051.2, 6201.2
1.0625%	State	Goes to Local Revenue Fund 2011	R & T 6051.15, 6201.15
1.00%	**Local**	0.25% Goes to county transportation funds	R& T 7203.1
		0.75% Goes to city and county operations	**R& T 7203.1 (Reduced from 1.00% to 0.75% on 7/1/04 as part of "Triple Flip")**

7.50%	State / Local	Total Statewide Base Sales and Use Tax Rate	

Local jurisdictions may adopt an additional use tax such as the 0.5% sales tax recently passed by the City of Paso Robles (effective April 1, 2013). These funds go directly to the city and are not shared with the State. The City of Atascadero does not have any of these additional use taxes and customers within the City pay the State base tax rate of 7.5%. With the recent passage of E12 in Paso Robles, all other incorporated cities within the County have/will have an additional 0.5% local tax and purchasers within those cities pay 8.0%.

Sales and Use Tax revenues for the City are made up of two separate and distinct components: *Sales Tax* and *Sales Tax in Lieu*. As the chart above shows, the City receives 0.75% in sales tax on each taxable transaction that occurs in the City of Atascadero. (This is the *Sales Tax* component.) Prior to July 1, 2004, the City received 1.00% in sales tax, however in 2004, the State Legislature adopted the "Triple Flip" legislation which in essence reduced the City's sales tax revenue by 0.25% and gave a *Sales Tax in Lieu* component. *Sales Tax in Lieu* funds are taken from the County's ERAF funds (property taxes) and distributed to the City. Although these funds are property taxes, the amount is based on sales tax figures and State accounting guidelines require the City to report them under sales and use taxes.

Sales Tax is distributed to the City by the State in monthly installments which lag significantly behind the period in which the sales occur. This chart illustrates payments that the City received for the second calendar quarter of 2012 (April – June). The monthly payments are beneficial to cash flow, but until the end of payment period (in this case late September), the payments are a reflection of statewide formulas and not necessarily a reflection of the City's actual sales.

SALES TAX DISTRIBUTION CALENDER
April - June 2012 Sales

Date	Amount	Receipt Description
06/22/12	$ 166,700.00	30% of the estimated sales tax for April- June
07/18/12	$ 166,700.00	30% of the estimated sales tax for April- June
08/22/12	$ 222,200.00	40% of the estimated sales tax April - June
09/26/12	$ 64,434.71	Positive or negative adjustment for the difference between the actual sales tax for April- June and the amounts distributed in June - August
	$ 620,034.71	Total Sales Tax April - June

Sales Tax In Lieu Funds are distributed twice annually and lag even further behind, since they are based entirely on state estimates until the following fiscal year. Each year the State estimates the amount of taxable sales in the City for the upcoming year and multiplies that figure by 0.25%. The amount is then forwarded to the County for distribution in 2 equal payments in January and May. The following year, the State compares the amount of *Sales Tax in Lieu* distributed to the city to the 0.25% of actual taxable sales within the City. The following year's distribution is adjusted upward or downward accordingly by the difference.

SALES TAX IN LIEU DISTRIBUTION CALENDER

Date	Amount	Receipt Description
01/10/12	$ 376,428.00	50% of the estimated sales tax for April 2011 - March 2012
05/10/12	$ 376,428.00	50% of the estimated sales tax for April 2011 - March 2012
01/10/13	$ 17,458.76	50% of the positive or negative adjustment
05/10/13	$ 17,458.76	amount for the difference between actual sales
	$ 787,773.52	Total Sales Tax in Lieu Fiscal Year - 2011/2012 Sales

HOW IS SALES TAX HANDLED ON INTERNET PURCHASES?

Under federal law, states cannot require businesses without an in-state physical presence to collect taxes on behalf of the consumers. This means that the State can require internet retailers with sales offices, stores or warehouses in the state of California to collect taxes on your internet purchase. The tax from these purchases are then allocated to the jurisdiction where the sales office, store or warehouse is located, not to the jurisdiction where the product was purchased or delivered (your home).

Internet retailers without a physical presence in the State are not required to collect sales tax; however the consumer is required to pay a use tax on the purchase. California state law requires that consumers that purchase personal tangible property (anything from shoes to boats) from out of State are liable for use tax on that purchase at a rate equivalent to the sales tax. So if last year you purchased a book from amazon and did not pay taxes at the time of purchase, state law requires that you report that purchase on your income tax return and remit the use tax to the State at that time. The use tax is then allocated to the State or County pools as appropriate.

The State is currently cracking down on use tax reporting and there have been multiple proposals to close internet sales loopholes; however both the State and City continue to lose much needed sales tax to internet purchases.

WHAT IS THE CURRENT STATUS OF SALES TAX REVENUES?

Representatives from the City's sales tax consulting firm, The HDL Companies, visited the City in early January to go over sales tax information for the July-September quarter. (Attachment #B is a copy of the quarterly report for that sales period.) Overall, the state experienced an increase of 6.6% in sales tax revenues on an adjusted basis compared to the same quarter in 2011. HDL commented that statewide:

> *"Gains in all seven of HDL's key economic groupings confirm that California's economy continues to mend, Statewide local sales and use tax revenues from transactions occurring July-September 2012 were 6.0% higher than the same quarter in 2011 after onetime accounting and reporting aberrations are factored out. The continued strong demand for new autos exceeded analysts' expectations and generated about one-fourth of the adjusted statewide increase. Restaurant sales posted another strong quarter with receipts 6.6% higher than the same period one year ago. Use tax from the development of solar energy projects and a modest recovery in some categories of building and construction materials also contributed to the rise."*

The City's sales tax revenues were up 17.3% or $117,000 on a cash basis compared to the same quarter of the prior year. A large portion of the increase was due to a timing difference in the receipt of Home Depot sales tax. This quarter's receipts included two Home Depot quarters. Staff has been told to expect no allocation from Home Depot in the next quarter, so overall the City will end up whole for the fiscal year; however the third quarter receipts are inflated.

On an adjusted basis, the City was up a healthy 4.9% over the third quarter of the prior year. As shown in the chart below, the City was either up or flat in each of the seven major industry groups.

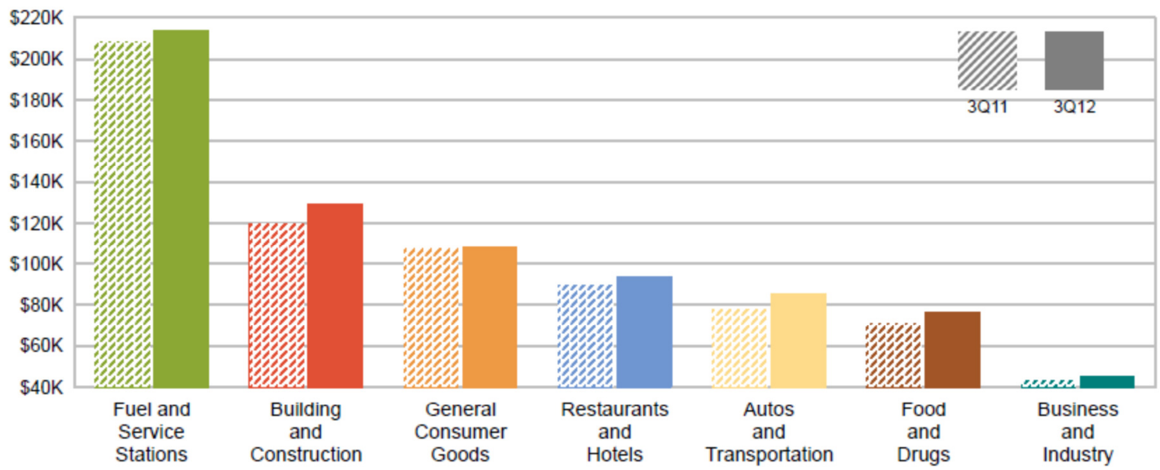
HdL COMPANIES ADJUSTED FOR ECONOMIC DATA

CITY OF ATASCADERO

MAJOR INDUSTRY GROUPS

Major Industry Group	Count	3Q12	3Q11	$ Change	% Change
Fuel and Service Stations	20	213,784	208,206	5,578	2.7%
Building and Construction	62	129,269	119,571	9,699	8.1%
General Consumer Goods	443	107,783	107,115	668	0.6%
Restaurants and Hotels	86	93,644	89,200	4,444	5.0%
Autos and Transportation	101	85,312	78,077	7,235	9.3%
Food and Drugs	24	76,593	70,753	5,840	8.3%
Business and Industry	263	44,913	43,089	1,824	4.2%
Transfers & Unidentified	0	0	0	0	-N/A-
Total	999	751,298	716,011	35,287	4.9%

3Q11 Compared To 3Q12



Fuel and service stations are now the largest sector of Atascadero sales tax, accounting for over $200,000 a quarter. Sales tax from fuel prices has been very volatile in California for the last few years. While HDL is predicting a flattening of the price per gallon in 2013-2014, they are also predicting that the number of gallons sold will continue to decline. As shown in Attachment C- *HDL's California Forecast: Sales Tax Trends and Economic Drivers*, sales tax from fuel and service stations is predicted to decline by 6% in 2013-2014

The building and construction industry continues to be a large contributor to the sales tax base for the City. Statewide, HDL is predicting a 5% growth in this sector. While the recent loss of DeCou Lumber and Grisanti's Hardware has hurt the sales tax base, other City sales tax figures seem to indicate that impacts from the opening of Lowes in Paso Robles and the downturn in construction have run their course. The City is beginning to see upticks in the overall Building and Construction sales tax base.

Sales tax from restaurants and hotels continue to show healthy growth coming in at 5% over the same quarter last year, with continued predicted growth in 2013-2014.

WHAT ARE SALES TAX REVENUES EXPECTED TO BE FOR THE NEXT 7 YEARS?

Sales tax is arguably the most volatile of the major revenues and is therefore the hardest to project in the seven-year revenue projection. When looked at as a whole, sales tax is closely tied to state and national indicators such as consumer confidence, availability of money, savings rates and other trend projections. It can be assumed that a portion of the City's sales tax may follow State projected trends. While State revenue projections are muddied by the recent passage of Proposition 30, the LAO is predicting growth in underlying sales for each of the next 2 years and an annual average growth rate of 4.6% for 2015-2018.

SALES TAX HISTORICAL INFORMATION

	Sales Tax*	% Increase / (Decrease)
1986/87	1,249,744	-
1987/88	1,390,245	11%
1988/89	1,525,468	10%
1989/90	1,802,531	18%
1990/91	1,781,580	-1%
1991/92	1,735,019	-3%
1992/93	1,838,041	6%
1993/94	1,790,118	-3%
1994/95	1,911,413	7%
1995/96	2,152,371	13%
1996/97	2,107,947	-2%
1997/98	2,354,859	12%
1998/99	2,364,647	0%
1999/00	2,721,805	15%
2000/01	3,020,604	11%
2001/02	3,441,717	14%
2002/03	3,682,751	7%
2003/04	3,501,198	-5%
2004/05	3,502,730	0%
2005/06	4,187,215	20%
2006/07	3,839,895	-8%
2007/08	3,535,322	-8%
2008/09	3,003,500	-15%
2009/10	2,681,642	-11%
2010/11	2,891,697	8%
2011/12	3,181,317	10%

*For consistency with figures prior to the triple flip, the adjustment for sales tax in lieu is reported in the fiscal year in which the underlying sale took place.

If the City of Atascadero had the same mix of business, the State projections could simply be used. The City of Atascadero, however, is unique and does not have the wide tax base that the State of California has as a whole. For instance, during the recession, a significant number of consumers put off large purchases such as new vehicle purchases. With the recovery, the state is saw a 35% increase in new car sales from 3rd quarter 2012 compared to 3rd quarter 2011. The City of Atascadero does not have a large new car dealership base, therefore we must look to other indicators.

The past may be looked at to predict what our recovery may look like. Unfortunately, there is one thing that most economists agree on and that is that this downturn in the economy is unlike any other, and looking to past downturns and recoveries to predict what this economy may do is not going to work. That doesn't mean however that there is not value in looking at past sales tax figures to understand what it is that the City has experienced in the last several years. For example, the chart at the left indicates that sales tax dropped almost 36% from the high of fiscal year 2005/2006 to the low of fiscal year 2009/2010. Sales tax has since recovered to a level slightly above the 2000/2001 sales tax in real dollars.

The most critical component of the projections must be: what is the unique business mix here in Atascadero and the Central Coast? Which businesses are building? Which are closing? Which sectors are strong in Atascadero? Where are competitors opening? What are local businesses expecting? What are the trends in businesses here in Atascadero?

In order to update the sales tax projections for the next few years, staff met with HDL sales tax experts, looked at projections from the LAOs office, met with selected business owners in town, discussed building trends, and looked at the expected effects of Council's current economic development policies and strategies. Over the next few months, staff will continue meet with experts and refine sales tax revenue projections.

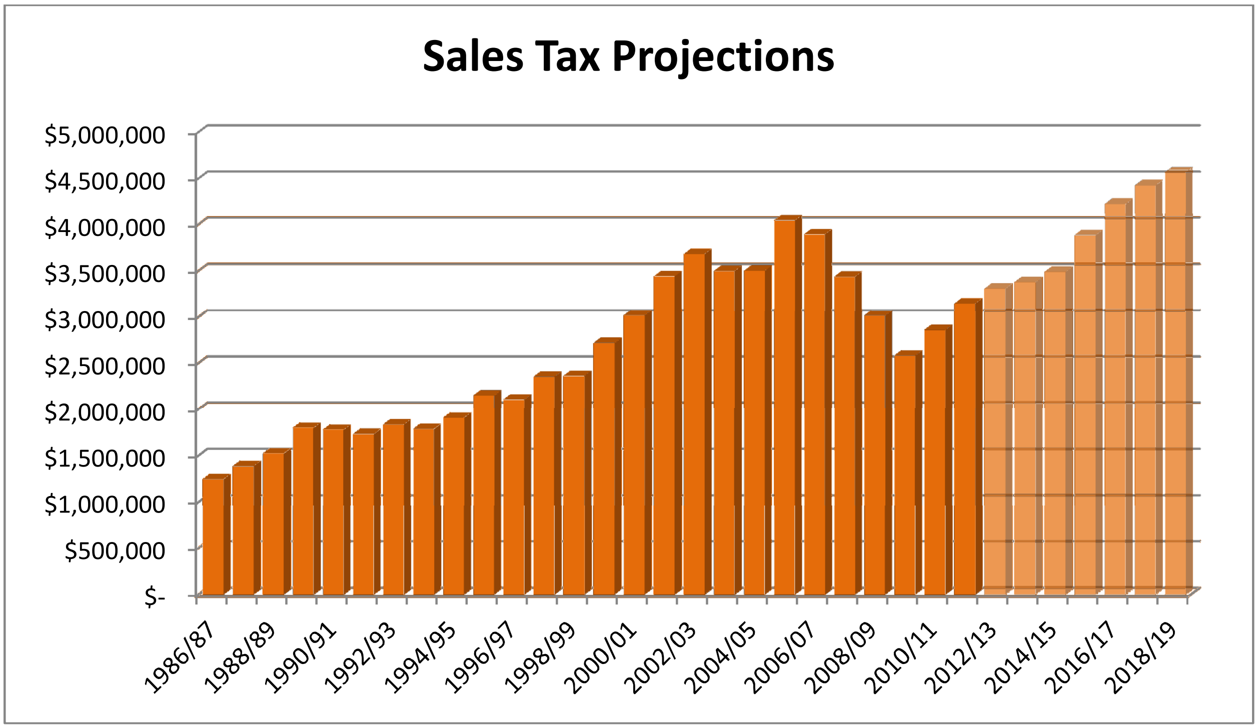
Current assumptions that went into the projected sales tax revenues were as follows:

- 2012/2013- Estimated a conservative underlying growth of 1.5% for the other three quarters with an added positive adjustment for changes at the Vons shopping center.
- 2013/2014- Assumed a continuing recovery with underlying sales tax growth between 2.0% and 2.5%. Added positive adjustments for final quarters of changes at the Vons shopping Center.
- 2014/2015- A modest 3% underlying growth spurred by growing consumer confidence, completion of fall-out from fiscal cliff changes, and Atascadero's efforts on economic development.
- 2015/2016- Addition of WalMart in the fourth quarter of 2015 and additional revenues from development of properties such as the Hoff property.
- 2016/2017- Assumed continued modest growth with positive additions for 1 quarter of WalMart, plus beginning revenues from the Annex and WalMart outlots.
- 2017/2018- Assumed a strong underlying 4% growth as consumers feel the recession is a thing of the past and the City's economic development program continues to make Atascadero a player in future business development.
- 2018/2019- Assumes strong underlying growth with fewer positive adjustments as unknowns are further into the future.

As with all projections, these assumptions are based on the information, policies and actions that are in place today. Changes in Council or State policies and/or additional information could and should adjust these projections. Staff will continue to monitor and update projections as things evolve.

PROJECTED SALES TAX REVENUES
As of Janaury 2, 2013

	Actual 2011/2012	Estimated 2012/2013	Estimated 2013/2014	Estimated 2014/2015	Estimated 2015/2016	Estimated 2016/2017	Estimated 2017/2018	Estimated 2018/2019
Sales Tax	$ 2,393,544	$ 2,462,000	$ 2,550,000	$ 2,630,000	$ 2,999,000	$ 3,215,000	$ 3,343,000	$ 3,440,000
Sales Tax In Lieu	$ 756,068	849,070	831,000	861,400	888,000	1,013,000	1,086,000	1,129,000
Total	$ 3,149,612	$ 3,311,070	$ 3,381,000	$ 3,491,400	$ 3,887,000	$ 4,228,000	$ 4,429,000	$ 4,569,000



Other Revenue

Property tax and sales tax account for over 60% of the City's general fund revenues, however there are a couple of other significant revenues that should be discussed.

FRANCHISE FEES

The City receives around $1,000,000 dollars a year from franchise fees. These are a tax charged on cable, electric, garbage disposal, gas, wastewater, recycling and Chicago Grade. These fees are based on the revenues collected by each of the entities charged. These revenues have remained fairly flat over the years and are expected to remain flat. Predicted increases in garbage disposal and electricity franchise fees are expected to be mostly offset by decreases in cable franchise fees and gas franchise fees.

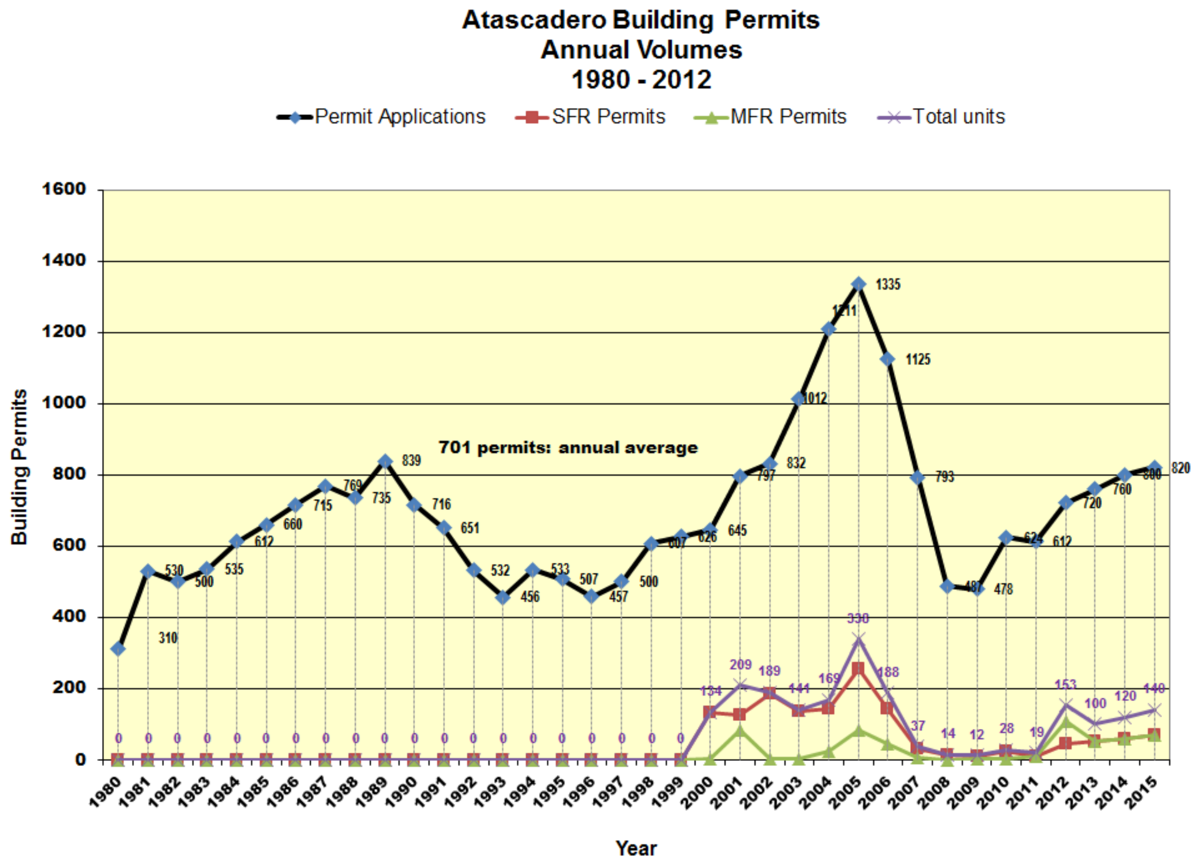
TRANSIENT OCCUPANCY TAX (TOT)

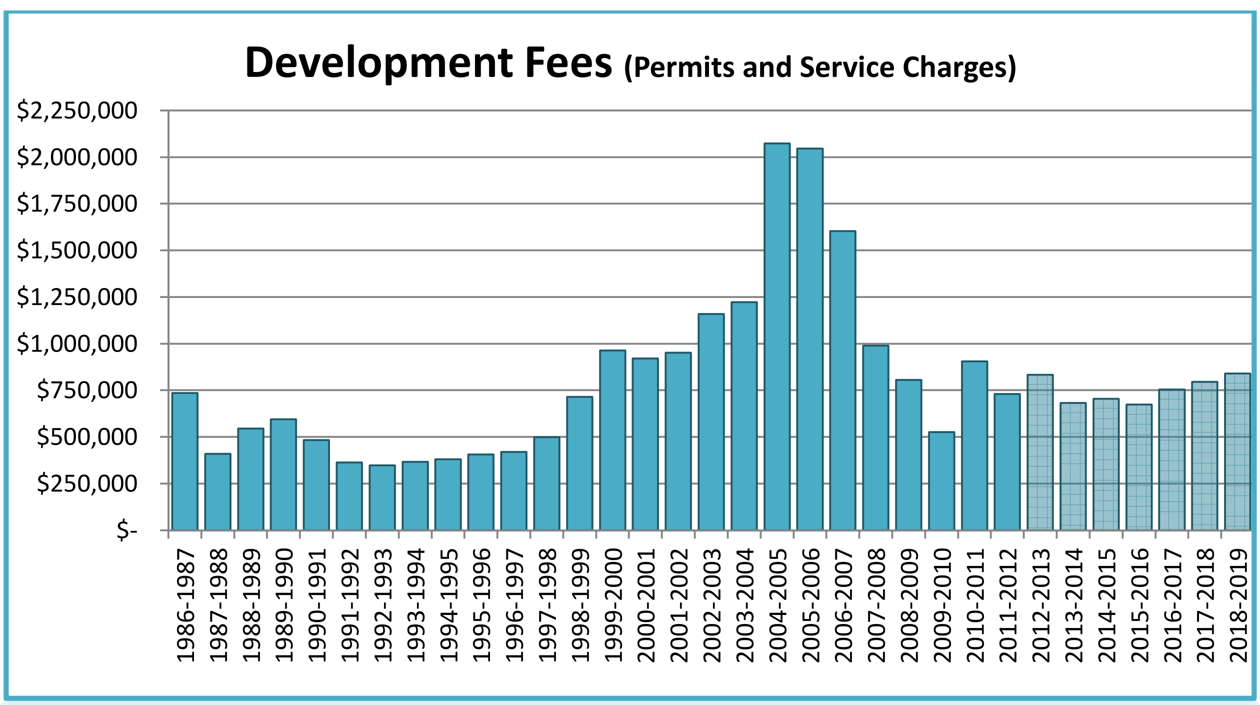
TOT is collected from guests staying at hotels within the City. The City has recently seen significant increases TOT revenues and with the Council's emphasis on promotion and economic growth, these increases are expected to continue. Included within the Seven Year Projection, are modest continued increases, along with the addition of a 90 room hotel in fiscal year 2014-2015. The City agreement with the Chamber of Commerce pledges 6.5% of the TOT collected to the Chamber and 10% of the TOT collected is pledged to tourism promotions. The related costs are also included in the projections.

BUILDING PERMIT ACTIVITY

Over the past decade, building permit activity in Atascadero has been rather volatile, reflecting the real estate boom and bust that occurred nationally. In 2005 the City received 1335 building permit applications and issued permits for 330 housing units. By 2009, overall permit activity dropped to 478 permits with only 12 housing permits issued. Since the bottom in 2009, permit activity has been steadily increasing with a forecast of 720 permit applications and 153 units approved by the end of the current fiscal year.

Looking forward, permitting activity is expected to remain steady though 2015. There is a backlog of 440 dormant housing permits, the Spring Hill Hotel, and the Walmart / Annex projects that are all expected to pull permits within the next three years. Staff is forecasting that annual permit activity will average 780 permit applications with 120 housing units per year. This will produce revenues similar to what the City saw in the late 1990's around $700,000 - $750,000 annually for all permits, planning, inspection and public works fees.


Atascadero Building Permits
Annual Volumes
1980 - 2012
Permit Applications
SFR Permits
MFR Permits
Total units
701 permits: annual average
Building Permits
Year


Development Fees (Permits and Service Charges)

OTHER FEES FOR SERVICE

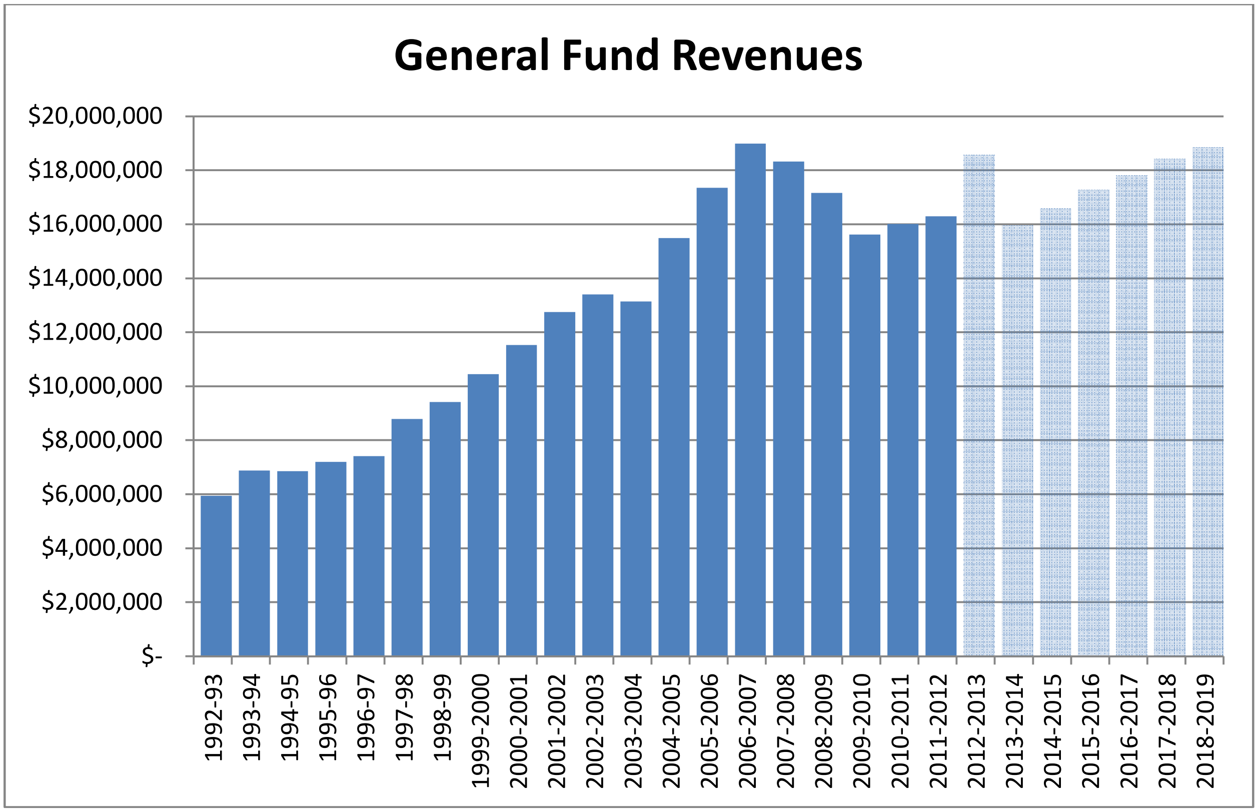
The City also receives over $1.2 million a year in various fees for other services. These fees include many items, including items such as zoo admissions, pavilion rentals, softball fees, park rental charges, weed abatement charges, and vehicle release fees. The assumptions for these revenues have been flattened from previous projections. Previous projections included expected rate increases to cover increased cost of providing services. Because of the tough economic times, the City has not brought forth fee increases, concentrating on keeping these services affordable. While this does keep these services affordable, it increases the tax subsidy to these service programs and erodes other City services typically paid for through taxes. The balance between maintaining service levels and maintaining affordability is a tough policy question that the Council will need to continue to address.

INTERFUND REVENUES

The 2012-2013 included over $1.6 million in interfund revenues. These are typically charges to other funds and departments within the city for services provided by the General Fund (such as legal, finance, capital project management, grant administration, affordable housing services, etc…). Staff has found it more efficient to allocate these charges out as Administrative Fees rather than charging a small portion of each support employee's time or a portion of each invoice to each fund directly. Interfund revenues are projected to come in almost $300,000 below previous projections due to the loss of redevelopment and reductions in future capital projects.

<u>Overall</u>

The overall revenue projections show a long slow climb in revenues over the next seven years. In 2006-2007, the City received $19.1 million in General Fund Revenues. Based on the current seven year projection, the City is not expected to see that level of revenues again until 2019-2020. While this may seem daunting, the long slow increases being projected seem more sustainable in the long run when compared to the meteoric rise that the City saw from 2003-2004 to 2006-2007.


General Fund Revenues
$20,000,000
$18,000,000
$16,000,000
$14,000,000
$12,000,000
$10,000,000
$8,000,000
$6,000,000
$4,000,000
$2,000,000
$-
1992-93
1993-94
1994-95
1995-96
1996-97
1997-98
1998-99
1999-2000
2000-2001
2001-2002
2002-2003
2003-2004
2004-2005
2005-2006
2006-2007
2007-2008
2008-2009
2009-2010
2010-2011
2011-2012
2012-2013
2013-2014
2014-2015
2015-2016
2016-2017
2017-2018
2018-2019

Atascadero

Comprehensive Financial Strategy
January 2013

Section 3- Operating Costs

Operating Costs

A healthy organization needs to review inflows (revenues) and outflow (expenses) on a regular basis in order to achieve balance over the long-run. Certainly, the Council has successfully navigated this balanced path over the years by holding to the fiscal strategy of saving up a little extra in the good years to use in the down years. The effect of the economic downturn has impacted the City's ability to bring in revenues, and therefore, expense reductions have been made over the last several budget cycles to better balance the inflow and outflow equation.

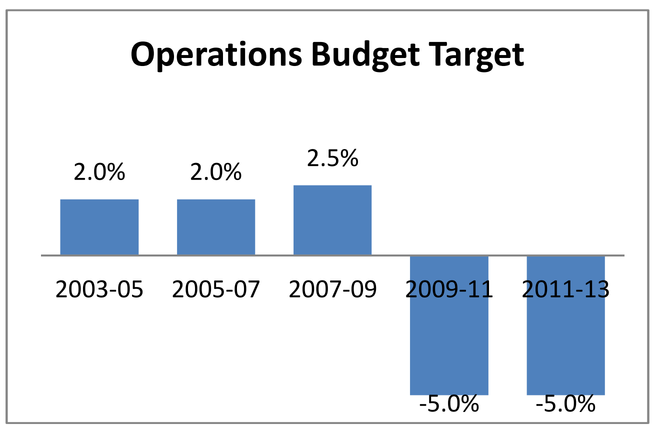
Operating costs are typically the bulk of the outflow side of the equation. Given the City's relative lack of control of the inflow side of the equation (property tax, sales tax, development revenue), operating costs are an area where the City has more control to determine its own fate.

Operating costs are typically broken into four different categories in the budget document:

- Employee Services
- Operations
- Special Programs & Projects
- Capital Projects

Each of these categories will be defined in this section, and assumption of the projected costs of each of these will be reviewed. The effective growth management of these categories is what helps the City to influence the bottom line. For the last decade and one-half, cost growth has been reasonably minimized.

Each year, as the budget is being prepared, a target is established to limit the operations expense category. Even with some expenses increasing at rapid rates, departments were targeting minimal increases of 2% and 2.5% for the budget cycles 2003-2005 through 2007-2009. For budget cycle 2009-2011, departments were asked to *cut* operating expenses by 5% in order to keep the deficit gap at a minimum. In addition, departments were asked to cut operating budgets *an additional 5%* for budget cycle 2011-2013.



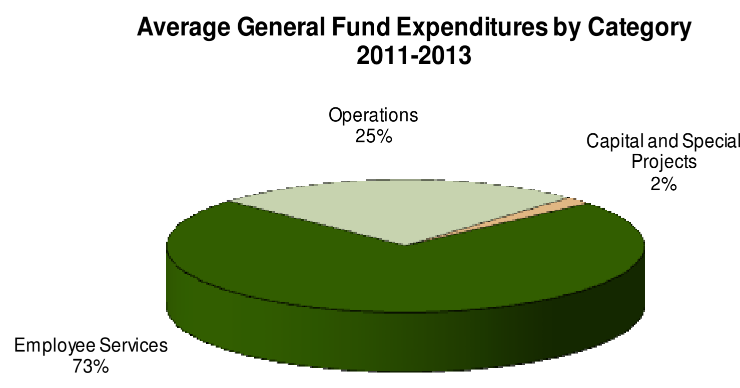
These decreases in operations were effective in closing the deficit gaps to an amount that was consistent with Council's strategic plan. Certainly these cuts were not easy, but on the short term were achievable. However, as the cost of doing business continues to rise, additional cuts or even zero growth operating budgets are unrealistic to sustain for the long-run. It will be difficult for almost all departments to stay within their 2012-2013 operating budget. Typically, there are relatively few dollars in most departments' budget that are subject to management influence. Most of the costs are either dictated (such as the county fee to collect property tax on behalf of the City) or are the costs of doing business to work toward Council goals (maintaining public safety requires gasoline in the patrol cars, whether the cost of gas is up or not.)

Beginning with the operating budget cuts in 2009-2010, the strategy to manage the decreased budgets was to lower service levels as necessary, where the services were least impactful to the public. Reducing service levels has proven to be much more difficult than imagined. Community members, Council, and employees are accustomed to a certain level of service, and changes decreasing service are difficult to accept. Therefore, instead of lessening the burden for employees by reducing service levels, the burden was increased as good-intended employees tried to maintain consistent service levels with fewer resources and less time. Certainly, Atascadero employees are dedicated to their community and committed to quality public service, but after an extended period of doing so much with limited resources, even the best employees get worn out.

EMPLOYEE SERVICES

WHAT ARE EMPLOYEE SERVICES COSTS?

Employee services are the backbone of the community. The City is a service organization, so the largest portion of General Fund expenditures is dedicated to employee services. In fact 73% of general fund expenditures go directly toward the cost of employee services. It is critical that the significance of this component to the budget is well understood since it plays such a major role.



Employees are grouped into 6 different categories or bargaining units. (Atascadero Police Association, Atascadero Firefighters Bargaining Unit, Local 620 Service Employees International Union, Mid Management / Professional Employees, Non-Represented Professional and Management Workers and Confidential Employees, Non-Represented Part-time employees.) Salaries and benefits for each of the four represented bargaining units are set forth in Memorandums of Understanding (MOUs). Pay and benefits for Management and Confidential employees are governed by a resolution of the Council and pay for part-time employees are governed by administrative policy.

The following are the general categories of labor cost that are found in the City's budget:

- *Salaries*- This base pay figure for full-time City employees represents 60% of the City's total general fund labor costs.
- *Wages*- This is the pay for part-time or hourly employees such as scorekeepers, lifeguards and fire reserves. (3%)
- *Overtime*- This represents the amount paid in overtime to both full-time and part-time personnel. (4%)
- *Other Pay*- This category includes amounts paid to employees for items other than base pay. Items charged to this category include stand-by pay, holiday pay-off, uniform allowance, pay-off of vacation upon leaving the City and other similar pay types. (1.5%)
- *Benefits, Taxes and Insurance*- This category is made up of the following:
    - *Health Benefits*- Each full-time employee receives health benefits upon employment. The City contributes varying amounts towards medical insurance, dental insurance, vision insurance and life insurance. The amounts vary between bargaining units and whether coverage is for the employee only, the employee plus one dependent or for the employee and his/her family. Employees who were hired prior to September 1, 2000 are entitled to a "medical payback" stipend if they elect employee only coverage. The stipends range from \$240.56 - \$319.50 per month. Current MOUs require the City to pick up 100% of the increased health benefits cost for the employee and 50% of the increased cost for dependents annually. (10%)
    - *Retirement*- The City and City employees do not contribute to social security and are therefore required to participate in another retirement program. For part-time employees who work less than 1000 hours per year, the City contributes 5% to a FICA Substitute / Defined Contribution plan. For full-time employees and part-time employees who work more than 1000 hours a year, the City participates in CalPERS. The City is now on a three-tiered system for both sworn safety personnel and miscellaneous (non-sworn personnel) as discussed later in this Section. This is a defined benefit plan which means that the City is guaranteeing the benefit that the employee will receive upon retirement (in the case of tier 1 sworn personnel, 3% of the highest year's salary for each year of service the employee has upon retirement at age 50 or older). Contribution rates for this benefit change annually based on actuarial studies performed by PERS. (17.5%)
    - *Medicare*- The City contributes 1.45% of pay to Medicare. (1%)
    - *Workers Compensation*- The City participates in CJPIA for workers compensation coverage. Cost of workers' compensation coverage is a

formula based on payroll, the City's loss experience and the overall loss experience of CJPIA. (2%)

- *Unemployment*- the City is self-insured for unemployment through the Employment Development Department. The EDD bills the City quarterly for actual unemployment benefits paid to former employees. (0.5%)
- *Other Benefits*- There are other minor benefits afforded to employees such as the education reimbursement program and long-term disability. (0.5%)

Payroll is not just a function of salary and benefit amounts, but is also a function of the number of employees. The current budget includes funding for 116 full-time employees. With a few exceptions, part-time employees are budgeted with a lump sum dollar amount, rather than the number of employees. In fiscal year 2011/2012, 89 part-time employees worked over 36,500 hours or the equivalent of 17.5 full-time employees.

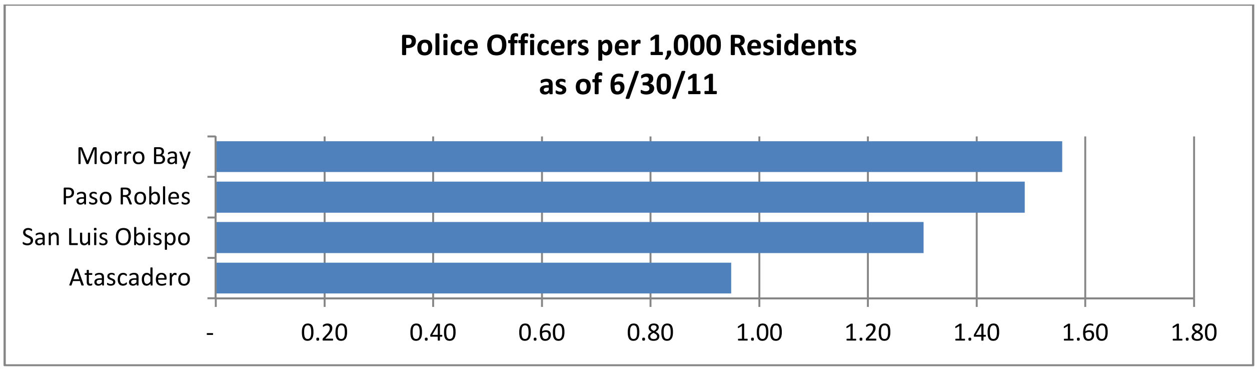
WHAT IS THE CURRENT STATUS OF EMPLOYEE SERVICES?

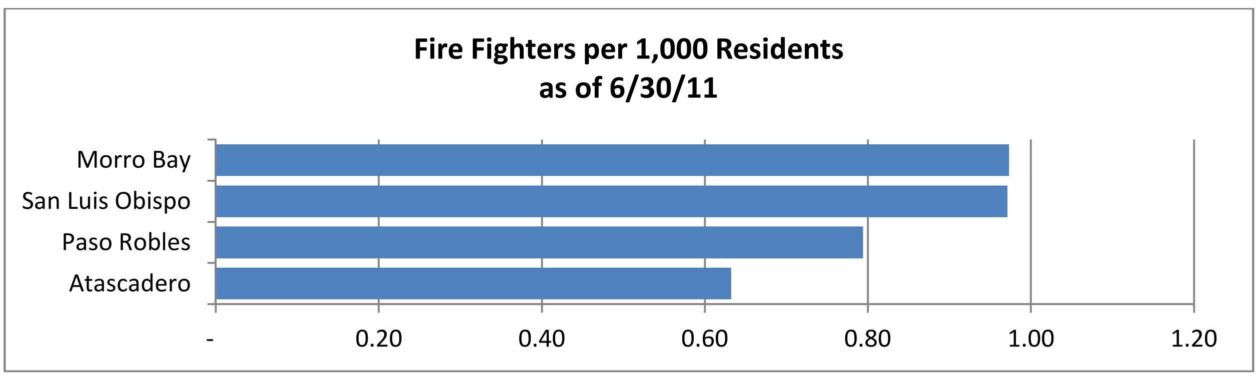
Savings in employee services have been achieved over the last few budget cycles in particular. Fifteen positions (seven of which were vacant at the time) were laid off prior to the 2009-2011 budget cycle. In addition, there is a continuing policy of hiring chills. This is a process of management evaluation for each position that becomes empty due to attrition; management takes a hard look at the position and its contribution to determine if that position is absolutely necessary in the short run.

A great example of the hiring chill analysis is illustrated in the recent staff reorganization that took place as a result of the resignation of several key employees. Management was able to look at the situation not as a loss but as an opportunity to reassess the staffing needs of the City as a whole and direct the resources where they were most strategic. As a result, three upper management positions and one inspector position were deleted and four new positions were added in key areas so there would be the hands needed to do the work as the economy begins to recover. Additionally, seven positions were reclassified for employees who have been, and will continue to, work at levels exceeding their original position requirements. After these changes were made, the City was still able to realize an annual salary savings of approximately $265,100. Certainly this is good news and it's definitely a move in the right direction, but as discussed in the Revenue Section, there is still a long road ahead and much to be addressed along the way.

Labor is one of the issues that will be of particular interest with the upcoming budget cycle and as the economy begins to turn around. There is no group of people that can do more with less than the City staff here in Atascadero. Of course budgets have always been lean, but starting with the 2009-2011 budget cycle, lean took on a whole new meaning. With the loss of the fifteen laid off positions and additional chilled positions, staff do their best to carry the load. The load does get burdensome after carrying it through several budget cycles.

Staffing continues to be a problem in all departments. This leaves many departments with minimum staffing and frustrations as coverage becomes an issue. Although other cities are experiencing similar difficulties and cutbacks, the City of Atascadero continues to lag behind other local jurisdictions when it comes to staffing level metrics. Per capita staffing for both police officers and fire fighters is low compared to surrounding cities, making it difficult to effectively staff these 24/7 operations without using excessive overtime. This situation becomes even more difficult when employees are out on vacation, are sick, or have been injured on the job.





In addition to reductions in staffing, employees are also managing the effects of reductions in operating expenses. Staff has been committed to the community through it all and has taken an active role in finding low cost solutions and alternate funding sources to pay for things. At some point, employees may become weary of doing so much with minimal resources and employee turnover could become an issue. Costs of high turnover include recruiting, testing, training, and loss of institutional knowledge. Of course, all of this affects the moral of the employee family.

Labor organizations have agreed to contribute to cost reductions by giving up cost of living salary increases for the last two budget cycles. In addition, the Fire Fighters' Union agreed to defer a scheduled salary increase, executive management agreed to a temporary salary decrease, and all employees agreed to an increase in employee pension contributions.

Recent State Pension Reform Assembly Bill 340, Public Employees'' Pension Reform Act (PEPRA), also affects City employees. This Bill went into effect on January 1, 2013. In anticipation of the upcoming reform, the Council last summer adopted pension reform that separates the City's retirement benefits into three different tiers: 1) existing employees, 2) employees hired after 7/14/12, but already part of the Public Employee Retirement System (PERS), and 3) employees hired after 1/1/13 not previously part of PERS. Each tier has a related formula that is used to calculate future benefits.

Safety			
	Tier 1	**Tier 2**	**Tier 3**
Employees Affected	Existing employees	PERS members hired after 7/14/12	Non-PERS members hired after 1/1/13
Formula	3% @ 50	3% @ 55	2.7% @ 57
Employee Contribution	4.7% of employee contribution rate	4.7% of employee contribution rate	11.5% of employee contribution rate
Salary Factor	single highest year compensation	3 year average compensation	3 year average compensation

Miscellaneous			
	Tier 1	**Tier 2**	**Tier 3**
Employees Affected	Existing employees	PERS members hired after 7/14/12	Non-PERS members hired after 1/1/13
Formula	2.5% @ 55	2.0% @ 55	2% @ 62
Employee Contribution	4.7% of employee contribution rate	4.7% of employee contribution rate	6.5% of employee contribution rate
Salary Factor	single highest year compensation	3 year average compensation	3 year average compensation

Vacation accruals are another issue to consider. Details on vacation and other leave accruals are discussed at length in Section 4 of this document. At this point, it is important to simply understand that as employees utilize more of their vacation time, there are less people to accomplish the tasks for the vacationing employees. While is some cases the work could be delayed, in most cases, the work still has to get done on schedule and/or works shifts have to be covered. At the end of the day, what this really translates into is additional overtime costs. It is projected that overtime will be an unavoidable component of spending down the vacation accrual.

The City has been on the offense regarding health care costs. Health care benefits are important to the well-being of the employee group. As health care costs continue to be on the rise, the City continues to search for efficient options to meet the employees' health care needs. As of January 1, 2013, the City switched from participating in the California State Association of Counties (CSAC) Excess Insurance Authority (EIA) insurance pool to direct paying. Under both the CSAC pool and the direct pay scenarios, Blue Shield was the provider. Overall, employee benefits under each plan remained very similar. Instead of increase in costs of about 11%, a *decrease* of about 11% was realized.

WHAT ARE EMPLOYEE SERVICE COSTS EXPECTED TO BE FOR THE NEXT 7 YEARS?

In order to project labor costs, a spreadsheet was developed which details salary and benefits for each employee. Every employee's expected labor costs were developed for each of the 7 years. Step increases and other expected pay changes as an employee moves through his/her career were built into the projections.

The projections do not, however, include a cost of living salary increase in any of the fiscal years. As the chart on the right shows, a one percent cost of living salary increase for the current employees would amount to over $110,600 of additional ongoing costs annually. This is not to say that staff is recommending a policy of no salary increases for the next 7 years. Instead, these projections are intended to illustrate that labor costs will continue to need to be a function of available funding and the market.

Annual Cost of 1% Salary Increase
Fiscal Year 2013/2014

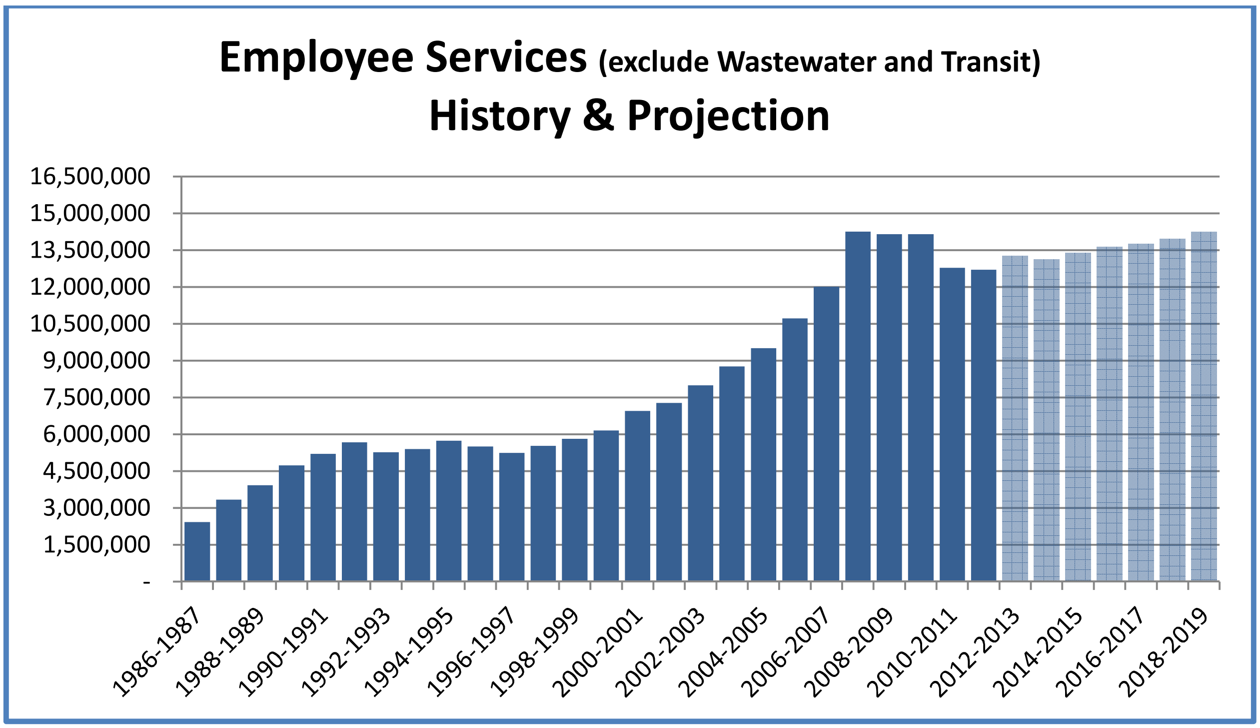
	Cost of 1%
Police	$ 33,600
Fire	24,600
SEIU	25,300
Mid Management	5,200
Management and Confidential	21,900
Total	$ 110,600

Assumptions that went into the projected employee service costs were as follows:

- <u>2013/2014</u>- Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. Assumes medical insurance costs increase by 6%, workers compensation remains flat, unemployment rates continue to decrease slightly, PERS rates for non-sworn employees increase by 0.76%% and PERS rates for sworn safety employees increase by 1.71%. PERS rates for vacant positions are assumed to be Tier 2 for most positions.
- <u>2014/2015</u>- Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. Assumes medical insurance costs increase by 6%, workers compensation remains flat, unemployment rates remain flat, PERS rates for non-sworn employees increase by 1.06% and PERS rates for sworn safety employees increase by 1.9%.
- <u>2015/2016</u>- Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. Assumes medical insurance costs increase by 6%, workers compensation remains flat, unemployment rates remain flat, PERS rates for non-sworn

employees increase by 0.5% and PERS rates for sworn safety employees increase by 2%.

- 2016/2017- Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. Assumes medical insurance costs increase by 6%, workers compensation remains flat, unemployment rates remain flat, PERS rates stabilize with increases of 0.3% for non-sworn employees and 0.5% for sworn safety employees .
- 2017/2018- Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. Assumes medical insurance costs increase by 6%, workers compensation remains flat, unemployment rates remain flat, PERS rates remain flat.
- 2018/2019- Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. Assumes medical insurance costs increase by 6%, workers compensation remains flat, unemployment rates remain flat, PERS rates remain flat.



OPERATIONS COSTS

WHAT ARE OPERATIONS COSTS?

Operations costs are expenditures related to the regular ongoing operation of the departments, including supplies, tools, utilities, insurance, contract services, and other similar expenditures.

Overall, the City has been able to keep these costs at a manageable level. There is no question that these budgets are tight, but the employees have been working hard at keeping costs down and are always looking for better and more cost effective ways to get things done. There are, however, a few areas of particular concern as the 2013-2015 budget cycle approaches:

- Regulations – while state and federal regulating agencies have good intentions with their various programs, compliance is becoming more burdensome and costly. The Air Pollution Control District, the Regional Water Quality Control Board, the National Fire Protection Association, Occupational Safety and Health Association and other similar agencies have specific requirements that the City must meet. Programs such as the Storm Water Management Plan, Groundwater Monitoring, and the National Pollutant Discharge Elimination System are just a few of the many that affect the City. The trend is toward greater regulation in a number of different areas which increases City costs for permits, monitoring, equipment replacement, training, and compliance.
- Vehicle fuel – the cost of gasoline and diesel fuel continue to be an area of concern for the City. Many City departments require vehicle fuel in order to function and perform essential tasks, regardless of the current price of fuel. Police cars, fire trucks, parks mowers, and street repair equipment would all be useless without gasoline or diesel. Staff makes an effort to be conscious of fuel efficiency when purchasing replacement equipment, but the performance demands of these types of vehicles are high, so increases in efficiency are somewhat limited.
- Water – the cost of water has been increasing in all departments. The increase is particularly severe in Parks as the department tries to find the balance between conserving budget dollars and keeping City parks green. The Parks department uses an irrigation monitoring system, Cal Sense, to conserve water as much as possible. Water costs are also affecting the Zoo and departments responsible for City buildings and landscapes.
- Animal Control – the City contracts with the County of San Luis Obispo for animal care and control services. Services provided include emergency and non-emergency response for injured and stray animals, investigative services for animal bites, abuse and neglect, sheltering and quarantine services, dog licensing, animal adoption, and other services as required either by State law or City Municipal Code. All of the incorporated cities in the county contract with SLO County for these services. The cost of the services has been growing each year. In fiscal year 2000, the annual cost to the City for these services was

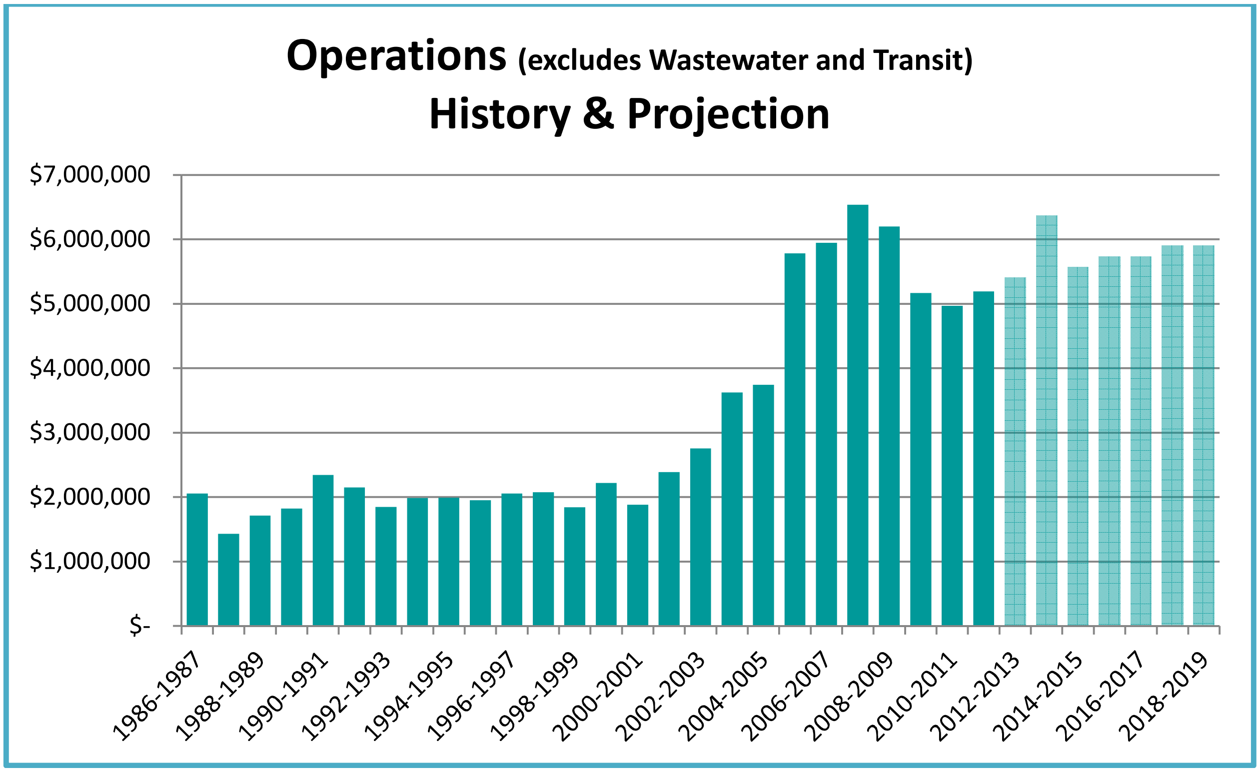
$55,000. For fiscal year 2012-2013, almost $250,000 is budgeted. Atascadero, along with the other contracting cities, was alarmed by the large annual increases in costs, and an in-depth study and analysis of the animal services being provided and the associated costs was completed in 2010. While recommended actions were implemented, the recommendations reduced costs by only 2%. However, many of the services provided by the Animal Control Department are required by law and it wouldn't be effective for the City to provide these services directly. Costs will continue to rise for these services into the future, and are largely out of the control of the City.

- CJPIA Reserve – the City is a member of the California Joint Powers Insurance Authority (CJPIA) and participates in the pooled liability insurance program. Insurance claims incurred in the pool in 2003-2005 were significant, and CJPIA determined a calculation that would charge members a portion of the costs (called a retrospective payment) over a series of years. In May 2010, CJPIA changed their methodology. They stopped charging the cities annually for the retrospective payments for fiscal years 2010-2011, 2011-2012 and 2012-2013, and determined that a lump sum shall be paid in fiscal year 2013-2014. While Atascadero recognized a temporary benefit over the last three years, these costs will experience a one-time spike up for 2013-2014 estimated at about $800,000, but then will flatten out with a more gradual upward trend in costs from 2014-2015 forward.
- Property Tax Collection Fees- A recent court case determined that the methodology used by counties to allocate the cost of collecting property taxes was flawed. Although the case has not yet been through the complete appeal process, it appears that property tax collection fees will be about $60,000 a year less than in previous years.

WHAT ARE OPERATIONS COSTS EXPECTED TO BE FOR THE NEXT 7 YEARS?

Because of the items above, the projections assume that further reductions or zero growth in operations costs are unsustainable going forward. Reduced or flat operations budget are a feasible option over a short course of years. However, the City cut operations costs by 5% for each of the two last two-year budget cycles. While the last 5% budget cuts are being achieved, all budgets are so tight, that departments at times forced to make decisions that help them come within the budget in the short-run but may not be the most cost effective choice in the long run. Realistically, small controlled net growth in operations costs would be prudent.

The seven-year projection assumes a net 3% increase in operations costs in the first year of each biennial budget cycle, and continued focus on keeping costs lean, smart, and effective. Fiscal year 2013/2014 also includes the one-time CJPIA insurance payment of about $800,000.



SPECIAL PROJECTS AND PROGRAMS COSTS

WHAT ARE SPECIAL PROJECTS AND PROGRAMS COSTS?

Special Projects and Programs are costs that are either atypical expenses or other projects or programs that are not part of the City's regular operations. Included in this category are items such as community promotions, equipment costing less than $2,500, studies, intangible assets, community programs, and infrequent repairs or maintenance. In order to stimulate the economy, Council voted to increase the budget commitment for community promotions in fiscal year 2012/2013. This is anticipated to create a healthier economy and increase City revenues.

WHAT ARE SPECIAL PROJECTS AND PROGRAMS COSTS EXPECTED TO BE FOR THE NEXT 7 YEARS?

The current year budget includes $250,000 in Eagle Ranch EIR expenses and various amounts for specific grant items. These expenditures are offset by revenues in 2012-2013; however the neither the expenditures nor the offsetting revenues are included in future years. Assumptions for future years include continued community funding at existing levels and continuation of the promotions program with growth built in for future revenue.

CAPITAL PROJECTS COSTS

WHAT ARE CAPITAL PROJECTS COSTS?

Capital Projects Costs are expenditures for new capital equipment, with a life in excess of one year and costing over $2,500, and capital improvement projects. Capital purchases are included in the budget only after supplemental budget requests effectively identify and justify the need for such a purchase. Most capital expenditures have been postponed over the last two budget cycles, in efforts to bridge the deficit gap. However, the lives of some assets and equipment can no longer be extended and some items will need to be replaced in the near future. Items such as fire employee turnout gear, self-contained breathing apparatuses, and public safety radios are included in this category and may need to be purchased soon. Staff will continue to pursue grants for the purchase of these and other items as well.

WHAT ARE CAPITAL PROJECTS COSTS EXPECTED TO BE FOR THE NEXT 7 YEARS?

The seven-year projection assumes a flat $100,000 each year to cover anticipated capital projects and expenses. This is a higher amount than has been budgeted in the last several budget cycles, but it is expected that some purchases cannot be delayed any longer.

Conclusion

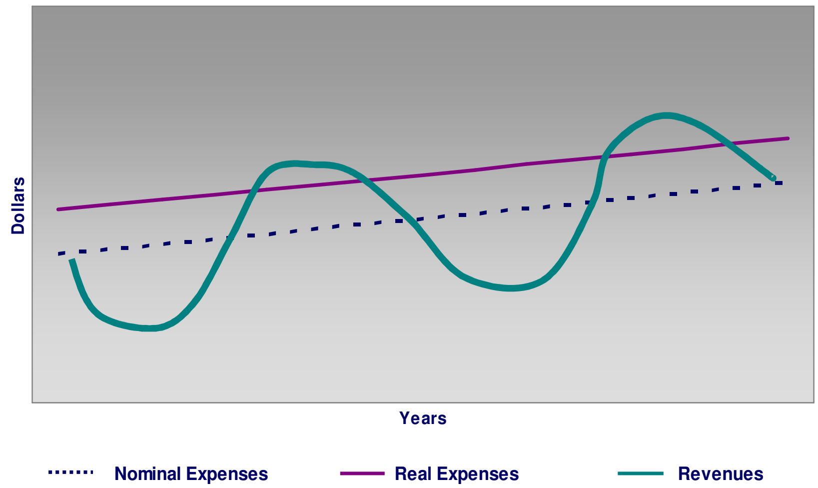
Atascadero has seen some tight economic times over the last several years. While most indicators imply the worst is in the past, the climb to more prosperous times is still long and hard. Council has shown strong leadership in sticking to its financial strategy; tucking away reserves in the good years and judiciously using them as the economy dipped and now continues to improve. Undoubtedly, as more and more indications of economic recovery appear, concerned individuals, groups, and organizations will come forward to urge the Council to focus resources in particular directions. The pressure will likely be significant to increase both one-time and on-going spending. The Council's strategic plan is effectively covering the temporary gap between revenues and expenses, but the current projections don't show revenues in excess of expenditures until fiscal year 2017/2018. While this was the planned and purposeful strategy, the addition of significant expenditures would extend the turn-around year out past 2017/2018. This doesn't mean that Council can't entertain anything new until fiscal year 2017/2018; it simply means that the volume and mix of expenses and revenues should continue to be carefully considered even as the economy recovers.

Atascadero

Comprehensive Financial Strategy
January 2013

Section 4- Long-Term Costs

Long-Term Costs



In the financial strategy diagram to the right, there are two expenditure trend lines. The lower dotted line represents the strategic plan. That is the limit at which the expenditures are budgeted. However, there are many services that are being consumed that are not included in the bi-annual budget. The upper solid line includes not only the budgeted items, but also all of the long-term expenses that will eventually come due. The City currently doesn't put any funding into Storm Drain Reserves, yet the storm drains are used constantly, and wear out a little more each day. At some point, they will need replacing and there will be a large price tag associated with this. Similarly, there is no reserve being set aside for replacement of park equipment. The parks in our community are very well used and are exposed to the elements. While the practice of not setting aside reserves for long-term assets is common among cities, counties and government agencies practices, it is prudent to analyze, evaluate and prepare for these long-term costs.

This section analyzes some of the annual long-term costs facing the City. The information developed within the following pages has been verified to the extent possible. However, as more information becomes known or as experience modifies the facts or assumptions, the information will be modified. The intent is one of information; to provide general facts about significant business concerns facing the City. This information is essential to establishing a practical financial strategy.

This section of the report includes a general discussion of wastewater assets; followed by an in-depth discussion of issues surrounding street and bridge maintenance, storm drains, building replacement, technology replacement, vehicle replacement, and equipment replacement (collectively referred to as infrastructure); and finally a discussion of long-term leave liability.

Wastewater

The Wastewater system is a significant part of the City's infrastructure, but is excluded from the analysis in this Section. The Public Works Department is in the process of updating its Wastewater Treatment Plant and Collection System Master Plan. From this study, the City's current list of necessary Capital Improvement Projects and system upgrades will be updated to meet changing State and Federal regulatory requirements, General Plan modifications since the last master plan update in 2002 that will increase flows to the sewer system, and new system collection and treatment deficiencies identified by staff and consultants.

Wastewater collection and treatment involves year round, 24-hour per day energy intensive and highly mechanical processes. Even pipes and manholes are constantly exposed to highly corrosive liquids and gasses. Pumps and equipment are particularly susceptible to constant repair, reconditioning, and replacement, and pipes and manholes have finite lifespans. Fortunately the City has a relatively simple and low cost treatment plant technology compared to surrounding communities like Paso Robles or San Luis Obispo. This treatment technology is not anticipated to change in the next 10 to 15 years; however the recent State and Federal focus on water quality will eventually force the City to upgrade the plant to a more advanced type of treatment.

Future increased wastewater treatment plant technology is expensive as evidenced by the proposed Paso Robles WWTP upgrade estimated at $40 million dollars.

The City's current challenge is to maintain and operate what we have today, and keep up with the replacement costs of the equipment and facilities described above. Fortunately wastewater is an enterprise fund and revenues are stable; and, the City has benefited from low cost treatment, and a relatively young collection system (1960's and 70's). Atascadero's current connection fees and monthly service fees are the lowest of any City on the Central Coast. While this is advantageous, the City is at a point where the current fees and rates just cover the on-going operations costs and near-term replacement costs. Staff will proactively look at future development projections, and energy and other operational cost factors to determine if and by how much those connection fees and annual sewer fees may need to be adjusted.

Once Staff has the results of the wastewater treatment plant and collection system master plans and a draft fee analysis, they will be able to more accurately update the Council on long-term wastewater system needs and direction for moving forward. Until then, suffice it to say that while the system is aging, it is still in fair condition and immediate needs can be addressed with current resources.

Infrastructure

Infrastructure includes the basic facilities and equipment needed to run the City. It includes public infrastructure such as streets, roads, storm drains, street lights, sidewalks, bridges and other large capital items needed for transportation and water to flow smoothly. It includes facilities such as fire stations, police station, parks, the zoo, City Hall and other large capital assets that are needed to provide services to the public. It also includes the basic underlying capital assets needed for the day to day operations of the City including computers, software, radios, breathing apparatus, police cars, tractors, fire engines, etc.

The research into these areas illustrates the need for reserve funds to deal with these business costs. The following table summarizes the findings contained in this Section. The Reserve Fund Strategy is the amount set aside in that fiscal year. The Annual

Reserve Fund Requirement is the annual need for each of the areas if the City was able to provide full funding. The Reserve Deficit is the amount of money that should have been placed in the reserve fund to date.

INFRASTRUCTURE REPLACEMENT			
	Annual Reserve Requirement	Reserve Fund Strategy	Reserve Surplus / (Deficit) Balance 6/30/2012
Streets & Bridges	$ 2,300,000	$ 600,000	$ (47,100,000)
Storm Drains	150,000	-	(725,000)
Building and Park Replacement	1,435,900	-	(7,878,000)
Technology Replacement	173,160	141,280	105,000
Vehicle Replacement	307,100	131,660	239,700
Equipment Replacement	137,900	-	(1,606,100)
TOTAL	**$ 4,504,060**	**$ 872,940**	**$ (56,964,400)**

While a $57 million infrastructure deficit may seem daunting, remember this is what the City should have on hand to bring all of its assets up to a new status. The City does not need to have all of assets in new condition to function smoothly and provide services to its citizens. As discussed in the roads report given to council earlier this year, if a “fair” condition for the roads is the targeted service level, then it is unnecessary to have a $47.1 million reserve to repair roads. Each infrastructure systems needs to be looked at individually and when analyzing infrastructure funding, the City should look at immediate needs, long-term funding needs, when an asset needs to be replaced, what has worked historically, and what are the service levels the City can maintain.

Street and Bridge Maintenance

Introduction:

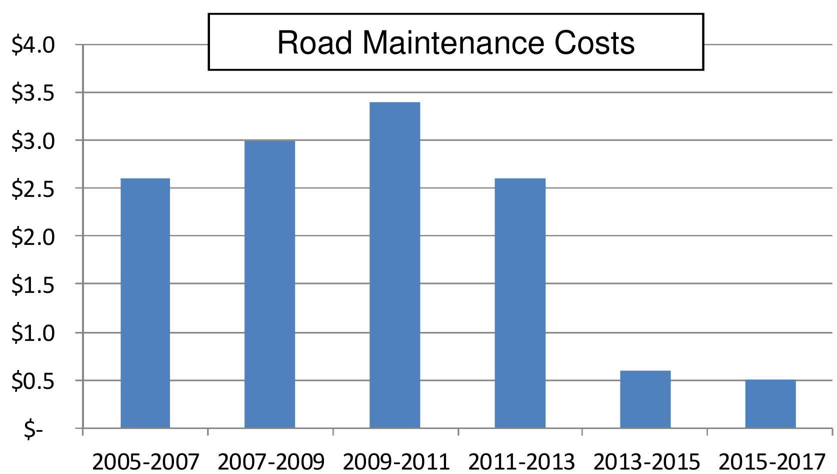
City of Atascadero is responsible for maintaining approximately 140 miles of roadway. This network represents a substantial investment by the City, and has been identified as a concern of the community. This section deals with the street, bridge and other similar infrastructure maintenance responsibilities of the City.

Analysis:

The Atascadero Road Program was developed in 1999 to focus the City’s efforts in maintaining and protecting the roads of Atascadero in an organized, efficient and cost-effective manner. Over the last ten years, the City has made good progress in improving the overall condition of the roads. However, the rural nature, relatively low population and high road miles of the community typically translate to low federal and state funding levels, since many road maintenance funds (i.e. Gas Tax revenue) are derived from population statistics. Similar to many other cities, Atascadero suffers from a funding short fall for road maintenance due to the aging road system and the economic downturn. The reality is that funding options from federal and state agencies are projected to be substantially reduced going forward, leaving the City with fewer options for maintenance and rehabilitation.

Since the inception of the Atascadero Roads Program, significant progress has been made in improving the roads and decreasing the maintenance deficit. The Atascadero Road Program is based on local pavement management strategy. Pavement management is the process of planning the maintenance and repair of City streets, in order to optimize pavement conditions over the entire network. Pavement management incorporates life cycle costs into a more systematic approach to minor and major road maintenance and reconstruction projects. The needs of the entire network as well as budget projections are considered before projects are executed. Pavement management encompasses the many aspects and tasks needed to maintain a quality pavement inventory, and ensure that the overall condition of the road network can be sustained at desired levels.

Public Works staff are currently implementing a new in-depth analysis and monitoring of road conditions within the City, using the *StreetSaver* pavement management system. This software is the accepted industry leader in pavement management technology. The road network and GIS information has been entered into the program, and this winter the Operations staff will finalize a citywide evaluation and rating of all streets within the City. The resulting data will help the City compete more effectively for State and Federal funds by allowing us to predict the effectiveness of requested grant monies invested in our roads. The City will have an enhanced Pavement Condition Index (PCI) for all Circulation Plan roads and local roads in the City. The rating scale is 100 being best and 0 being worst.

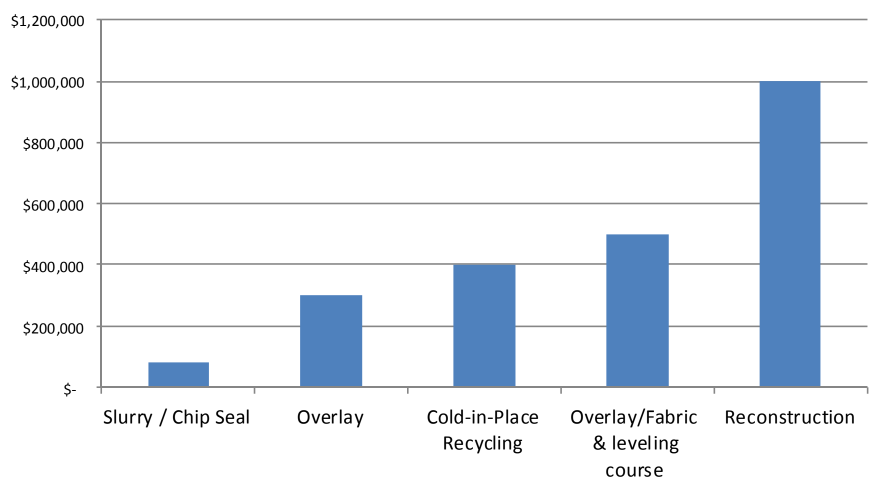


Currently City roads overall are roughly estimated at a PCI of 70, which is considered “fair,” and is average compared to other cities in the County.

Road maintenance and rehabilitation for City streets have had substantial budgets over the last 8 year period as shown in the graph above. However, as indicated in the City’s 5-year Capital Improvement Plan, road project budgets (excluding Del Rio Interchange project) for 2013-2015 and 2015-2017 are $600,000 and $500,000, respectively.

As these figures indicate, the current economic downturn is reducing the City's ability to invest in road maintenance and repair. Fewer road repair and pavement preservation projects will result in lower quality roads citywide, and higher long-term road maintenance costs. In response to reduced funding, staff has now changed the focus from overlays and road rehabilitations to the implementation of lower cost pavement preservation surface treatments. It is a widely accepted industry standard that spending funds on preservation (crack filling, seal coating, chip seals, etc.) delays or prevents major restoration projects, and results in lower long-term costs. Well-timed preventative maintenance of a roadways' surface increases its service life and delays the need for expensive rehabilitation or reconstruction. This is illustrated below in the cost per mile for minor maintenance all the way up to major reconstruction.

Cost for One Mile of Road Maintenance



The Streetsaver pavement management approach will assist the City in optimizing available funding by focusing projects in the highest need ranked areas and performing lower cost preventative maintenance as much as possible to avoid higher cost reconstruction project.

In addition to roads, the City's infrastructure also includes bridges, the pedestrian tunnel, sidewalks, curbs, gutters, traffic signals, parking lots, and medians. The reserve deficit for the roads and bridges is estimated at $46.1 million and an additional $1 million for the other items. Approximately $2,300,000 is required annually to maintain the infrastructure in the community.

City Department	Accumulated Reserve Requirements	Estimated Annual Reserve
Street and Bridge Maintenance	$47,100,000	$ 2,300,000

Conclusion:

It is the City's goal to fully fund street maintenance; however, reductions in regional, state and federal road funding continue to be a challenge. Grants such as the ARRA grants and other transportation funding allowed the City to make significant progress on the Roads Program, funding not only the annual requirement, but improving the overall condition of the roads. Although funding roads is a challenge in this current economic environment, staff will continue to work toward seeking out funding opportunities and protecting road revenues currently in place.

Storm Drain Maintenance

Introduction:

The City has not had a meaningful inventory of the storm drain system in the past. The purpose of this system is to collect excess runoff and keep the streets from flooding. Thanks to the efforts of the Public Works department, the storm drain system is fairly effective now in keeping the water off the streets, but it hasn't always been like that. In the not too distant past, rains typically brought uncontrolled flooding. By better understanding the system and evaluating the condition of each of the components, the City is better able to manage the system and be proactive in preventing problems.

Analysis:

To this end, in 2012, the Public Works Department inventoried the complete drainage system of all pipes, inlets, manholes and bridges and measured and characterized the location, size, material and general condition of each facility. There are currently over 28-miles of culvert or storm drain piping within City road right-of-way. The study created an initial priority list for future projects, and established a replacement schedule and the funding needs based on conservative lifespan and construction costs so as to not overstate the cost to maintain these facilities.

Using the information collected, a number of immediate maintenance and replacement projects were identified and carried out within the limitations of the current operations budget.

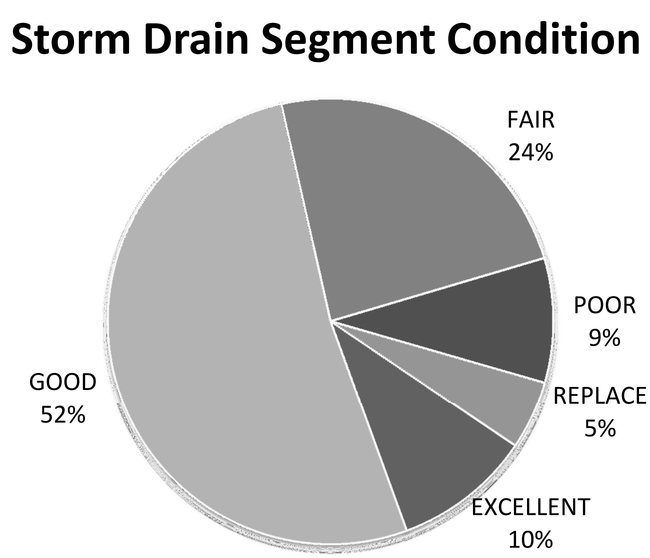
The following are some highlights of the study's findings:

<u>Existing Storm Drain Inventory</u>

- 28 miles of existing culverts within the city's storm drain network
- A total of 1,740 individual pipe segments
  - 1,022 segments are CMP (shortest lifespan)
  - 416 segments are HDPE
  - 238 segments are RCP
  - 60 segments are PVC
  - 4 segments are Steel
- 1,440 segments are City maintained
  - 48% of all city maintained culverts are CMP
  - Currently 3,180 feet of culvert is characterized as needing near term replacement

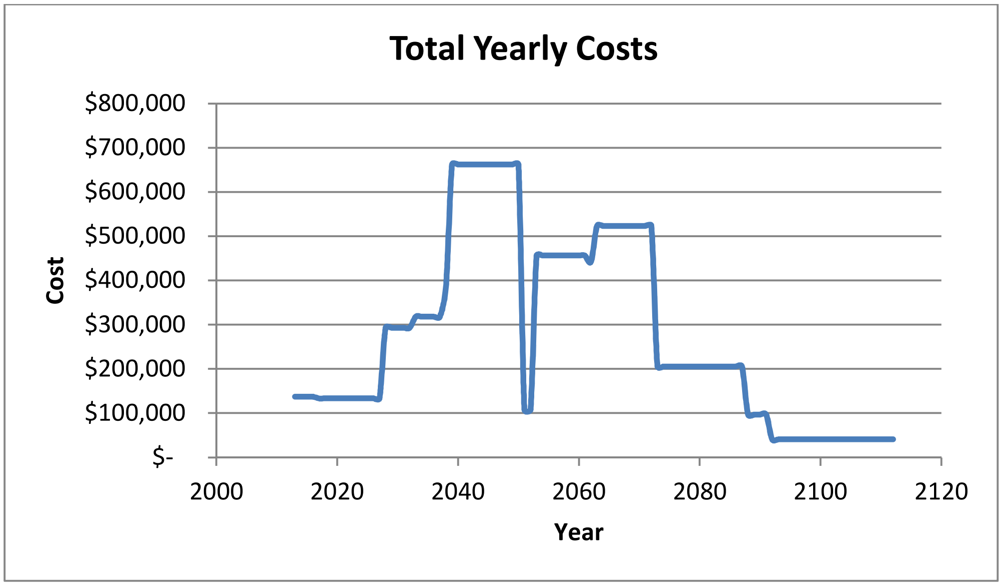
The following graph illustrates the condition of the segments:

The good news is that 86% of pipes currently in place are considered "fair" or better. That leaves only 14% in a condition that needs replacement in the next 6 to 12 years. There is an immediate need to replace 5% of the culverts and storm drains over the next 5 years. A rough estimate of the annual storm drain replacement needs over the next 10 to 12 years is $150,000 per year.



The future replacement schedule will significantly increase as CMP material culverts (primarily) installed in the '70's, 80's and '90's reach their expected lifespan. The study concludes that replacement costs (in 2013 dollars) will double each 12 to 15 years for the next 25 to 30 years (2013-2025 = $150,000/yr., 2025-2040 = $300,000/yr., and 2040-2055 = $600,000/yr.).

The replacement of existing pipes can be characterized in this graph:



City Department	Accumulated Reserve Deficit at 6/30/12	Estimated Annual Reserve Requirement
Storm Drains	$ 725,000	$ 150,000

Conclusion:

The City has a much better understanding of the Storm Drain system than it ever has before. The recent study has provided valuable information on the condition and location of each of the many components so the Public Works department can best focus resources on the issues of highest concern. Although the system is aging, the bulk of it is in relatively good shape. The proactive approach to repairs of the storm drain components protect life and property by reducing or preventing flooding and helping to preserve the adjoining roads and infrastructure.

Building Replacement

Introduction:

City of Atascadero owns a number of different buildings including City Hall, Police and Fire Stations, the Lake Pavilion, and the Colony Park Community Center. This section also encompasses a wide range of assets such as park restrooms, playgrounds, sports areas, building improvements, and Zoo exhibits, just to name a few. Assets of most departments are including in the following discussion, with the exception of the Wastewater Department.

Analysis:

The City keeps a list of all buildings and improvements within the City. The list estimates the original cost, replacement cost, size, age and remaining life of the assets. The list tracks all buildings, storage structures, park buildings and improvements, and Zoo exhibits along with the corresponding costs and depreciation. The amount of annual depreciation on the assets is approximately what the City should be setting aside each year in the reserve account to fund replacements and major repairs. The reserve deficit, the amount that should currently be in reserves, is estimated at $7.9 million. This amount was previously much larger, but the recent repairs and renovations to the Historic City Hall have rejuvenated that large asset. However, the cost to maintain that building will continue to be significant, and will require an annual reserve contribution of about $600,000 beginning with fiscal year 2013-2014. The current and annual reserve liability for building replacement is demonstrated below:

BUILDINGS		
City Department	**Estimated Accumulated Reserve Requirements 06/30/12**	**Estimated Annual Building Reserve**
Historic City Hall	-	(600,000)
Fire	(1,671,000)	(84,900)
Parks	(1,716,000)	(153,600)
Pavilion	(2,670,000)	(140,400)
Police	(2,281,000)	(120,100)
Recreation	(1,457,000)	(251,400)
Public Works	(46,000)	(30,600)
Zoo	(480,000)	(54,900)
Total Ideal	**(10,321,000)**	**(1,435,900)**
Current Funding Level	**2,443,221**	**-**
TOTAL (Deficit) / Surplus	**$ (7,877,779)**	**$ (1,435,900)**

Conclusion:

It is the City's goal to fully fund building replacement. The City was able to begin partially funding building replacement in fiscal year 2000-2001, and continued through 2008-2009. There is currently about $2.4 million saved up in the fund, but this is short of the $7.9 million in projected need. Historically, the building reserves are largely used to pay for repair projects and improvements which prolong the lives of the assets and keep them in good working order. In addition, staff actively looks for grants and other opportunities to augment available funds. The City has been successful with programs such as the Energy Efficiency Grant that the City recently received. This has been an effective strategy thus far, and with $2.4 million in the bank and a “new” City Hall, it is anticipated that the strategy will effectively meet the City’s short-term (next ten years) needs. Like other long-term assets, however, the City should begin looking for long-term solutions.

Technology Replacement

Introduction:

The City has a significant investment and dependence on technology equipment throughout the different departments. The computers and associated software make-up a technology system that is crucial to the day-to-day operations of the City. The system represents a total value of almost $1.1 million including specialized software. This section deals with the current technology replacement responsibilities of the City.

Analysis:

Each department was reviewed for the number of computers and associated software necessary to complete department objectives. Expected useful lives and replacement costs are determined and used to calculate the amount of reserve necessary each year. As technology continues to emerge quickly, it can be difficult to know what the future brings. Technology staff are always on the lookout for newer and more efficient technology that will provide safe and effective computing tools for managing City business. The City has been funding replacement and maintenance reserve for technology for almost 15 years, and as a result, the technology reserve is fully funded. Both hardware and software are maximized and best efforts are made to stretch the useful life out as long as possible, while keeping a tight balance with efficiency. The total budgeted contribution for the 2011-2013 is actually less than the total annual replacement cost because some of the items have been fully funded and their replacement is being postponed because the items are still functioning effectively.

The reserve fund allows for hardware and upgrades as determined necessary. Daily City business functions are dependent on the consistent operation of the City’s computers, associated technologies, data backup, and data integrity. Therefore, it is necessary that the City have a designated reserve for the replacement of computers and other technology equipment as it becomes elite. The annual cost to provide for replacement of the technology system is as follows:

TECHNOLOGY		
City Department	**Estimated Accumulated Reserve Requirements 06/30/12**	**Estimated Annual Technology Reserve**
City Council	(11,500)	(1,830)
City Manager	(16,000)	(3,510)
Administrative Services	(172,500)	(18,990)
Police	(125,900)	(25,130)
Fire	(83,100)	(12,430)
Community Development	(80,500)	(10,510)
Community Services	(67,600)	(14,100)
Public Works	(45,500)	(11,940)
Information Technology	(500,500)	(74,720)
Total Ideal	**(1,103,100)**	**(173,160)**
Current Funding Level	**1,208,100**	**141,280**
TOTAL (Deficit) / Surplus	**$ 105,000**	**$ (31,880)**

Conclusion:

It is the City's goal to maintain a technology fund that will provide for the replacement and upgrading of technology as needed. Since the City began funding technology replacement in the 1998-99 budget, an adequate reserve exists to fund the City's technology needs in order to keep operations running smoothly and efficiently. Costs to fully fund technology have not been delayed as other reserve funds were. In addition to providing the opportunity to replace items as needed, the technology reserves allow the City to take advantage of newer and more efficient technologies as they become mainstream.

Vehicle Replacement

Introduction:

The City owns many vehicles that are operated in the various City departments, from patrol cars to parks vehicles. The estimated replacement value of this rolling stock is about $3.8 million. Eventually, all of this equipment must be replaced as it become ineffective. Like similar tools addressed previously, vehicles are critical to performance of department objective and in order to carry out the priorities of the community.

Analysis:

Ninety-five percent of the value of the $3.8 million in vehicles belongs to the police, fire and public works departments. All of these departments require employees to travel throughout the community with very specialized vehicles. Police officers need patrol cars to keep criminal activity in check, fire fighters need fire trucks and engines to fight fires, and public works need tractors, mowers, and service trucks to keep up the infrastructure the community treasures.

These specialized vehicles are important to the operations of the departments and are typically higher priced purchases. The Council has been successful at fulfilling its goal to fully fund the vehicle replacement fund. The strategy the Council used to put away enough each year to fund the vehicles has paid off, and now only needs to be maintained annually.

Vehicles, like technology, are used until they either become inefficient or inoperable. Savings can be achieved when a vehicle's useful life can be stretched out by one or more extra years. Staff have been conscientious about how this affect's the City's bottom line and have utilized this technique effectively.

The accumulated reserve and estimated annual reserve for vehicle replacement is as follows:

VEHICLES		
City Department	**Estimated Accumulated Reserve Requirements 06/30/12**	**Estimated Annual Vehicle Reserve**
Police	$ (338,200)	$ (107,500)
Fire	(973,800)	(149,400)
Community Development	(30,700)	(5,800)
Recreation	(19,400)	(4,100)
Zoo	(6,400)	(2,000)
Public Works	(261,800)	(28,400)
Parks	(49,900)	(7,600)
Building Maintenance	(22,100)	(2,300)
Total Ideal	**(1,702,300)**	**(307,100)**
Current Funding Level	**1,942,000**	**131,660**
TOTAL (Deficit) / Surplus	**$ 239,700**	**$ (175,440)**

Conclusion:

While replacement remains fully funded, the City has not fully funded the annual replacement cost in the last two budget cycles. This was done by:

1. Using available surplus reserves
2. Delaying replacements- through prudent maintenance, the City has been able to extend the life of many vehicles
3. Delaying funding replacement of vehicles with a life exceeding 20 years: fire engines, fire trucks, dump trucks, and tractors. These vehicles in particular were delayed for annual funding because of the longer replacement period. The

longer replacement period allows the City to fluctuate funding levels without affecting replacement timing. Similar to the City's economic strategy, the City can put away more when times are good and less when times are bad.

As part of the normal budget cycle, staff will look at the City's fleet of vehicles to determine the appropriate amount of annual funding to insure that vehicles are replaced in a timely manner without affecting General Fund operations.

Thanks to the careful planning of the Council, the City has met its goal to fully fund vehicle replacement. Because the City has committed to annual contributing to vehicle replacement, vehicles are replaced as needed. The City's fleet is now efficient, safe, and dependable.

Equipment Replacement

Introduction:

The City has a significant amount of equipment which is essential to the operation of the City. These tools are necessary and allow employees to effectively perform their duties. The ideal strategy would work toward a program where replacement is funded annually, allowing the City to stay current with equipment. Wastewater equipment is not included in the estimates for this section.

Analysis:

Each department has specialized equipment that assists employees in performing their duties as expected. Office staff needs office machines such as copiers, police officers need radios and radio repeaters, fire fighters need breathing apparatuses and jaws of life, parks needs mowers and irrigation equipment. Grants have been an effective funding source for this type of equipment, but grants are not always available, and are even more competitive in today's environment.

While staff does their best to keep existing equipment running for the maximum amount of time, eventually equipment ceases to be effective. Often times, specific items of equipment must be replaced to comply with new regulations or safety requirements. The City's budget has included some contribution to equipment replacement during most of the fiscal years 2000/2001 through 2007/2008. And fortunately that was the case, because some of these funds were later used to either repair or replace equipment. However, with the economic downturn, the equipment replacement was one of the reserve contributions that was postponed in order to more closely make ends meet. There is currently about $450,000 saved up in this fund for equipment.

The estimate of the reserve deficit is approximately $1.6 million, and the amount that should annually be placed into a reserve account to fund the equipment replacement is about $138,000.

EQUIPMENT		
City Department	**Estimated Accumulated Reserve Requirements 06/30/12**	**Estimated Annual Equipment Reserve**
Administration	$ (45,500)	$ (12,800)
Police	(583,700)	(33,100)
Fire	(428,200)	(34,500)
Recreation	(120,900)	(17,800)
Pavilion	(13,600)	(1,800)
Zoo	(9,700)	-
Public Works	(445,500)	(13,800)
Parks	(411,200)	(24,100)
Total Ideal	**(2,058,300)**	**(137,900)**
Current Funding Level	**452,200**	**-**
TOTAL (Deficit) / Surplus	**$ (1,606,100)**	**$ (137,900)**

Conclusion:

It is the City's goal to fully fund equipment replacement; however, the recent economic climate has made this a difficult goal to achieve. Equipment replacement was funded from about fiscal year 2000 to fiscal year 2008. Fortunately, these funds have been available to fund the replacement of needed equipment. City staff has been very successful obtaining grants for critical equipment replacement as it arises. City staff will continue to maximize the equipment life to the extent possible, take advantage of savings opportunities as they arise, and continue to pursue grant funding as an alternative funding source. It is anticipated that with increased capital funding from the General Fund and anticipated grant funding, that the City will be able to meet its equipment needs for the short-term (within ten years); however like other long-term assets, the City should begin looking for long-term solutions.

Leave Accruals

Introduction:

There are several different types of paid leave that accrue to full-time employees. These include vacation, holiday, administrative leave, sick leave, and compensatory time accruals. The amount of leave employees are eligible to accrue is governed by Memorandum of Understandings (MOUs), personnel contracts, and the Personnel Rules and Regulations (Rules and Regs).

Analysis:

Each employee is required to record time worked and time off in official attendance records that are recorded with payroll. Depending on the specifics of the governing MOU, contract and Rules and Regs, employees earn paid time off each year. As the employee earns leave, it is accrued in an appropriate leave bank as leave hours. The employee may take these hours off of work during the year and be paid for their regular rate of pay for the hours, thus decreasing their leave bank hours. When an employee leaves the City they must also be paid for certain leave hours they have on the books. What is paid off is governed by law, MOUs, Rules and Regulations and past practice. If all City employees left the City on June 30, 2012, the total value of all leave accruals eligible to be paid off would have been just over $1.7 million.

Leave Accrual	Dollar Value of Accrual
Vacation Leave	$ 970,380
Holiday Leave	321,240
Administrative Leave	3,800
Sick Leave	366,070
Compensatory Time	70,100
TOTAL AMOUNT FUNDED	**$ 1,731,590**

Vacation Accrual

Much of the recent focus of Leave Accruals has been focused on vacation accruals. Typically the City's vacation accrual balances ebb and flow with the economic tide. As the economy is tight, fewer employees leave the City and thus there are fewer vacation payouts, increasing the liability balance. Affecting the leave balance to an even greater extent is the tight staffing in each of the departments. Atascadero employees are a loyal group of individuals and are dedicated to getting their work done. Because staffing is tight, overtime budgets are tight and the work doesn't go away, employees tend to forgo taking time off. This increases the leave balances.

Historically, the City has had enough vacancies throughout the course of each year that the cost of paying out the vacation accruals was covered by the payroll savings with the unfilled positions. However, the extended downturn in the economy was increasing the leave liability and this long-term practice was inconsistent with the City's written Rules and Regs which required a cap on vacation accruals. The amount of vacation accrual as of June 30, 2012, was just under $1 million as seen in the table below, and the amount of vacation time accrued in excess of the maximum according to the policy in place at the time was $350,190. The majority of the $1 million accrual fell within the policy maximum.

Vacation Accrual within Maximum at 6/30/12	Vacation Accrual in Excess of Max at 6/30/12	Total Vacation Accrual at 6/30/12
$ 620,190	$ 350,190	$ 970,380

In order to achieve more consistency between established practice and written policy, the Council approved changes on June 12, 2012, to the Rules and Regs affecting the maximum vacation accruals. Individuals employed with the City prior to July 1, 2012, had their vacation leave split into two banks on October 20, 2012; a historical bank and a current leave bank. All new vacation time earned subsequent to that date accrues to the current leave bank and will cease to accrue when that bank balance has reached two times the employee's current annual accrual. After the one-time split into the historic bank, no more time will be accrued into that bank. Time in the historic bank may only be used after all the time in current bank has been exhausted. Employees hired after July 1, 2012 shall only have a current bank and shall cease to accumulate vacation once their accrued vacation balance has reached two times their current annual accrual.

The new vacation accrual policy requires that employees take enough time off to avoid hitting the maximum accrual amount. This new practice will significantly reduce the long-term liability, and will be healthier for the employee; but it will not come without operational costs. The operational issue with this is that the work of the vacationing employee doesn't dissolve as the person vacations, and there is still the same number of employees to get the work done. This often means overtime to cover the shift or get the work done. Staff is currently evaluating the effect of the new vacation policy and will work through the budget process to ensure that there is adequate funding for the new policy.

Holiday Accrual

There are similar staffing issues that result in increasing holiday pay accruals. Employees received 12 paid holidays per year (Fire receives 5.6 shifts per year). Some employees are unable to take the holidays off when the holiday occurs due to the nature of their position. Primarily, this is a function of the 24/7 scheduling of public safety. Employees of both Police and Fire work regularly on holidays and accrue the paid time off. The MOU between the City and the Police department allows employees to either take the time off or to be paid off annually for the holiday time accrued. (Most eligible employees are paid off annually and this amount in included in the police budget.) The MOU with the Fire department does not include a similar annual payoff. Because the staffing levels of the Fire department are also lean, employees tend to build up paid holiday time off as an alternative to causing the department to pay overtime to backfill their shift. Gradually, the accruals build up. There is no maximum cap for holiday accruals. The value of this accrued time is paid out to the employee upon termination of employment. Hiring of a replacement employee has historically been postponed until payroll savings on the vacancy is enough to cover the payout amount.

Fire Department Holiday Accrual at 6/30/12	Other Departments Holiday Accrual at 6/30/12	Total Holiday Accrual at 6/30/12
$ 273,340	$ 47,900	$ 321,240

Administrative Leave Accrual

Administrative Leave is paid leave granted to certain positions that are exempt from overtime. It is common practice to include administrative leave in compensation packages for salaried positions. The employees in these positions usually work a significant number of hours, and receive administrative leave as a benefit in lieu of overtime that is typical of non-exempt employees. Administrative leave functions similar to vacation time except that it is tracked separately and is carried over to the next fiscal year only under specific conditions.

Administrative Leave Accrual at 6/30/12
$ 3,800

Sick Leave Accrual

Sick Leave is provided to employees to minimize the economic hardship that may result from an unexpected personal or dependent illness or injury. It is accrued at the rate of eight hours per month (12.01 for Fire personnel) without a maximum cap. Some employee groups are eligible for an annual Stay Well Bonus that pays out a portion of the employee's sick leave accrual, at the employee's option, up to an established maximum. Additionally, some employee groups are eligible to receive up to one-half of the employee's accrued sick time paid out at termination. The City's policy and practice support an employee's use of his/her entire sick leave accrual bank, as necessary, with an appropriate verification documenting the illness or injury.

Total Sick Leave Accrual at 6/30/12
$ 366,070

Compensatory Time Accrual

Non-exempt employees may choose to accumulate compensatory time instead of overtime for the mutual convenience of the City and the employee. The compensatory time credit is computed at time and one-half. The maximum non-exempt employees may accumulate is 80 hours. Compensatory time may be partially or fully paid out at any time at the request of the employee or may be used as paid time off in place of vacation or other similar paid leave. Compensatory time accrual is paid out to the employee at termination.

Total Compensatory Time Accrual at 6/30/12
$ 70,100

Conclusion:

While the City's leave accruals are real liabilities, they have different characteristics than other long-term liabilities. As an employee terminates employment, the City pays out that person's leave liability. The City then has an option as to how quick to hire a replacement employee for that position and can opt to hold off until sufficient salary savings has been achieved to cover the outgoing employee's payoff. Of course in this downturn, this can also cause operational issues, as the work does not go away. While often during a vacancy, a department is able to move around shifts or workloads to minimize overtime while a replacement is recruited, there is some level of service reduction during this period.

The City is a service organization and much of the General Fund is spent on labor. The leave liability is a part of doing business. This is not a liability that the City would expect to have to payout all at once, but instead it's a liability that grows and contracts by relatively small amounts each year. The balance of the leave liability has always been very closely tied to the economy. As the economy booms, leave liability is used or paid off. Employees take vacations as they can afford to go nice places, and staffing is less of an issue. Employees are also more mobile in a growing economy, not staying with the City for as long of periods and thus taking earlier payoffs. It is projected that because of uptick in the economy, the recent departures of long-term employees and the implementation of a new vacation policy, that the liability will be contracting (or getting smaller) for the next few years.

Summary

While the reserves and deficits discussed in this section may seem daunting, they are not unlike what other city's face. The nature of government, its accounting methods, and citizens' desire for services make the funding of long-term assets very difficult until it becomes critical. Atascadero is ahead of the game by looking at these costs, analyzing them bi-annually, and determining what the horizon looks like.

The City has made incredible strides towards funding long-term assets since 1997 when the City did not have a financial plan and did not have a funding plan for any of its long term assets: vehicles and technology equipment are fully funded with scheduled replacement of all assets, building reserve deficits have decreased, the road program is in place and has made great strides towards roads, equipment replacement has been funded through grants, donations and available funding. Evaluation of assets and the seven year projection show that the City can continue fund the immediate infrastructure needs throughout the projection period. There are no known immediate needs that the City cannot meet with current funding levels, so the City is OK and will continue to be Ok for at least 10 years.

Unpalatable as it may be, the City, however, will at some point to need to look to additional funding mechanisms for funding long-term infrastructure needs. No matter how much we stimulate the local economy, the fundamental funding make-up of the City cannot support the vast infrastructure required for a City of the size. At some point, the City will have to consider an additional assessment for properties or an increased sales tax for long-term infrastructure needs. The City is meeting its short-term needs, so there is no action needed at this time, but the long-term needs should be kept in mind as the City moves forward.

Atascadero

Comprehensive Financial Strategy
January 2013

Section 5- Reserves

Reserves

RESERVES

WHAT ARE RESERVES?

City finances are comprised of various funds, which for legal purposes have to be separated. For example, sewer charges are to be spent on maintaining and operating the wastewater system and may not be used to hire police officers or firefighters. One fund over which the Council may exercise considerable discretion is the General Fund. General taxes and receipts are deposited into this fund and the Council decides on how to spend these general revenues, whether it's for police, fire, parks maintenance, recreation services or other public services. (There are restricted revenues such as grants or fees for services that are also deposited into the General Fund.) The City must cautiously guard its General Fund to ensure that there are always adequate resources to provide critical services to the public.

The term *reserves* is used quite universally in governmental finance. There are different types of reserves with different purposes and different legal restrictions. Essentially, they are the collective amount of revenues in excess of expenses, or similar to what a company might term *retained earnings*. Typically, the General Fund reserves are the most carefully monitored as these are the most flexible and discretionary of all the funds. There are reserves in other City funds that could legally be tapped into if the City found it necessary, each having their own specific rules.

General Fund reserves are often thought to be one indicator of the fiscal stability of an organization. In the early 1990's, the City of Atascadero had a negative General Fund balance, forcing layoffs and service reductions in order to weather the storm. In fiscal year 1995, the collapse of the Orange County Investment Pool hit the City and the General Fund reserves fell to an all-time low of $-790,360. At that time, the City's audit carried a note of "going concern": in other words, the City's finances were so bad that there was a serious question of ongoing solvency. Around 1998, as the economy was starting to turn around, Council adopted a fiscally conservative reserve policy and began to aggressively go about building reserves in order to avoid history repeating itself.

The General Fund Reserves are broken down into different components, each with separate ramifications and costs. The Governmental Accounting Standards Board (GASB) changed how fund balances are classified and reported effective June 30, 2011. While the categories are similar, there are some differences. In the past, the Council through the budget process, would designate a portion of the fund balance to be used for a specific purpose. This would show up as a designation in the financial statements. Under current GASB guidelines, the Council may still designate a portion of the fund balance for items such as roads, libraries, economic uncertainties, etc; however this has no legal effect on the funds and thus does not show up in the fund balance designations. The new fund balance (or reserve) designations are as follows:

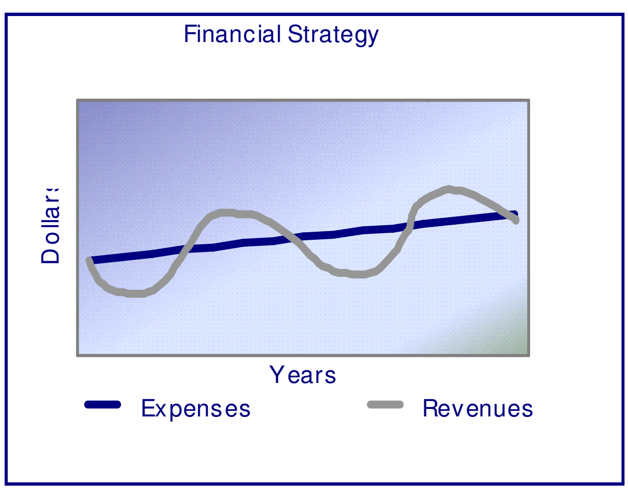
Non-spendable- includes fund balance amounts that cannot be spent either because it is not in spendable form or because of legal or contractual constraints. Because some assets are not easily convertible to cash in a timely manner, the fund balance is designated to show the portion that is non-spendable or can't be spent within a timely manner. For example, the General Fund had loaned the Redevelopment Agency $1,375,175. This is reported as an asset of the General Fund, but because of recent legislation, the General Fund will not get paid back on this loan for many years to come. Thus when taking assets minus liabilities to arrive at fund balance, the City must report that $1,375,175 of the fund-balance is non-spendable.

Restricted- includes fund balance amounts that are constrained for specific purposes which are externally imposed by providers, such as creditors or amounts constrained due to constitutional provisions or enabling legislation. For the City, these typically include the fund balances of most other funds. For example the fund balance Circulation System Impact Fees fund is constrained by state legislation (AB1600) which sets forth specific criteria for collecting and expenditure of these funds. The use of the fund balance is restricted.

Assigned- includes fund balance amounts that are constrained for specific purposes by the City through formal action of the City Council and does not lapse at fiscal year end. These amounts typically include encumbrances or amounts that Council has formally set aside by resolution or contract.

Unassigned- includes positive fund balance within the General Fund which has not been classified within the above mentioned categories and negative fund balances in other governmental funds. These are funds that have not been earmarked for any specific purpose and are available for Council discretionary spending.

WHAT IS THE CURRENT STATUS OF RESERVES?



The City first adopted a Financial Strategy in 1998 and the results of having such a plan are clear. Over the years, the overall strategy has consistently been to maintain a conservative outlook by putting aside reserves in good times and then using those reserves during down periods to achieve stable operations. By employing this cautious strategy in the past, the City is now weathering the current valley in revenue fluctuations. The City has used reserves along with other fiscal strategies to maintain services and ensure the City's long-term financial viability.

As of June 30, 2012, the General Fund reserve balance was almost $6.5 million. During the 2011-2013 budget process, Council continued to support using an average of $1.0 million in reserves annually to close the gap between projected revenues and expenses. While the City budgeted the use of $1.0 million in reserves, actual use of reserves for each of the last two fiscal years has come in significantly below budgeted use. In 2010-2011, the City used $597,000 of General Fund reserves and in 2011-2012 only $454,000 was used.

In addition to General Fund reserves, it is equally as important to understand which other accounts there might be within the City that are legally accessible to the General Fund in order to meet its operational needs. There are two other sources of potential funds that could be considered. The first is the internal service account replacement funds and the second is unspent funds transferred to the Capital Projects Fund for road replacement.

Internal Service Account Replacement Funds - The City also has amounts set aside for replacement of vehicles, equipment, buildings and technology. The City has the legal right to transfer these funds back to the General Fund; however, it is not necessarily prudent to do so. Historically, the City has put away amounts annually so that as vehicles, computers, software and buildings become old and no longer function, the City has funds to replace them. These funds are legally available to transfer back to the General Fund; however, it does not change the time frame that roofs will have to be replaced or software will no longer be supportable. The City had $6.6 million in unrestricted net assets in the internal services funds as of June 30, 2012.

Unspent Capital Project Road Funds – In past budgets, the City Council approved transferring City General Funds to the Capital Projects Funds for road projects. While many road projects were accomplished with the transferred funds, approximately $600,000 of these funds remained unspent. They are programmed to be spent on road programs within the five year capital improvement program; however they are available to be transferred back to the City's General Fund if the Council chose to do so instead.

WHAT SHOULD OUR RESERVES BE?

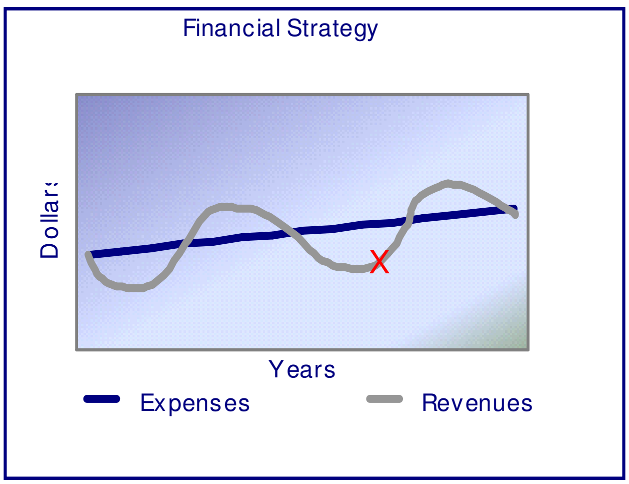
The Adoption of Reserve Policies in California Cities by Anita Lawrence asked "What is the amount of fiscally prudent reserve? How much would be enough to cover certain events and develop a sense of security for the organization and the community? At what level would the constituency begin to question it as too much? What is the risk tolerance of the organization and the community? What criteria should be used to make that decision?" There is no easy answer to these questions. Anita's research showed that "…if you asked 100 city finance professionals these questions, very few would provide the same mix of answers. The elements that are right for one city are entirely wrong for another."

The real question is: What is the right amount of reserves for the City of Atascadero, both at this point in time and for the foreseeable future? In order to formulate a reserve policy, it is important to answer the following:

1. State of the Economy
2. The level of diversity in General Fund revenues
3. The stability of the revenue base
4. Potential actions of State and Federal agencies
5. Cash flow needs
6. Costs of potential natural disasters and emergencies
7. Asset replacement requirements
8. The consistency desired in service levels
9. Available opportunities

<u>Measurement #1 – State of the Economy</u>

In the City's reserve strategy, the largest driver of what should be done with reserves is the state of the economy. Are we in an economic boom?- if so we should be putting away reserves for a rainy day. Are we in a severe a recession?- if so, we should be using those reserves to stabilize services and the organization. Are we in a period of recovery?- if so we may still need reserves to stabilize services, but we need to be looking to the future to insure that reserves will last. Are we in a stable period of flat growth?- if so, we should neither add to, nor use reserves. The simple reserve strategy graph tells us what action we should take. So the question becomes, where are we on the graph? Is the economy booming, busting, recovering or somewhere in between?



Most economists agree that the City has just gone through the worst recession since the Great Depression. Economists also agree that the recession is over and has been over for some time now. US Real gross domestic product is up 2.7% over the prior year, California's unemployment rate is down to 9.8% (the lowest since the recession began), existing home sales are up 7% statewide, and California's median existing home prices are also up (See Attachment C- *HDL's California Forecast: Sales Tax Trends and Economic Drivers*.) All of these are positive signs that the economy is in recovery. Warnings of a double dip recession and hyper-inflation are still out there, but are much quieter. Most people believe that the City is on the way to recovery, but that it will be a long slow recovery.

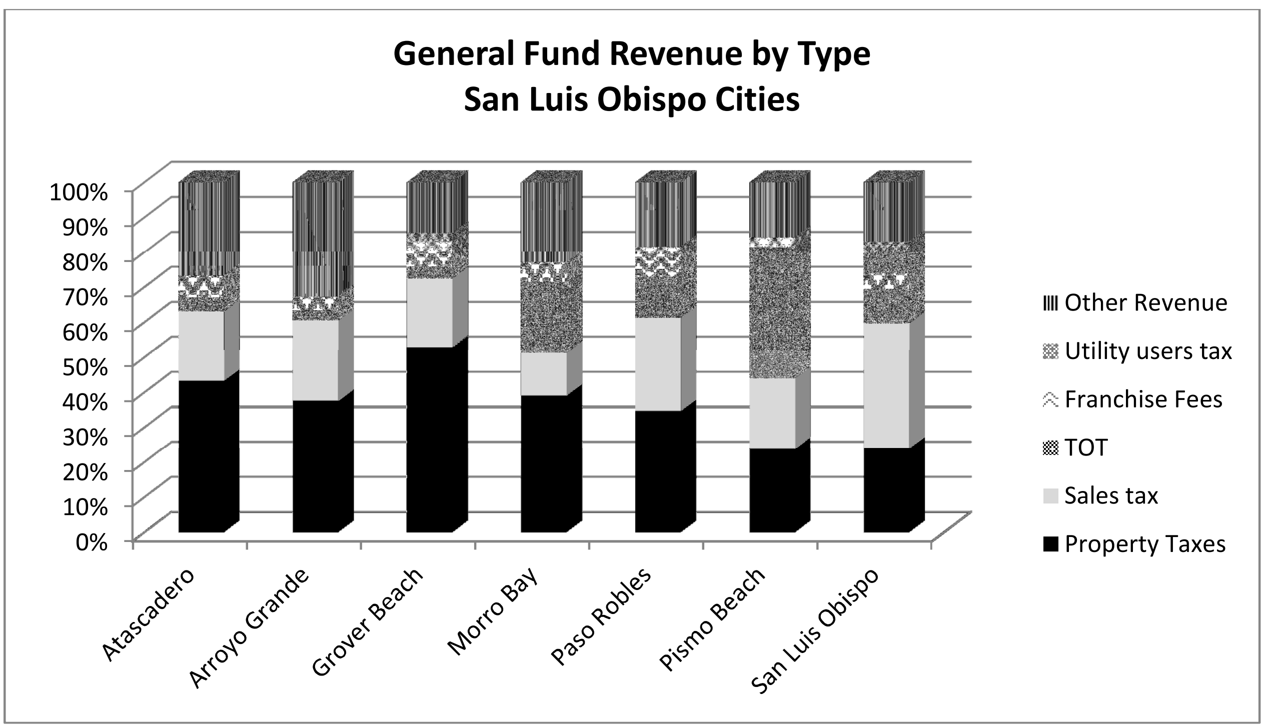
Atascadero's General Fund revenue picture seems to support this theory. General Fund revenues hit a low of $15.6 million in 2009-2010 (from a high of $19.0 million in 2006-2007). In 2010-2011 General Fund Revenues were $16.0 million and in 2011-2012 $16.3 million. These figures seem to support that the City found the bottom of the revenue trough and are very slowly climbing out, but are still a long way from where the City was.

Based on the financial strategy that the Council has been following, this means that the City should be still using reserves in order to maintain service levels, but judiciously. Continued monitoring and evaluation of the financial situation, reserves and reserve projections should continue to be used to ensure that reserve levels do not fall below the reserve minimum.

The next eight measurements should be used in determining what level of reserve minimum is right for Atascadero.

Measurement #2 – Level of Diversity in General Fund Revenue

One measurement to quantify an appropriate level of reserves concerns how broad a range of General Fund revenues the City receives and what the future holds for such revenue. Some cities have a very broad range of General Fund revenues not associated with fees. For example, Pismo Beach and Morro Bay enjoy a large amount of transient occupancy taxes (hotel tax). Other cities, such as Grover Beach and San Luis Obispo, have a utility user tax. This is a percentage of the cost of all utilities used by citizens of those cities, including gas, electric, phone, cable TV, and even the city's own utilities of water, sewer, and garbage.

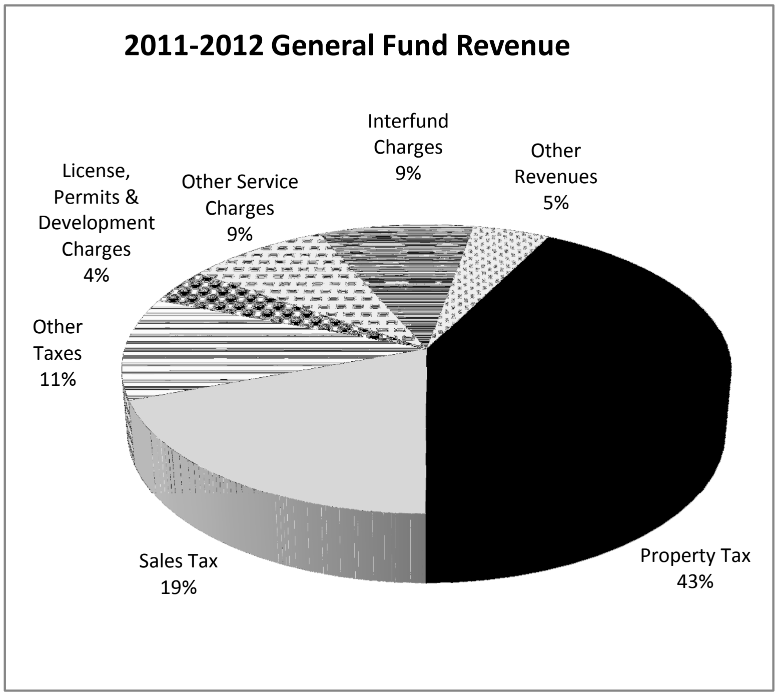


Cities with fewer sources of General Fund Revenue will require a greater amount in reserves in order to successfully weather a downturn in one revenue area. This is true for the City of Atascadero. Property based taxes account for over 43% of general Fund revenues in 2011-2012, with sales tax accounting for an additional 19%. These two revenues sources alone account for 62% of the City's General Fund revenues. In the graph on the previous page, one can compare to this to revenue base for a city such as San Luis Obispo which has a more diverse revenue base.

One reserve methodology dictates that that reserve levels should be tied to the broadness of General Fund tax revenues sources. The greater number of revenue sources require fewer layers of reserves. Conversely, the fewer number of revenue sources require higher levels of reserves. As Atascadero's property tax and sales tax revenues comprise $10.1 million of the $16.3 million in General Fund taxes, the City is defined as having a narrow base of revenue-just two significant categories.

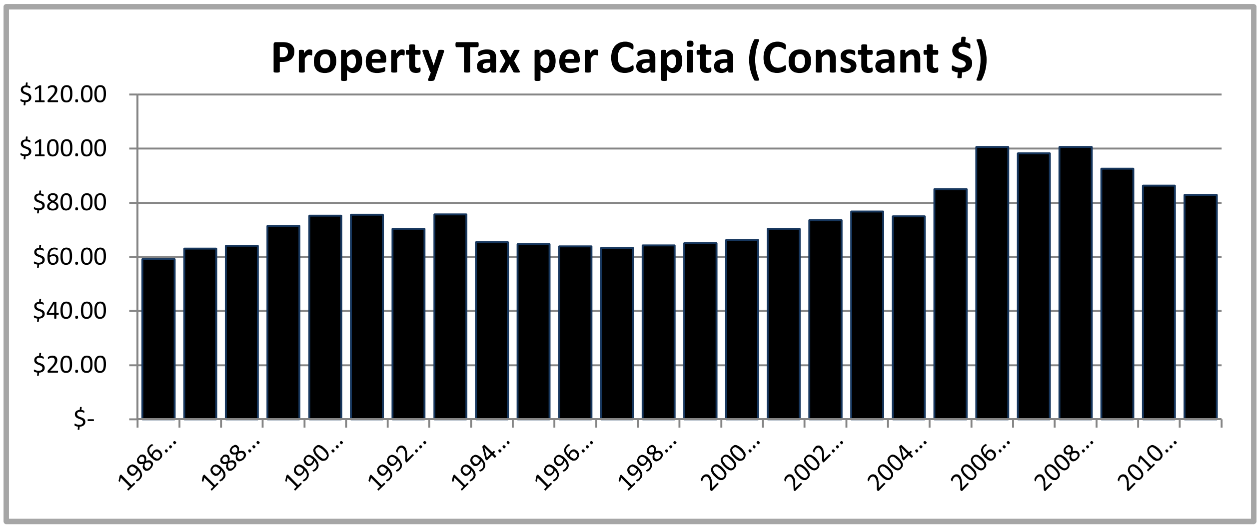
Measurement #3 – Stability of Revenue Base

As discussed above, General Fund revenues for fiscal year 2011-2012 were $16.3 million. Seventy-three percent of this was from taxes, with the balance coming from fees, grants, and other sources. The fees and grants pay for specific services or projects. To examine the tax base more closely, it is helpful to break it down further. Property tax comprises 43% of the revenues, sales tax 19%, other taxes 11%, development costs and other fees for services 13% and other revenues/interfund charges make up 14%

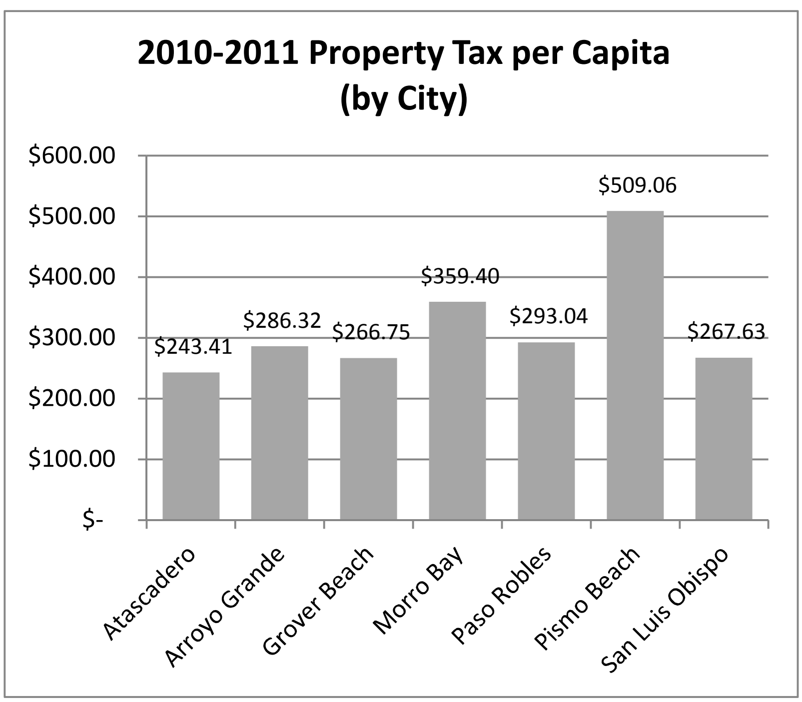


Property tax is considered to be one of the more stable sources of revenue. Although there were large increases in the boom years 2000-2008, most other years since incorporation have seen either modest (1-4%) increases or decreases in the tax base. Historically the property tax revenues have two components: (1) a stable base that does not vary drastically from year to year and (2) a housing market boom and correction component.

While there is a stable underlying base, this revenue does vary with the strength of the housing market. The table below shows property tax per capita on a constant dollar basis. The constant dollar smooths out changes for normal inflation so that it is obvious if the condition has gotten better than 1987 or worse.



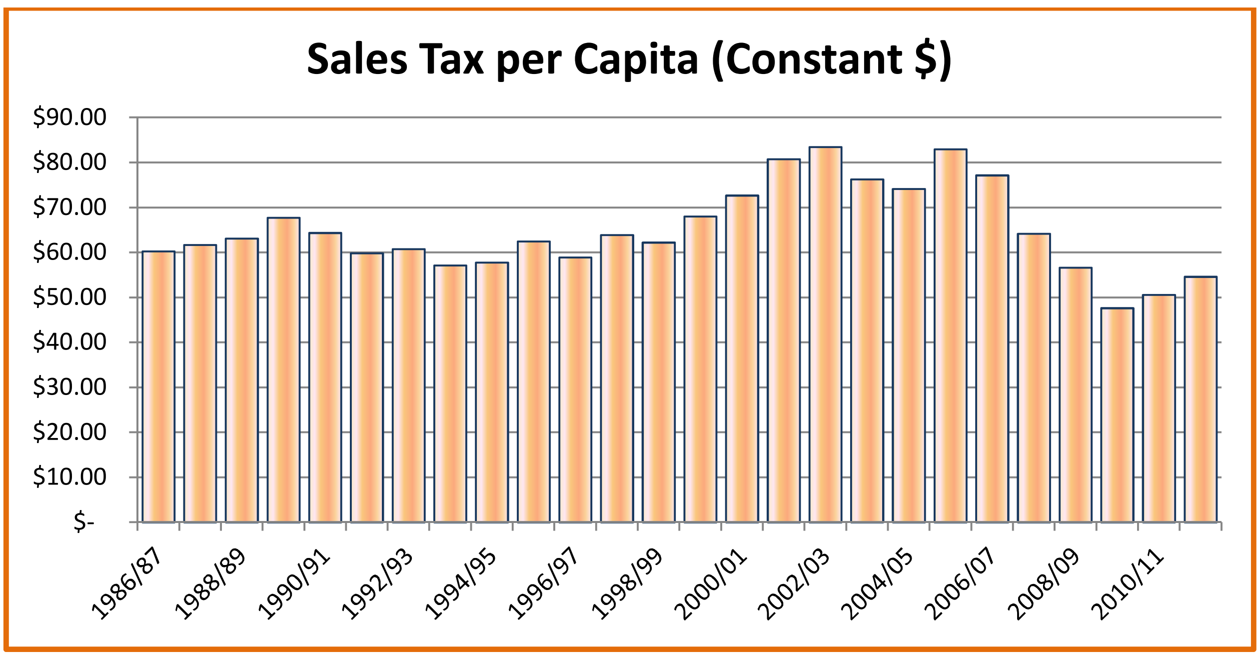
In California in the late 80's/early 90's and then again in the mid-2000's, the housing market did not follow normal inflation. Housing prices and new construction boomed causing spikes in the property tax revenue base, followed by a smoothing or flat period. Overall the smooth or flat period of revenue is the stable portion of the revenue base and is what the City can count on year after year. The spikes are periods of boom where there are opportunities for the City to sock away reserves and address one-time fixes. Since it appears that the real estate market has generally corrected itself and there are signs of growth in the property tax base, it is reasonable to assume that the City is now again in the flat period where the entire property tax base is considered very stable.



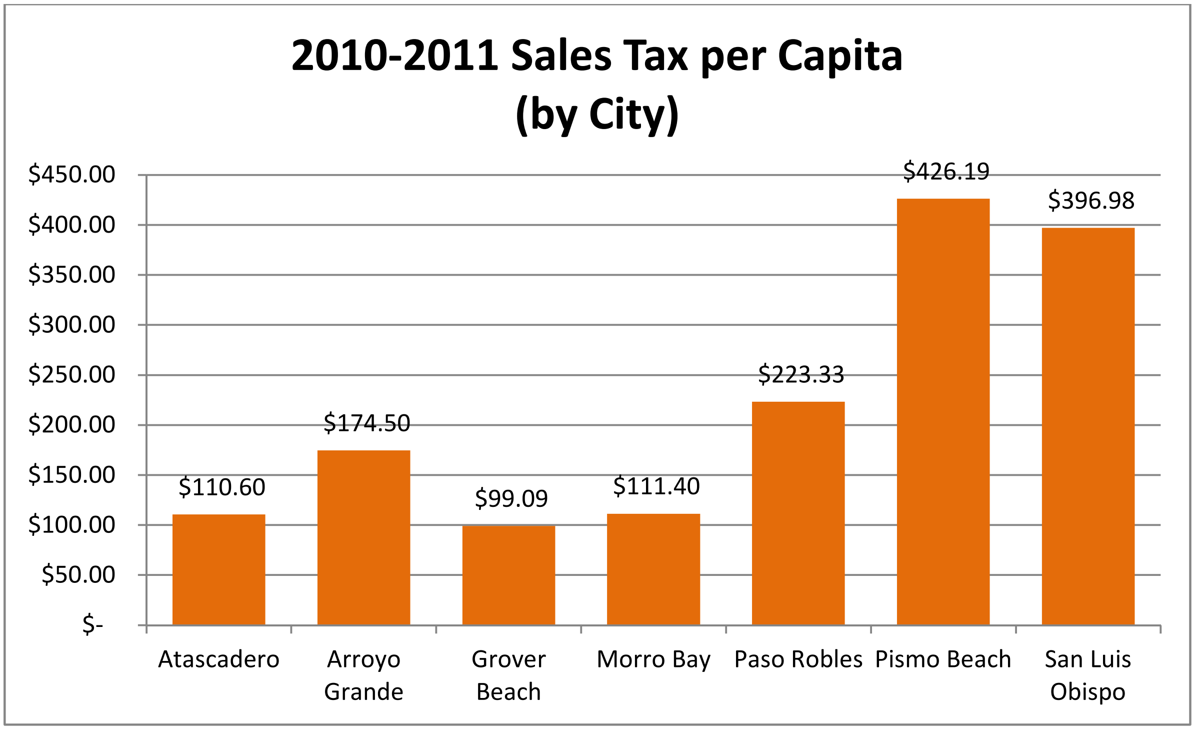
It is also interesting to compare Atascadero's property tax per capita with other cities in the county. The chart to the left shows that Atascadero's community has the lowest per capita property tax in the county. It is true that in this county, each city has its own unique characteristics which often make it hard to do comparisons. Even with that in mind, however, this chart does make one thing painfully clear. Atascadero has less money per person to spend on essential functions such as public safety and parks that are critical to citizens of the community. In other words, the relative strength of Atascadero's dollars per capita is not as good as that of neighboring cities.

Sales tax is much more susceptible than property tax to fluctuations in the economy. As of 2011-2012, only 19% of General Fund revenues come from sales tax. There are 1,000 businesses that report sales tax within the City of Atascadero, however one business accounts for over 10% of the sales tax revenue that the City receives, and the top 25 businesses account for over 57% of the sales tax revenue. The City's sales tax is currently heavily reliant on the continued health of the top 25 businesses listed in *Attachment B- HDL's City of Atascadero Sales Tax Update Q3 2012*

The chart below depicts sales tax per capita, constant dollar, over the last 20+ years. Like property tax, it too shows evidence of the ebbs and flows of the market, but to a greater extent. Atascadero started experiencing an increase in this revenue after Home Depot came on line in fiscal year 2000-2001, but then a sharp decrease with the loss of large sales tax producers such as Atascadero Ford and Ted Miles Jeep. The good news is that the City is starting to turn around again. Although the numbers are not yet back up to the $60.00 (1987 dollar value) per capita benchmark that was historically enjoyed, the planned development at Del Rio along with the aggressive economic development policies of the City Council should bring Atascadero back over that benchmark in the near future.



The strength of sales tax can also be compared to the other cities, as shown below in the per capita comparison.



One silent thief comes in the form of internet transactions. These transactions, when done via the internet, replace retail sales that the City would otherwise have earned sales tax revenue for. This trend has steadily grown and will continue to do so, further impacting future sales tax revenue.

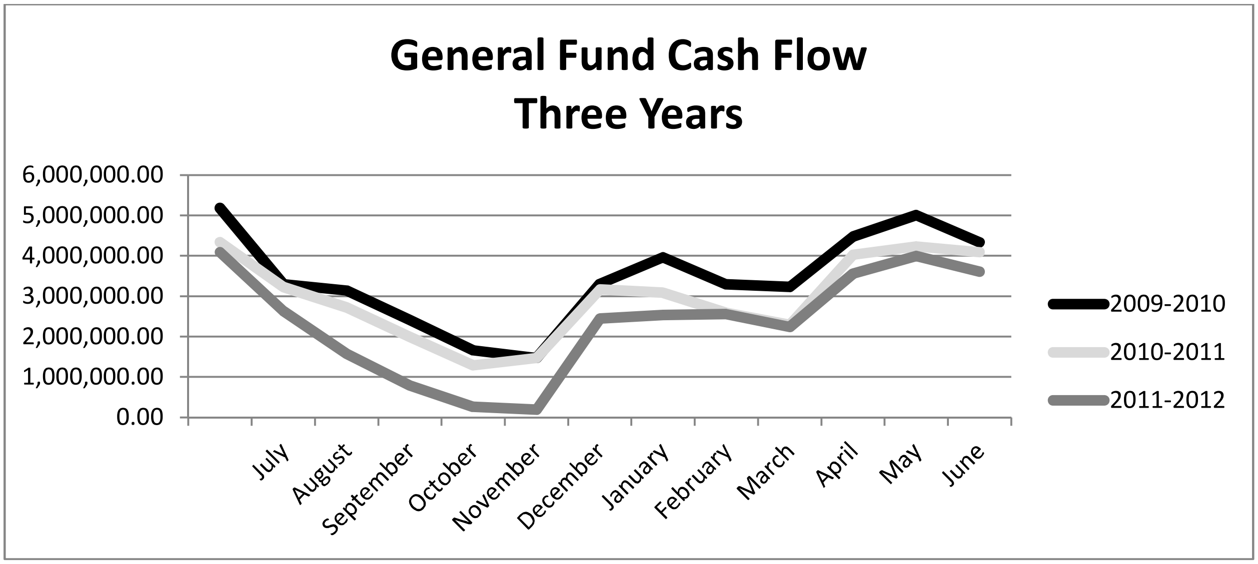
<u>Measurement #4 – Potential Actions of Federal and State Agencies</u>

When the State faced fiscal challenges in the early 1990's it simply transferred property tax revenues from cities and counties in effect to itself (known as the ERAF I & II shifts). In addition, the State reduced funding for counties, and in turn allowed counties to recoup these lost revenues by charging cities for services such as collection of property taxes and booking people into county jail. In the late 1990s, the State was in very good financial position and desired to give constituents a tax break. The State did this by reducing one City revenue (VLF) and promising to backfill it with a different one. Most recently, in spite of the passage of two separate local revenue protection measures, the State has eliminated Redevelopment Agencies.

With the recent passage of Proposition 30 and the improved financial health of the State, the risk of State revenue raids is lower than it has been in years. The City is currently more vulnerable to continued increased costs due to added regulations. Although in a better position than in years past, the City's financial well-being continues to be vulnerable to political action.

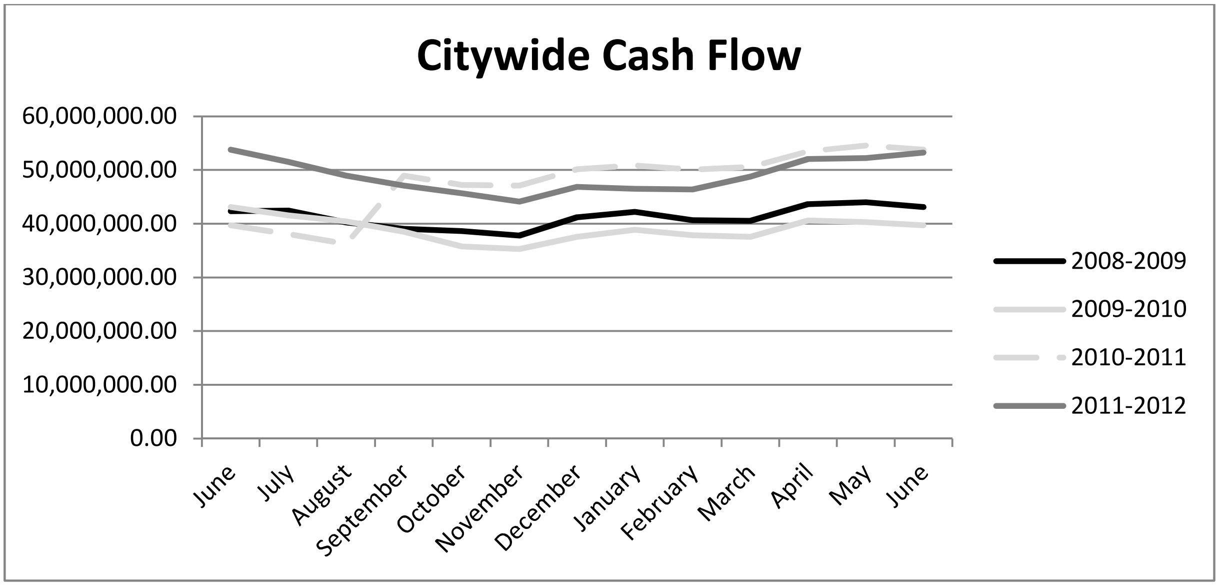
Measurement #5 – Cash Flows Needs

The cash flow needs of the City have a direct bearing on the amount of reserve needed. Unlike many private organizations and businesses with a steady cash stream, the City receives large portions of its annual revenues in chunks, twice a year. The fiscal year begins in July and ends in June. During the summer months, the City incurs more expenses for fire reserves, recreation programs, and capital projects than during other months of the year. However, the City does not receive its first fiscal year injection of property tax until late December, and then waits to receive the rest in late April. In other words, the City's general fund receipts go down from April through November while the City's disbursements go up during the same period.



If the City continues to use General Fund reserves, it is possible that the General Fund may have a negative cash balance at some points in future years. While this is a concern, it is not insurmountable. The City has a couple of fairly simple options at its disposal.

1. The City overall does NOT have a cash flow issue. The graph of the cash situation for the last few years is very different for the City as a whole. The cash balance on hand at June 30, 2012 was over $53 million and the lowest cash balance in the last 3 years is $36 million.



The City's General Fund can borrow funds from other available funds within the City. The City has over 50 funds in total. Some funds, such as the internal service funds mentioned above, are not restricted at all and may be loaned or transferred back to the General Fund at Council's directions. Other funds may have legal restrictions on how they can be spent. The restricted funds, however, may be loaned to other funds as long as they receive at least the same interest as they would've received without the loan, and the loan does not interfere with the purpose of the funds (i.e. the monies are not slated to be spent prior to the payback period). The City does have many funds available to loan, especially for the very short period (2 – 3 months) that is being discussed. As always, borrowing funds does not come without concerns. Prior to any borrowing projections of incoming funds and the ability to pay back should be evaluated and assessed.

2. As of June 30, 2012, the General Fund had $1.5 million in loans that it had given to other funds. Typically loans to other funds are made for expenditures purposefully made in advance of receiving the revenues. This may be for a grant, where the funds must spend funds first and then be reimbursed, or it may be for impact fees, where the Council decides to build a specific project now in order to benefit future development, and then collects the funds as development occurs. These loans have historically been from the General Fund as it has had available funds on hand. Council could determine that these loans would be more appropriate from different funds, thus paying the General Fund back its cash.

3. Historically, the City was one of many cities that issued Tax Revenue Anticipation Notes, or TRANs, to cover annual General Fund cash shortfalls. The TRANs were issued through the California Statewide Communities Development Authority. Because the TRANs were tax free issuances and the funds were needed for just a short period of the year, it was an opportunity for the City to

cover the short period of negative cash, and earn interest on the funds for the rest of the year. The City was not allowed to participate in the TRANs issuance once it had positive General Fund cash flow throughout the year. Current market conditions do not make the TRAN as attractive as it has been in years past.

Ideally the City General Fund would have enough cash on hand to cover the annual cash ebbs and flows; however the City does have options for these annual fluctuations. A much harder look must be taken though, when the annual negative cash balance is no longer annual, but instead a long-term loan. It would not be consistent with Council's conservative fiscal policy to allow reserves to fall so low that interfund loans are not paid back within the fiscal year. While the current seven year projection does not anticipate such an occurrence, it is something that must be monitored.

Measurement #6 – Potential Natural Disasters or Emergencies

Atascadero is subject to potential natural disasters including earthquakes, floods, fires, major auto and train accidents, and hazardous materials spills. The San Simeon Earthquake and storms in the not-too-distant past are proof of that. City staff are well trained in responding to emergencies and meeting the needs of the community. Any natural disaster or emergency will undoubtedly cause unbudgeted expenditures, fortunately, however, in the event of a declared disaster, agencies such as FEMA and CalEMA provide assistance to help the City recover. The funding received from these agencies are reimbursement funds; in other words, the City spends the funds and then requests reimbursement. In the event of a disaster or emergency, the number one priority of the City must be to respond to the emergency. When looked at as a whole, the City has ample cash on hand to respond to an emergency until assistance funds could be received. It may mean once the emergency is over and the accounting done, that the General Fund cash was negative and it had to borrow from other funds, but the Council priority to insure the safety of its citizens was attained.

The City is fully insured against property damage and liability claims. Additionally, Atascadero is very aggressive in applying for all applicable grants, when available, particularly to pay for the cost of responding to emergency situations.

Measurement #7 – Asset Replacement Requirements

The City of Atascadero owns large amounts of assets that have lives longer than a year such as buildings, infrastructure, technology, and vehicles. Council began back in the late 1990's putting money into the reserves for many of these items so they could be replaced as needed. While not all of these assets reserves are fully funded, many of those that most directly affect community service levels have been funded. These include technology and vehicles. Asset replacement reserves have been evaluated in Section 4 of this report. See Section 4 for more detail on this subject.

Measurement #8 – Service Level Consistency

Another issue to consider is how important it is to the organization and constituents that services levels are consistently maintained. Looking back almost two decades ago, this was a key concern. A less fiscally conservative policy was in effect during that time, and when the economy became sluggish, reserves were insufficient to carry the City through the tight times. Services were cut. Many families had to seek alternate sources for youth recreational activities. Parks and Public Safety services were at a bare minimum. Employees were laid off. The few employees that remained to run the City were overworked and frustrated. Morale was at an all-time low. Recruitment during the recovery period was difficult at best.

Fortunately, as the Council put the fiscal sustainability policy in place, things began to turn around. This strategy of putting aside reserves in good times and then using those reserves during down periods to achieve stable operations has allowed the City to maintain fairly consistent operations over the last two budget cycles. Instead of burdening the ongoing operations budget with significant new purchases and programs when times were good, the Council kept level heads and tucked away some extra funds. As the economy started to turn south, instead of cutting programs and staff to uncomfortable levels, Council was again able to maintain services to the public by utilizing some of the reserves that were saved up. The ability to maintain level and consistent services is important to consider when evaluating reserve levels.

Maintaining a service level consistency is even more of a delicate balance as the City begins to come out of the economic downturn. The wants of the citizens, employees and other constituents are immediate. During the downturn, people understand why City Hall is closed on Friday. When the economy is coming back, it is a natural reaction to want service levels to improve. The economy is better therefore the City is receiving more revenue, so services should be better. Remember the cornerstone of the fiscal policy is to set aside money in good times for use in bad times so that **service levels remain constant.** This means that in the bad times, while the City did cut back in some small areas, in most areas, the service levels remained constant. The City was providing services at a level higher than revenues for the year could afford. Consistent with the policy, the City is using reserves to maintain service levels. In order for this strategy to work, the City has to continue to maintain service levels during the upturn. While the next few years will bring higher revenues, it will be some time before revenues are equal to the costs of the service levels that the City provides. The reserve policy will be even more difficult to adhere to due to as public pressure increases to increase service levels, however the current service levels are the levels that the City can afford in the long run. New or improved service levels or programs can only be added with a fundamental shift or a change in funding for the City.

Measurement #9 – Available Opportunities

In the good years, previous Councils have wanted the flexibility to take advantage of opportunities as they arose, and used reserves at times as a tool to achieve such goals. More recently with the economic downturn, the focus has been directed not at new programs or services, but ways to improve and streamline existing programs and services to better serve the public and attract businesses and visitors. Available reserves can be used for these opportunities. Alternatively, if it makes fiscal sense, financing can be another option to achieve identified goals or pursue opportunities.

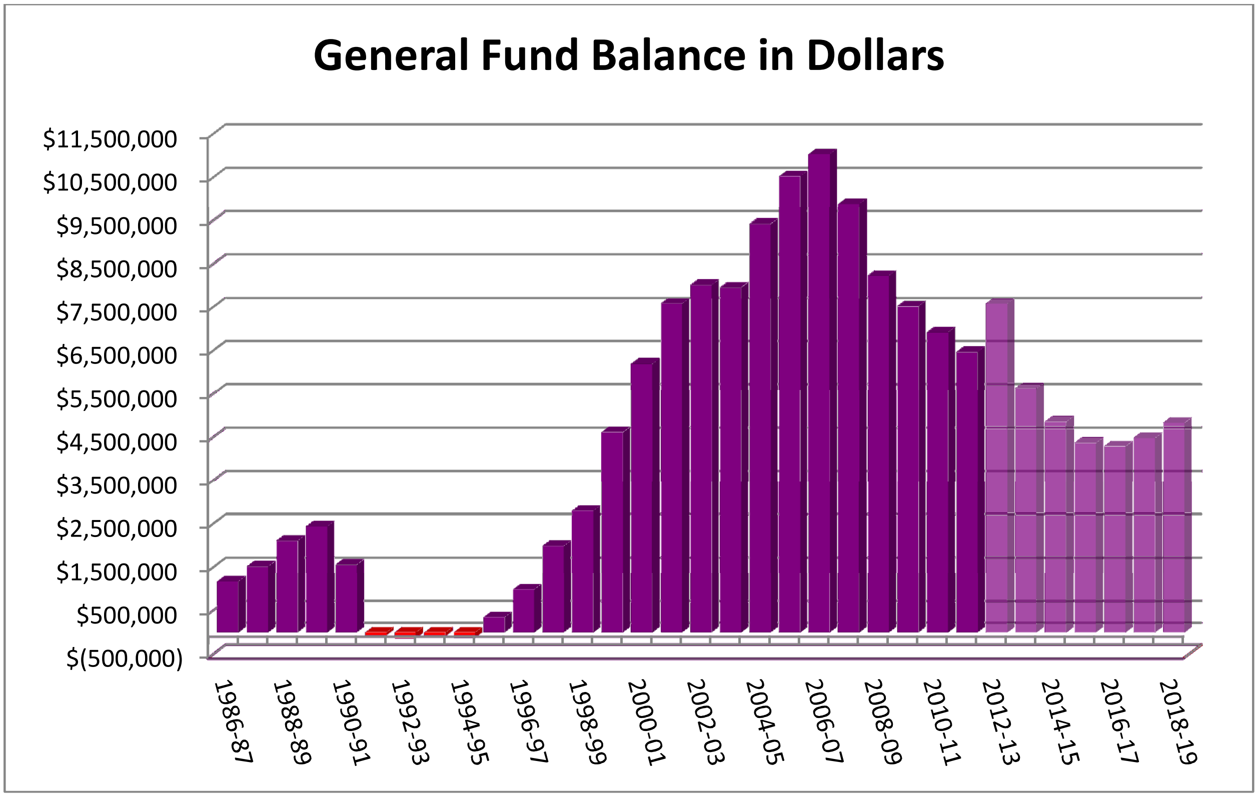
Look at the Big Picture

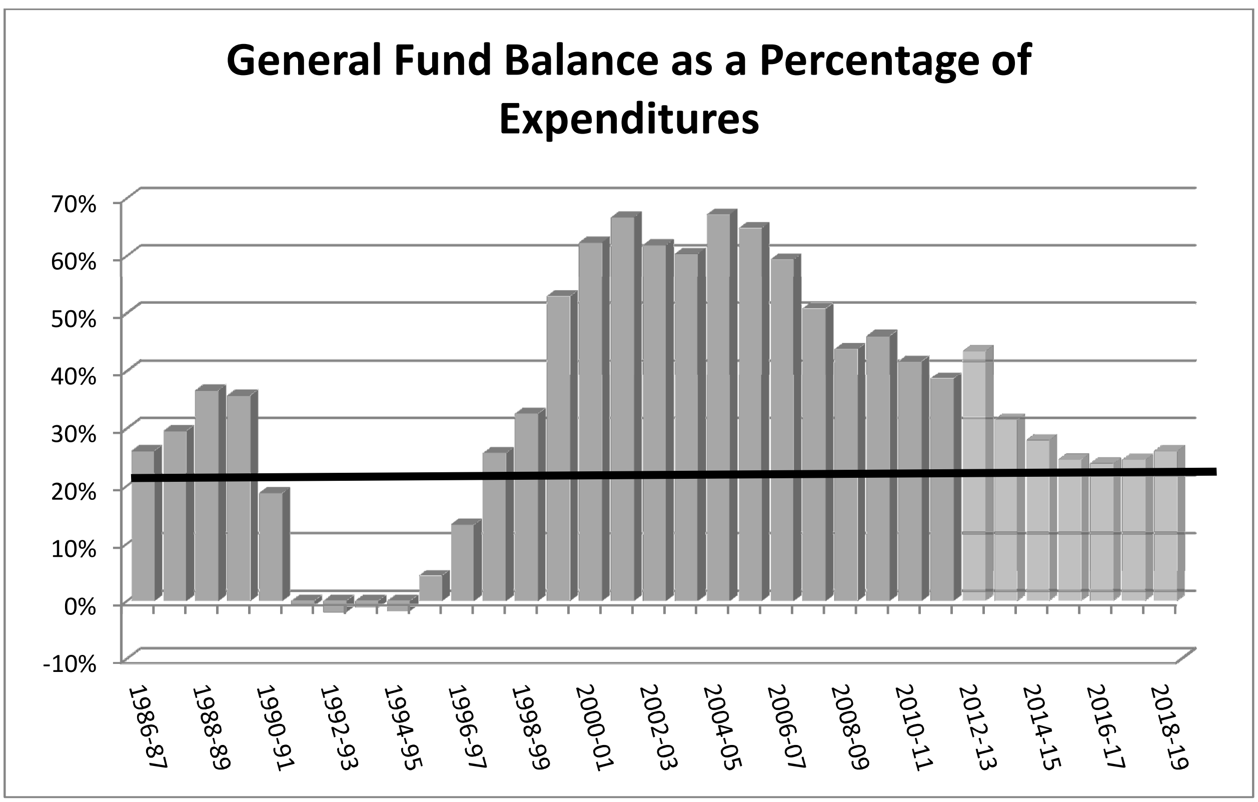
Nine criteria have been analyzed in order to ascertain what constitutes a prudent reserve for the City of Atascadero. While each of these is an important measurement, they should not be looked at individually but instead as a whole. They must also be considered within the framework of the financial picture for the entire organization rather than just the General Fund.

If each reserve was to be considered individually, it might be recommended that the City reserve 10% of sales tax in case a major sales tax provider closes its doors, plus three months' worth of expenditures for natural disasters, plus $3.8 million for annual cash flow needs, plus $2 million on hand just in case an opportunity comes up, etc. Each item listed is an individual event, and, in theory, could all happen at the same time, but the risk of that happening is minimal. It would be irresponsible to the constituents to keep the cumulative amount of what would otherwise be prudent individual reserves. These are funds that could be used to fund City services. Instead, as looked at above, it is sensible to analyze each potential use of reserves and determine what risk and use level is acceptable to the City and what other options are available.

CONCLUSION

As of June 30, 2012 the City's General Fund had a reserve $6.5 million. This represents a healthy 38.6% of General Fund expenditures. As of June 30, 2013 the reserve is expected to jump to $7.6 million or 43.4% of General Fund expenditures. While this is not equal to the all-time high level of $11 million reached in 2006-2007, the reserve levels are very consistent with the financial strategy set by the City Council.





In accordance with the City's financial strategy, the City should have its highest level of reserves just prior to an economic slowing. Fiscal year 2006-2007 was the last strong year for the City and it was the year the City had the largest reserves. In 2007-2008 the bottom dropped out of the economy and the City began using reserves. By 2008-2009, the City was using reserves and began to realize that this was no ordinary recession, so Council made the tough decision to reduce service levels. The City has continued to monitor reserves levels, allowing the City to remain financially healthy in this downturn. Staff recommends that City continue to use reserves to keep service levels, monitor and adjust through the budget and strategic planning process. Staff recommends that if there is a substantial change (something along the magnitude of the elimination of Redevelopment) that it would be addressed immediately and adjustment made accordingly.

Staff believes that this uptick in the economy is just beginning and that it will be a long slow climb before the City sees anything like the revenue numbers in 2006-2007. The financial policy has worked in the past, and if adhered to, it appears that it will work through this next financial planning horizon. Current projections show that using current assumptions and strategies in place, reserves will fall to a low of $4.3 million or 24%. This is above the 20% that the Council has set as the “norm” in the historical financial strategy. It is important that as the City recovers that the organization is intact and ready to take advantage of opportunities. The general financial plan laid out in the Seven Year Projection ensures that the City is not borrowing against the future and that there are sufficient reserves on hand to address the needs of the City throughout this downturn and recovery.

GENERAL FUND RESERVE BALANCES
As of January 2, 2013

	Actual 2011/2012	Estimated 2012/2013	Estimated 2013/2014	Estimated 2014/2015	Estimated 2015/2016	Estimated 2016/2017	Estimated 2017/2018	Estimated 2018/2019
Total Revenues	$ 16,290,637	$ 18,575,000	$ 15,958,000	$ 16,582,150	$ 17,278,070	$ 17,815,650	$ 18,428,880	$ 18,854,750
Total Expenses	(16,744,519)	(17,463,820)	(17,901,420)	(17,361,430)	(17,765,130)	(17,896,640)	(18,233,740)	(18,506,610)
NET INCOME / (LOSS)	(453,882)	1,111,180	(1,943,420)	(779,280)	(487,060)	(80,990)	195,140	348,140
Fund Balance Beginning of Year	6,920,444	6,466,562	7,577,742	5,634,322	4,855,042	4,367,982	4,286,992	4,482,132
FUND BALANCE END OF YEAR	**$ 6,466,562**	**$ 7,577,742**	**$ 5,634,322**	**$ 4,855,042**	**$ 4,367,982**	**$ 4,286,992**	**$ 4,482,132**	**$ 4,830,272**
Fund Balance as % of Expenses	**38.6%**	**43.4%**	**31.5%**	**28.0%**	**24.6%**	**24.0%**	**24.6%**	**26.1%**

It is important that the City maintain an appropriate level of reserves. The fiscal strategy has been an effective tool to keep the City in a respectable financial position. Continued judicious use of reserves is key to keeping a steady course throughout the remainder of the economic storm. Historically, Council has agreed that reserves should not drop below 20% of General Fund expenses. Through careful planning and many years of belt tightening through the worst of it, this seems to be an achievable goal. While it will certainly be a long, slow climb out of this current economic downturn, overall the City is in a respectable position. Staff will continue to monitor actual figures as they come in and compare them to the projected numbers. With consistent monitoring, the Council has been, and will continue to be, alert and effective leaders guiding the City toward future abundance.

Atascadero

Comprehensive Financial Strategy
January 2013

Section 6- Policies

Review of Fiscal Policies

The budget document allocates City resources such as personnel, materials, and equipment in tangible ways to achieve the general goals of the community. It is prudent, therefore, for the City to have in place fiscal policies and practices to guide the City Manager and City Council through the budget decision-making process. These policies and practices are:

Operational Efficiencies:

- Continue to look for opportunities to reduce operating expenses through various methods including deferring purchases, conserving utilities (using high energy efficient lighting, watering less, raising thermostats), and minor decreases to service levels;
- Continue to implement internal operating efficiencies to the extent possible;
- Look for opportunities to enter into joint operating arrangements with other organizations so as to provide services more cost effectively;
- Continue the use of valuable volunteers.

Staffing:

- Continue hiring chill that requires management evaluation for each position that becomes empty due to attrition; management takes a hard look at the position and its contribution to determine if that position is absolutely necessary in the short run. Utilize private contractors when the same or higher level of service can be obtained at lower total cost;
- Utilize consultants and temporary help instead of hiring staff for special projects or peak workload periods.
- Attract and retain competent employees by providing a professional work environment, competitive salaries, safe working conditions, and adequate training opportunities;
- Base salary increases on individual merit and job performance levels;
- Strive toward maintaining above average employee compensation packages in order to retain and recruit the best and the brightest;
- Work toward adequate staffing for the service levels being provided;
- Be aware of and plan for state, federal and OSHA mandates which might have an effect on staffing levels;
- Be aware of, monitor and avoid the costs of employee turnover, burnout, and stress due overwork;
- Look for service level reductions in areas where there will be minimal impacts to citizens, thus “freeing” employee time.

Education and Communication:

- Encourage employee ideas for efficiency, reduction in costs, or increases in revenues;
- Provide Council and public with information regarding the City's financial outlook through both the audit and budget process, and continue to update with any changes that occur.

Economic Development:

- Provide a climate that encourages healthy commercial areas that capture more of the purchasing power of the community and creates more destination commercial activities to capture regional money;
- Aggressively pursue new developments and businesses which are consistent with the community's quality of life and add to the City's economic base, particularly those that generate sales tax revenue;
- Promote a mix of businesses that contributes to a balanced community;
- Continue to improve programs to enhance and retain existing businesses.
- Continue to invest City resources in programs such as the promotions program in order to grow the City's revenue base. (Monitor investments to ensure that revenues produced exceed the amounts invested).

Community Development:

- Ensure that adequate funding is in place to provide essential services to new residents without diluting services for existing residents by:
  - Formation of a Community Services District to fund the addition of the necessary police, fire and parks personnel needed to provide services to these new residents;
  - Requiring each project that comes before Council to annex into the newly formed Community Facilities District. (The general plan requires that only developments with 100 or more units be fiscally neutral);
  - Formation of road maintenance districts in order to provide an ongoing revenue source needed to maintain new, expanded or recently accepted roads.
- Require that new growth pay for the expansion of facilities and infrastructure necessary to serve the expanding population;
- Plan community growth with service and maintenance funding requirements in mind.

Infrastructure:

- Fully fund technology replacement funds;
- Work toward fully funding vehicles and equipment replacement funds;

- Keep in mind the long-term replacement needs for items such as roads, storm drains and buildings;
- Continue to determine and implement strategies to reduce the current backlog of deferred maintenance projects;
- Provide sufficient routine maintenance each year to avoid increasing the deferred maintenance backlog;
- Determine a maintenance plan and funding strategy prior to the construction, improvement or acceptance of new infrastructure.

New Services:

- New or expanded programs should only be implemented when a new funding source has been developed or when an equal or greater cost program has been eliminated;
- Require agreements for specific services and monitor effectiveness on an ongoing basis.

Construction of New Facilities:

- Plan for new facilities only if construction and maintenance costs will not negatively impact the operating budget.

Cash Investment:

- Follow adopted Investment Policy guidelines for the prudent investment of City funds not required for the immediate needs of the City;
- Maximize the efficiency of the City's cash management system;
- Enhance the economic status of the City while protecting its pooled cash.

Fiscal Management:

- Analyze and set the appropriate use of reserves in this economic downturn.
- Consider the long-term and the short-term when making financial decisions;
- Continuously monitor operations and make adjustments as necessary;
- Take full advantage of opportunities to receive reimbursement funding at maximum rates possible;
- Look for opportunities to generate additional revenue by marketing City services to other agencies on a contract basis;
- Maximize revenues by utilizing grants from other agencies to the fullest extent possible;
- Understanding that these are tough economic times for everyone, review charge fees for services. Make conscious decisions to subsidize particular programs or services while charging the full cost of other services.

- Fully account for the cost of enterprise operations to avoid any subsidy by the General Fund and to charge all enterprise funds their fair share of the cost of City support services;
- Maintain accurate accounting records to keep the City Manager, City Council and public informed of the financial condition of the City at all times;
- Think out of the box to achieve revenue opportunities that wouldn't otherwise exist;
- Consider partnerships and taxing opportunities when appropriate.

Conclusion

The policies and practices listed in this section have been practical guides toward a consistently healthy fiscal condition. The importance of these and a well-defined financial strategy to anticipate and conquer difficult issues cannot be understated. The responsibility to maintain a strong organization is shared community wide, but as the City Council and City employees, we agree to be the leaders in this effort. Council has shown integrity in the decisions made to maintain the conservative fiscal strategy. When resources are tight and needs are plenty, it is difficult to commit to saving some of those precious resources for the future. Those reserves are most appreciated now as the City continues to climb out of the economic downturn. The General Fund reserve is projected to be $7.6 million at June 30, 2013; certainly, the fiscal strategy is working.

The recovery will be long and slow, but the economy is moving in a positive forward direction. Public pressure to increase one-time and on-going spending will continue to make decisions difficult. However, the fiscal strategy has provided the option to keep operations and service levels stable, and continued use of the strategy will undoubtedly produce similar positive results. Steady and consistent spending will be keys to success. Thoughtful decisions on spending produce judicial use of the precious reserves. Judicial use of the reserves produces a City with a responsible fiscal attitude. A responsible fiscal attitude produces citizens confident in their government. All these taken together produce an abundant and sustainable future.

ATTACHMENTS:

Attachment A- *The State Legislative Analyst's Office's (LAO's) California Fiscal Outlook November 2012, Chapter 2*
Attachment B- HDL's City of Atascadero Sales Tax Update Q3 2012
Attachment C- *HDL's California Forecast: Sales Tax Trends and Economic Drivers*

Atascadero

Comprehensive Financial Strategy
January 2013

Attachments

The 2013-14 Budget:
California's Fiscal Outlook

MAC TAYLOR • LEGISLATIVE ANALYST • NOVEMBER 2012

LAO

Table of Contents

Chapter 2

Economy, Revenues, and Demographics

ECONOMIC OUTLOOK

Figure 1 shows a summary of our forecast for both the U.S. and California economies through 2018. Figure 2 (see next page) compares the near-term economic forecast with other recent California economic forecasts, including the Department of Finance's (DOF) May Revision forecast (which was used as the basis for revenue assumptions in the *2012-13 Budget Act*).

U.S. Economic Forecast Down, State Forecast Up From Budget Act Forecast. In

Figure 1

LAO Economic Forecast Summary

United States	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Unemployment rate	9.3%	9.6%	8.9%	8.2%	8.0%	7.6%	6.9%	6.4%	6.2%	6.0%
Percent change in:										
Real gross domestic product	-3.1%	2.4%	1.8%	2.1%	1.8%	3.0%	3.4%	2.9%	2.7%	2.5%
Personal income	-4.8	3.8	5.1	3.5	3.9	4.9	4.9	4.9	4.3	4.4
Wage and salary employment	-4.4	-0.7	1.1	1.4	1.3	1.8	2.0	1.8	1.3	0.9
Consumer price index	-0.4	1.6	3.2	2.0	1.3	1.7	1.7	1.9	1.9	2.0
Housing starts (thousands)	554	587	609	751	949	1,276	1,587	1,690	1,713	1,709
Percent change from prior year	-38.8%	5.9%	3.7%	23.3%	26.4%	34.5%	24.4%	6.5%	1.4%	-0.2%
S&P 500 average monthly level	947	1,139	1,269	1,384	1,476	1,541	1,615	1,684	1,751	1,817
Percent change from prior year	-22.5%	20.3%	11.4%	9.0%	6.7%	4.4%	4.8%	4.3%	3.9%	3.8%
Federal funds rate	0.2	0.2	0.1	0.1	0.1	0.1	0.6	2.6	4.0	4.0
California	**2009**	**2010**	**2011**	**2012[a]**	**2013[a]**	**2014**	**2015**	**2016**	**2017**	**2018**
Unemployment rate	11.4%	12.3%	11.8%	10.6%	9.6%	8.7%	7.8%	7.1%	6.7%	6.7%
Percent change in:										
Personal income	-5.8%	3.1%	5.2%	4.1%	4.7%	5.5%	5.8%	5.4%	4.9%	4.7%
Wage and salary employment	-6.0	-1.1	0.9	1.7	2.3	2.5	2.6	2.1	1.7	1.1
Consumer Price Index	-0.3	1.3	2.6	2.2	1.3	1.7	1.7	1.9	1.9	2.0
Housing permits (thousands)	36	45	47	63	83	113	139	155	168	164
Percent change from prior year	-43.9%	23.0%	5.9%	32.6%	32.6%	35.8%	22.4%	11.6%	8.4%	-1.9%
Single-unit permits (thousands)	25	26	22	27	37	53	70	80	87	82
Multi-unit permits (thousands)	11	19	26	36	46	61	68	75	81	83

[a] Generally excludes extraordinary one-time personal income effects of Facebook, Inc. initial public offering. These effects will be displayed in future official economic data for 2012 and 2013.

general, our updated U.S. economic forecast is somewhat weaker than the forecast upon which the *2012-13 Budget Act* was based. This is based on recent trends in the nation's economy, including apparent hesitation by businesses to invest and hire due in part to uncertainty concerning future federal tax and fiscal policies. At the same time, we are somewhat more optimistic about the California economy than we were in prior months due to rising strength in the state's depressed housing market, vehicle sales, and various employment trends. Nevertheless, as noted below, this remains a slow economic recovery by historical standards.

(We note that our economic forecast was developed prior to both the election and the date on which Hurricane Sandy struck New Jersey and New York. Sandy is likely to affect national economic data in the coming months. One possibility is that the storm's effects will reduce U.S. gross domestic product [GDP] growth below our forecast by a few tenths of a percentage point in the fourth quarter of 2012, but add back about that amount to GDP in the following quarter due to reconstruction efforts.)

U.S. Economy

Slow Recovery From a Severe Economic Contraction. The 2007-2009 recession was the most severe economic contraction since the Great Depression. Moreover, as shown in Figure 3, the nation's recovery from the recession has been slow by historical standards. Following the 1981-1982 recession, U.S. real GDP expanded at 3.5 percent or greater in each of the next four years, and the nation's employment grew at 2.5 percent or greater in five of the six years

Figure 2

Comparing This Economic Forecast With Other Recent Forecasts[a]

	2012				2013			
	DOF May 2012	LAO May 2012	UCLA September 2012	LAO November 2012	DOF May 2012	LAO May 2012	UCLA September 2012	LAO November 2012
United States								
Percent change in:								
Real Gross Domestic Product	2.2%	2.2%	2.1%	2.1%	2.4%	2.4%	1.7%	1.8%
Employment	1.6	1.6	1.4	1.4	1.7	1.7	1.4	1.3
Consumer Price Index	2.1	2.2	2.0	2.0	2.0	1.7	1.7	1.3
S&P 500 Stock Index[b]	8.1	9.2	NA	9.0	3.5	4.0	NA	6.7
Unemployment Rate	8.2	8.2	8.2	8.2	7.9	7.9	8.0	8.0
Federal Funds Rate	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1
California								
Percent change in:								
Personal Income	4.9[c]	3.9	3.0	4.1	3.4[c]	4.7	4.1	4.7
Employment	1.4	1.7	1.7	1.7	1.9	2.1	1.5	2.3
Unemployment Rate	10.9	10.7	10.7	10.6	10.4	9.9	9.8	9.6
Housing Permits (thousands)	53	59	50	63	81	69	69	83

a Recent DOF and LAO economic forecasts generally assume that Congress and the President agree to extend the "Bush tax cuts" and recent payroll tax cuts beyond their scheduled expiration dates at the end of 2012 and also lower spending more gradually than the current-law federal sequestration plan indicates.

b Based generally on assumed average daily closing levels of the index and the resulting year-over-year changes in such levels.

c The DOF May 2012 economic forecast includes various effects of the initial public offering (IPO) of stock by Facebook. The LAO economic forecasts largely or entirely exclude the effects of the IPO. If the IPO had been excluded from the Governor's May 2012 economic forecast, growth in California personal income would have been 4.0 percent in 2012 and 4.2 percent in 2013. Both LAO and administration revenue forecasts since February 2012 have included effects of the IPO.

DOF = California Department of Finance; UCLA = UCLA Anderson Forecast for the Nation and California; NA = not available.

during the 1984-1989 period. After the 1990-1991 recession, GDP grew by 3 percent to 5 percent in all but two years between 1992 and 2000, while employment grew by 2 percent to 3 percent annually through almost all of that period.

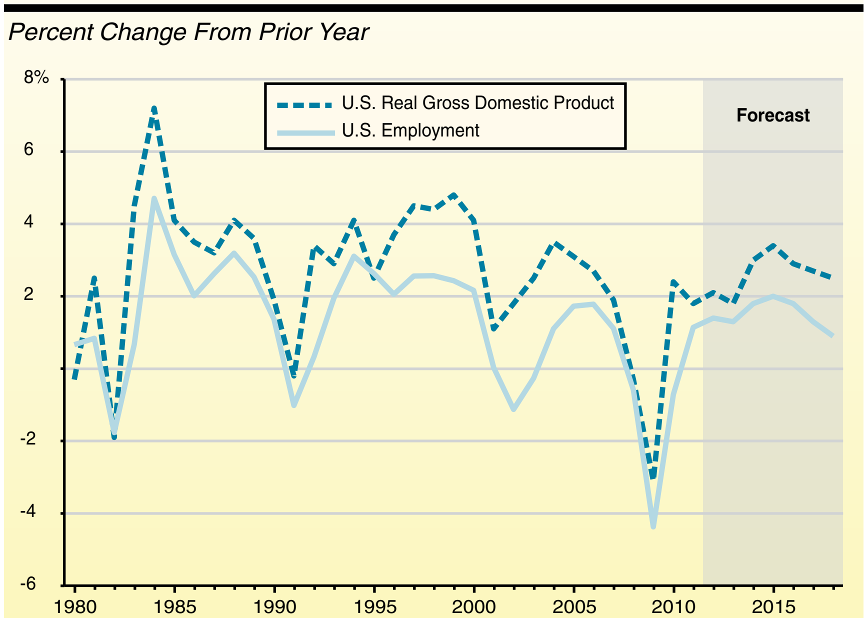
As shown in Figure 3, the current recovery—from the far more severe economic contraction of 2007-2009—is slower than the two recoveries described above in several respects. To date, GDP growth since the recession has been in the range of 2 percent per year, and we forecast that it will remain between 2 percent and 3 percent per year in all but one year between now and 2018. United States employment is forecast to grow at 2 percent or less each year through 2018.

Reasons for the Slow Recovery. Unlike other recent recessions, the 2007-2009 downturn was caused by an implosion of the nation's financial sector and housing markets. This resulted in significant harm to banks' balance sheets, as well as the balance sheets of households—particularly those that saw their net worth decline with the collapse of home values. Since the recession, financial institutions, households, and many businesses have been "deleveraging"—rebuilding their net worth and balance sheets step by painful step. Deleveraging requires saving, reducing consumption, and, in some cases, shedding liabilities through bankruptcies and renegotiation with creditors. Households and businesses are less capable of prodding the economy forward through spending, and financial institutions are less able to lend to facilitate such spending. These are some of the reasons why the U.S. economic recovery is so slow, relative to historical standards.

Federal Policy Important in the Forecast. The U.S. government borrowed significant amounts—including from international lenders—before, during, and after the recession to address the collapse of the financial sector, support some other economic sectors (such as the automotive industry and state and local governments), and provide economic stimulus. The Federal Reserve also has taken significant monetary policy actions intended to support the economy. As discussed later in this chapter, the U.S. government now faces major decisions about the future course of its fiscal and tax policies. These decisions have the potential to alter our economic forecast significantly over the next few years. In the worst case, federal decisions concerning the so-called "fiscal cliff" could plunge the U.S. economy into recession in 2013 and result in much weaker economic conditions in the near term than reflected in our forecast.

Figure 3

U.S. Recovery From Recent Recession Slow by Historical Standards



California Economy

California Also Recovering Slowly From the Recession. A similarly tepid recovery—compared to historical standards—is occurring in the California economy. The 2007-2009 recession was much more severe than recent downturns. Similar to the nation, personal income growth in California following the 2007-2009 recession has been much lower than after recent recessions. The rate of employment growth also has been slower. These trends are projected to continue in our forecast, although the recovery we are now projecting in the housing market is assumed to increase employment growth over the next four years, compared to what it would be otherwise.

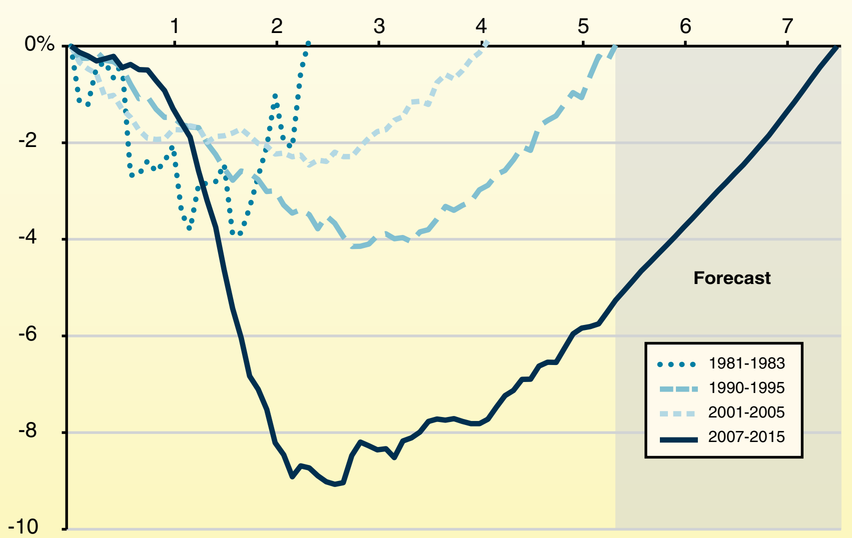
Figure 4 shows another way to look at the slowness of the current recovery in California. Covering the periods after the last four recessions, this figure shows how long it took California's economy to return to the pre-recession peak level of jobs. After the 1981-1982 recession, it took over two years for the number of jobs in California to return to the pre-recession peak. After the 1990-1991 recession and the resulting cutbacks in the defense industry, it took over five years. After the 2001 recession and the bust of the "dot-com" bubble, it took four years. As shown in the figure, the total decline in jobs during and after the 2007-2009 recession—about 1.4 million jobs (9 percent of seasonally-adjusted employment)—was far greater than in the prior recessions shown. Moreover, the projected recovery period is *much* longer than for the prior recessions shown. Our forecast assumes that seasonally adjusted employment in California reaches its pre-recession peak in early 2015, or 7.5 years after its pre-recession peak in July 2007. (In 2015, California's unemployment rate is projected to be around 8 percent—around 2 percentage points higher than it was in 2007—due in part to the state's growing population over the period.)

Improvements in Job Market. Despite the slowness of this recovery, improvements in the state's job market are evident. California now has regained 500,000 of the 1.4 million jobs it lost between July 2007 and February 2010, including a net gain of 262,000 jobs (1.9 percent) since September 2011. (This was faster than the national rate of employment growth—1.4 percent—over the same time period.) Due in part to some improvement in the housing sector, even California's weakened construction industries now are adding jobs—up about 26,000 (4.7 percent) in the past year. Every category of construction jobs—except highway, street, and bridge construction—has contributed to these gains.

Figure 4

Jobs in California Recovering Much More Slowly Than in Prior Recoveries

Job Loss and Years to Return to Pre-Recession Employment Peak



Manufacturing and Government Are Weak Job Sectors. While manufacturing employment has grown 1.5 percent for the U.S. as a whole over the past year, recent monthly jobs reports show that manufacturing jobs continue to decline in California—now down 11,000 jobs (0.9 percent) from one year ago. Moreover, while government employment has stabilized nationally, the combined number of federal, state, and local government jobs in California has declined—down 1.7 percent from one year ago. The bulk of the decrease is attributable to a drop of 35,000 jobs in local government educational services (a decline of 4 percent of jobs in this category). Manufacturing and government, therefore, are notable weak spots in an otherwise improving job situation in the state.

Housing Recovery Is Strengthening Somewhat

Recovery Has Been Slow. California's housing market is well into its third year of recovery from the recent housing crisis, during which home prices declined substantially before hitting bottom in 2009. (The median existing single-family home price fell from $560,000 in 2007 to $275,000 in 2009.) The recovery has been anything but stable, marked instead by a series of false starts. Beginning in late 2009, for example, home prices in the state's most populous areas—as shown in Figure 5—made solid gains for nine consecutive months before reversing trend throughout 2010 and 2011.

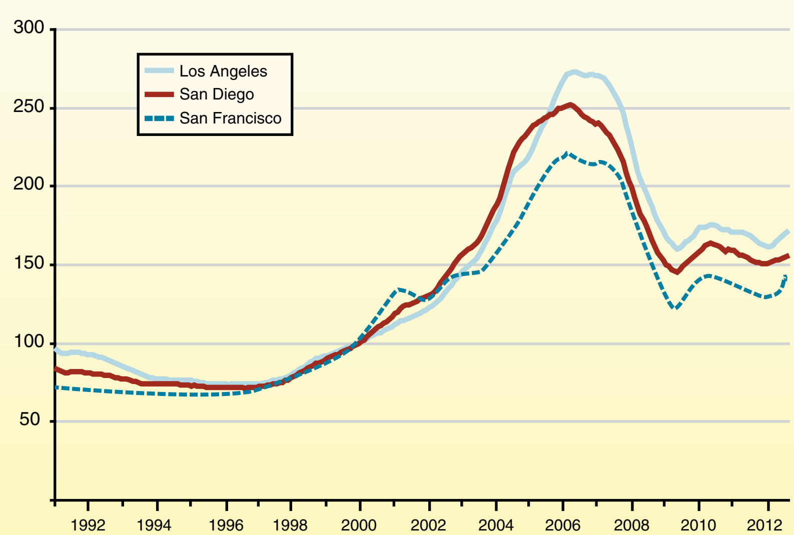
Construction activity also suffered during the housing crisis, coming to a near halt in 2009. As shown in Figure 6 (see next page), single- and multi-family unit building permits declined from their combined peak of around 210,000 units annually in 2004 to just 36,000 units in 2009. Not surprisingly, construction-related jobs were one of the state's most significantly weakened employment sectors.

Recent Housing Market Activity Stronger Than Previously Expected. A number of factors suggest that the demand for housing in California has picked up significantly from last year. Home prices in Los Angeles, San Diego, and San Francisco increased for the eighth consecutive month in August. Prices also have increased lately in the area's most affected by the housing crisis: the Central Valley and the Inland Empire. In addition, monthly rents have increased throughout the coastal regions of the state, with some areas posting double-digit annual increases. Not only do large annual rent increases act as a signal to developers to build more units, they can also indirectly affect the market for single-family homes. Specifically, as the cost to rent increases more quickly than the cost to own, many current renters may find that

Figure 5

Home Prices Now Recovering After Steep Decline

S&P/Case-Shiller Price Index of Existing Homes, Indexed to 100 in 2000



is has become comparably more affordable to purchase a home, further bolstering the modest housing recovery. Finally, a recent jump in the number of building permits—an indicator of future housing activity—suggests that housing development may already be responding to recent demand indicators.

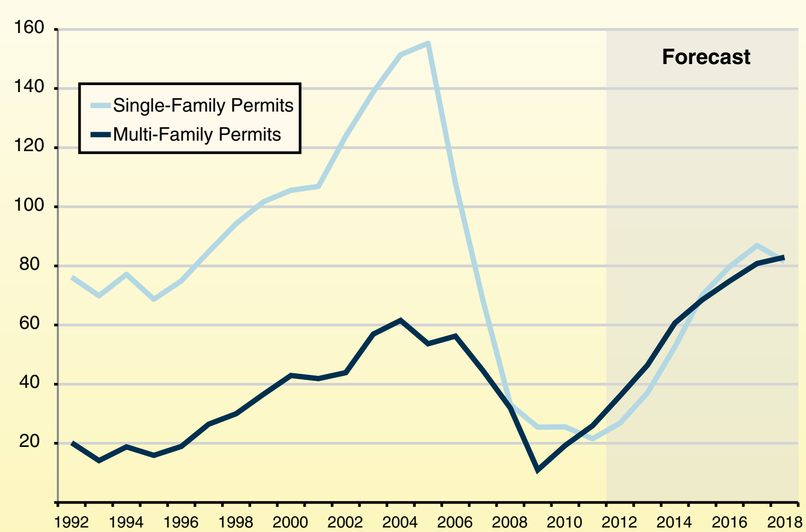
Current Forecast Projects Recent Strength to Continue. We view the trends discussed above as potentially more sustainable than those associated with earlier signs of housing strength, which proved largely illusory. Accordingly, we now forecast housing activity in the state to build upon current trends and stabilize in the final years of our forecast at approximately 160,000 new units annually, as shown in Figure 6. We forecast growth in both single- and multi-family unit building activity. Although our forecast level of building permits is much lower than during the housing boom of the mid-2000s, it remains a substantive upward adjustment in this forecast compared to our previous projections. This strength carries over to our forecast for assessed property values and property taxes, which is discussed in the nearby box.

Considerable Uncertainty Due to Difficulties in Forecasting Housing Trends. Forecasting housing activity is difficult because housing is influenced by complex and often unpredictable economic relationships. These include broad indicators like income and employment growth; real estate metrics like credit availability, mortgage rates, affordability, and prices (which may be subject to speculation); as well as behavioral markers like household formation and consumer confidence. In addition, the most recent data used in most economists' forecast models—including our own—are from two atypical periods: the housing boom of the mid-2000s and the ensuing crisis of the past few years. Forecasting future housing activity relies heavily, therefore, on judgment and is prone to significant upward and downward variation. Because of the importance of the housing market to the state's economy, housing activity below the levels in our forecast would in turn influence other key economic variables. For example, should building permits peak at 120,000 units annually (somewhat below our expectation of 160,000 units), the state's sales tax base could grow about one-half of a percentage point slower each year through 2017-18 than our current forecast assumes. Construction employment and, therefore, income taxes also would be affected.

Figure 6

California Building Activity Is Forecast to Recover

Annual Residential Building Permits (In Thousands)



Federal Policy

As noted in Chapter 1, the fiscal cliff is a key uncertainty in this forecast. All economic and tax forecasts are based on assumptions about future federal tax, spending, and regulatory policies. Similar to recent forecasts from our office, the administration, and many economists, this forecast assumes that the President and the Congress agree to actions in the coming weeks to delay or eliminate the tax increases and spending cuts of the fiscal cliff in the near term. We believe this is the most likely type of outcome.

Tax Policy Issues Are the Key Short-Term Risk for the State Budget. We believe that the most significant fiscal cliff issues affecting the state budget in the near term are the tax policy decisions facing the President and the Congress. Under current federal law, many federal taxes are scheduled to rise in 2013—potentially increasing tax liabilities of about 90 percent of the population. The following tax increases (or end to temporary tax reductions) are scheduled to occur as part of the fiscal cliff:

- The end of the "Bush tax cuts" (which were extended during the Obama administration), resulting in increased federal income tax rates for the vast majority of all taxpayers and a variety of other tax changes. Among the tax changes are higher capital gains and dividend tax rates for many taxpayers.

Assessed Property Values Projected to Improve

Local Property Taxes Affect State Budget. Although property taxes are a local revenue source, our office forecasts statewide property tax revenue because the portion of these taxes that goes to school districts generally offsets—on a dollar-for-dollar basis—state General Fund spending on schools and community colleges.

Statewide Assessed Value Set to Improve. We expect net assessed property value in the state to increase 1.7 percent to $4.4 trillion in 2012-13. (Net statewide assessed value is the main determinant of property tax revenue and consists of the combined taxable value of all property in California.) For 2013-14, we project statewide assessed value to strengthen further, consistent with recent trends in the state's housing markets, increasing 3.7 percent to $4.6 trillion. Over the final four years of our forecast, assessed value increases by an average of about 5 percent per year. This growth is based on the projected recovery in building activity and home values, as well as the general economic expansion that is assumed to continue in our forecast through 2018.

Property Taxes Available for School Districts Expected to Grow Faster Than Assessed Value. We expect local property taxes that go to K-12 and community college districts—revenues that generally offset state spending—to grow faster than statewide assessed value, for two reasons. First, local school property taxes benefit in the near term due to the dissolution of redevelopment agencies (RDAs) because a portion of property taxes that went to these agencies in recent years is now distributed to other local governments, including schools and community colleges. (The dissolution of RDAs is discussed in Chapter 3 of this report.) Second, the expected retirement of the state's 2004 economic recovery bonds in 2016-17 increases local property taxes available for schools in the final years of our forecast by about $400 million per quarter. Because of these two factors, we expect property taxes for school and community college districts to grow at an average annual rate of over 6 percent between 2013-14 and 2017-18, notably faster than the growth in assessed value (about 5 percent annually) over the same period.

- The expiration of the 2 percentage point reduction in Social Security payroll taxes in effect for the last two years—increasing the taxes of about 120 million households.

- Increased applicability of the federal alternative minimum tax (AMT)—potentially affecting tens of millions of taxpayers nationwide—in the coming months due to the fact that there has not yet been an AMT "patch" passed for 2012. (Taxpayers in states with relatively high state or local taxes—such as New York, New Jersey, and California—may be the most likely to be affected if there is no AMT patch.)

- An additional 0.9 percent tax on higher-income taxpayers' earnings and a new 3.8 percent investment surtax on higher-income taxpayers' capital gains, dividend, and interest income over certain thresholds, among other tax changes included in the Patient Protection and Affordable Care Act (the federal health care reform law).

- The expiration of several expanded tax credits for low-income households adopted during the Obama administration, such as the expansion of the earned income tax credit adopted as part of the 2009 federal stimulus package.

- The expiration of various other short-term tax provisions that Congress regularly extends (known as "extenders"), such as the adoption credit, the deduction for qualified education expenses, and the research and experimentation business tax credit.

- The end to the temporary "bonus depreciation" business tax provision for new investments, which has allowed companies to expense more costs of qualified machinery and equipment, rather than claiming deductions for depreciation over time.

- A resumption of pre-2000 federal estate tax rates and exemption amounts, which could result in the number of estates subject to this tax increasing by more than ten times.

In addition to the tax increases, a broad array of domestic and defense-related spending cuts—some of which are to be implemented via the federal government's "sequestration" process—are scheduled to begin in 2013. (These would impose on many programs an across-the-board spending cut—generally between 8 percent and 10 percent—but would not directly affect most of the major federal funding streams that flow through the state treasury.) Extended emergency unemployment insurance (UI) benefits also are scheduled to expire, which would shorten significantly the amount of time that some unemployed workers are eligible for benefits.

Forecast Assumes That Washington Avoids the Fiscal Cliff. As noted above, our economic and budgetary forecast assumes that the President and the Congress adopt measures in the next few weeks to delay or eliminate virtually all of the near-term tax increases and spending cuts of the fiscal cliff. Instead, we assume that federal officials eventually reach agreements that involve spending cuts and tax increases, phased in over many years, to address the federal government's serious long-term budgetary challenges. Our forecast also assumes that the necessary increase in the federal debt ceiling in 2013 causes little or no disruption to the economy, including consumer confidence.

Recession Likely if Federal Leaders Are Deadlocked. If the President and the Congress cannot come to an agreement and the fiscal cliff tax increases go into effect (particularly when combined with the domestic and defense federal spending cuts in the current sequestration law), the U.S. economy likely would fall into recession in 2013. This in turn would cause the California economy to perform considerably weaker than we assume in our forecast and reduce state revenues substantially in the near term. In an alternative simulation in which we assumed a 0.6 percent contraction of real U.S. GDP in 2013—rather than the 1.8 percent increase in our forecast—state revenues in 2012-13 and 2013-14 combined were about $11 billion lower than indicated in our forecast. (For the state's General Fund expenditures, such a revenue reduction would be accompanied by a lower Proposition 98 minimum guarantee and higher spending requirements under current law for various health and social services programs.) The bulk of the assumed drop in GDP in this alternative recession scenario results from the expiration of the Bush tax cuts and the payroll tax cut. Spending cuts, the end of the bonus depreciation policy, and the expiration of emergency UI benefits each are responsible for a smaller part of this hypothetical near-term economic contraction.

Policy Uncertainty Hindering U.S. and Global Economic Growth. The perception of political paralysis concerning economic policy in the U.S., Europe, and China has constrained global economic growth in recent months. These issues contribute to our weaker projections for near-term U.S. economic growth. Exports and business fixed investment had—until recently—been key drivers of the current global economic recovery, but U.S. export growth has slowed. Exports to China are growing at only 2.2 percent on a year-over-year basis, while exports to Europe have been down recently—both figures related to the weakened economies of those important trading partners. Our forecast assumes that business investments in structures, equipment, and software are now growing more slowly than before—a trend that could affect California's technology and service sectors in the coming months. In general, uncertainty about federal tax and spending policy inhibits risk taking and causes businesses and consumers to be more cautious in their spending and investment decisions. While there are "downside" risks due to the fiscal cliff, we note as well that there are "upside" risks to our economic forecast. If, for example, there is a speedy agreement concerning these federal issues, this could be looked upon favorably by consumers and businesses, thereby encouraging them to spend, invest, and hire even more in the short term than we are projecting.

THE DEMOGRAPHIC OUTLOOK

Domestic and International Migration Expected to Climb. A summary of the key findings of our California population forecast is shown in Figure 7. Over the next several years, we project steady overall growth in the state's population of about 1 percent per year.

Figure 7

LAO California Population Forecast

(In Thousands)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Population (as of July 1)	37,077	37,318	37,639	38,004	38,414	38,849	39,305	39,727	40,133	40,541
Percent change from prior year	0.6%	0.7%	0.9%	1.0%	1.1%	1.1%	1.2%	1.1%	1.0%	1.0%
Births	527	510	507	511	516	522	528	534	538	542
Deaths	220	229	231	234	237	239	242	245	248	251
Net domestic migration	-144	-133	-87	-61	-27	-3	13	-19	-31	-31
Net international migration	58	94	128	149	157	155	157	151	147	147

Migration into California—from other states and countries—declines during periods of relative economic weakness here. As Figure 7 shows, we estimate that the state has recently experienced significant declines in domestic migration (that is, many more people have left California for other states than have come from other states). Our forecast projects that these trends are turning around, and total net migration (domestic and international) will be positive over the forecast period. The state's population—now just over 38 million—is projected to surpass 40 million in 2017.

Our forecast assumes continued declines in both birth rates and death rates. Specifically, women are waiting until later to have children and are having fewer children, on average, than in the past. This trend is largely responsible for a projected small decline in the state's school-age and college-age populations between the 2010 and 2020 censuses. We forecast that there will be 6.7 million Californians age 5-17 in 2020 (down 1.4 percent from 2010) and 3.8 million who are age 18-24 (down 2.8 percent from 2010). In addition, Californians are living longer and this—coupled with the aging of the massive post-World War II "baby boom" generation—is resulting in large increases in the elderly population. We forecast that there will be 6.5 million Californians age 65 and over in 2020 (up 51 percent from 2010).

California's Racial and Ethnic Makeup Continues to Change. In 1980, about 67 percent of Californians were non-Hispanic whites, and about 19 percent were Hispanic. By 2010, the census indicated that 40 percent of the state's population consisted of non-Hispanic whites, and Hispanics made up 38 percent of the population. During the same time period, Asian Americans climbed from 5 percent to 13 percent of the population. African Americans made up 6 percent of the population in 2010, down from 7.5 percent in 1980.

In the next few years, the number of Hispanic Californians should surpass the number of non-Hispanic white residents. In 2020, we project that Hispanics will comprise 39 percent of the state's population, followed by non-Hispanic whites (37 percent), Asian Americans (14 percent), African Americans (6 percent), and other racial and ethnic groups (4 percent).

REVENUE OUTLOOK

Figure 8 shows our multiyear forecast of General Fund and Education Protection Account (EPA) revenues, including revenues resulting from the two tax-related measures that voters approved at the statewide election on November 6, 2012. These two measures are Proposition 30 (which increases personal income tax [PIT] rates for higher-income Californians through 2018 and raises the sales and use tax [SUT] rates by 0.25 percentage points for four years beginning in 2013) and Proposition 39 (which institutes a new corporation tax [CT] apportionment policy that will result in some businesses paying more in taxes).

Figure 9 compares our revenue forecast for 2011-12 and 2012-13 to other recent forecasts. (Additional figures comparing this forecast with other recent forecasts are available on our website.)

Personal Income Tax

Little Net Change in Budget Act Revenue Assumptions. Before considering the passage of Proposition 30, which will generate some revenue that the state plans to attribute—or "accrue"—to 2011-12, PIT revenues for the prior fiscal year currently are estimated to have been $50.4 billion. After including our current projections for Proposition 30 collections, we now estimate that 2011-12 General Fund and EPA PIT revenues will total $53.2 billion, $255 million above the level assumed in the 2012-13 budget package. In 2012-13, we project

Figure 8

LAO November 2012 Revenue Forecast[a]

General Fund and Education Protection Account Combined (In Millions)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Personal income tax	$53,213	$59,860	$61,712	$66,848	$71,602	$75,678	$79,786
Sales and use tax	18,859	20,839	22,721	24,354	25,993	26,835	27,214
Corporation tax	7,603	8,535	9,119	9,236	9,734	9,935	9,979
Subtotal, "Big Three" Taxes	($79,675)	($89,234)	($93,551)	($100,438)	($107,329)	($112,448)	($116,979)
Insurance tax	$2,204	$2,050	$2,187	$2,415	$2,492	$2,576	$2,667
Other revenues[b]	2,819	2,695	2,129	2,071	2,103	2,034	2,069
Net transfers and loans[c]	1,784	1,631	-1,149	-622	-941	-638	-134
Total Revenues and Transfers	**$86,482**	**$95,610**	**$96,743**	**$104,332**	**$111,017**	**$116,461**	**$121,627**

[a] Includes additional revenues from approval of Propositions 30 and 39 at the November 2012 statewide election.

[b] Includes no estate tax revenues, given what we assess as a low likelihood that anticipated future federal legislation will include provisions allowing resumption of California's state-level estate tax. If the current-law estate tax were to resume, it could generate a few hundred million dollars of 2013-14 revenue and over $1 billion per year by 2017-18. Exact dollar amounts would vary based on details of the future federal legislation related to the tax.

[c] Reflects various transfers, including transfers to the Clean Energy Job Creation Fund required by Proposition 39 for five fiscal years beginning in 2013-14. Generally reflects actual or projected dates for repayment of loans to special funds listed in a July 30, 2012 report from the Department of Finance. Does not reflect any transfers to the Budget Stabilization Account under Proposition 58 (March 2004).

PIT revenues to reach $59.9 billion, $408 million below the level assumed in the 2012-13 budget package. Therefore, for the two fiscal years combined, our PIT forecast is $153 million below the level assumed in the budget plan. For such a large, volatile revenue source, this is a minor forecasting difference.

The over $6.6 billion of year-to-year growth between 2011-12 and 2012-13 is due to

Figure 9

Comparisons With Prior Revenue Forecasts[a]

General Fund and Education Protection Account Combined (In Millions)

	2011-12			2012-13		
	LAO May 2012	Budget Act June 2012	LAO November 2012	LAO May 2012	Budget Act June 2012	LAO November 2012
Personal income tax	$52,366	$52,958	$53,213	$59,368	$60,268	$59,860
Sales and use tax	18,927	18,921	18,859	20,765	20,605	20,839
Corporation tax	8,623	8,208	7,603	8,869	8,488	8,535
Subtotals, "Big Three" Taxes	($79,916)	($80,087)	($79,675)	($89,003)	($89,361)	($89,234)
Insurance tax	$2,150	$2,148	$2,204	$2,093	$2,089	$2,050
Other revenues	2,800	2,810	2,819	2,712	2,849	2,695
Net transfers and loans	1,784	1,784	1,784	1,489	1,588	1,631
Total Revenues and Transfers	**$86,650**	**$86,830**	**$86,482**	**$95,297**	**$95,887**	**$95,610**
Difference—LAO November Forecast Minus Budget Act			**-$348**			**-$277**
Difference—LAO November Forecast Minus LAO May Forecast			**-$169**			**$314**

[a] Estimates include the effects of Proposition 30, which was approved by voters at the November 2012 statewide election. In addition, the LAO November 2012 forecast includes the 2012-13 effects of Proposition 39.

(1) a full fiscal year of increased revenue under Proposition 30, (2) assumed growth in the economy and stock market, and (3) 2012-13 revenues related to Facebook, Inc.'s initial public offering (IPO) of stock.

About 6 Percent Annual Growth in PIT Revenues Forecast. For 2013-14, we forecast General Fund and EPA PIT revenue to grow to $61.7 billion, with steady growth thereafter, reaching $79.8 billion in 2017-18. Between 2012-13 and 2017-18, we forecast average annual growth in PIT collections of 5.9 percent.

Strengthening Job Market Helps PIT Revenues. The PIT is the state's largest General Fund revenue source and grows over time largely in line with the main component of taxable personal income: the wages and salaries of Californians. The most recent data for 2010 indicate that wages and salaries made up 73 percent of California resident tax filers' adjusted gross income (AGI) and accounted for 63 percent of PIT revenue. Accordingly, the strength of trends in the state's job market plays a major role in the PIT's overall growth rate.

Consistent with the decline in employment in the state during 2008 and 2009 (illustrated earlier in this chapter in Figure 4), resident tax filers saw their wage and salary income drop from $716 billion in 2008 to $679 billion in 2009 (down 5.2 percent). In 2010, wages and salaries grew to $697 million (up 2.7 percent). The Franchise Tax Board (FTB) will provide us with our first solid data on 2011 wages later this month, but based on 2011 and 2012 PIT collections, economic data, and our forecasting estimates, we currently assume that wages and salaries grew to about $730 million (up 4.6 percent) in 2011. The significantly greater increase in wages and salaries in 2011 was driven by the start of the state's job recovery in that year.

Furthermore, based on data received to date for 2012, we assume that wages and salaries will grow to $774 million (up 6 percent) in 2012. As 2012 job growth in the state is faster than that in 2011, so is the growth in overall taxable wages. (A small portion of this 2012 gain represents taxable income that higher-income Californians, in particular, are projected to accelerate—that is, choose to receive early—in order to benefit from lower federal tax rates in current law before the scheduled fiscal cliff tax increases.)

Our forecast model assumes that California resident tax filers' wage and salary income surpasses $1 trillion for the first time in 2017. Between 2012 and 2018, we assume that wages and salaries for all resident California taxpayers grow at an average annual rate of about 5 percent—similar to the growth rate in recent decades. Employment growth, inflation, and changes in labor productivity contribute to rising wages and salaries throughout the economy.

Capital Gains Drive PIT Volatility. Net capital gains made up only 6 percent of AGI in 2010 and 3 percent in 2009, but this relatively small part of overall income is the most difficult element of the PIT to project. Net capital gains—the difference between capital gains and capital losses reported on tax returns—represent net investment gains from sales of assets such as stocks, bonds, and real estate. Data suggest that the single greatest driver of capital gains trends is the direction of the stock market. All economic models must make assumptions about stock market trends, as does ours. Nevertheless, in any given time period, the stock market can move up or down in ways that are both wildly volatile and inconsistent with trends elsewhere in the economy. As such, capital gains forecasts are subject to a wide band of uncertainty.

While capital gains made up 6 percent of AGI in California in 2010, personal income taxes paid on these capital gains totaled 10.5 percent of overall PIT paid that year, according to FTB estimates. The typical dollar of capital gains is taxed at a higher rate than the typical dollar of wage and salary income. In 2010, 15 percent of total AGI was reported on tax returns that had AGIs of $1 million or greater. By contrast, over 75 percent of capital gains were reported on returns with taxable income of $1 million or greater. Returns with $10 million or more of taxable income had 46 percent of all capital gains.

Net capital gains reported by resident tax filers climbed as high as $120 billion in 2000 (equal to 10.6 percent of personal income) and $132 billion in 2007 (8.4 percent of personal income), as shown in Figure 10. Such increases were driven by "asset bubbles" in the stock market and/or the real estate market. Net capital gains fell to $29 billion in 2009 (1.9 percent of personal income) before rising, along with the recovery in the stock market, to $55 billion in 2010 (3.5 percent of personal income). While the stock market has grown fairly well during much of the time since then, we assume that *net* capital gains remained fairly flat in 2011, given the substantial losses that investors experienced during the recession (which "offset" the gains that they report). Figure 10 shows our forecast for net capital gains, including gains assumed to be accelerated from 2013 to 2012 due to the lower federal tax rates currently in federal law prior to the fiscal cliff.

Volatility Likely to Increase Due to Proposition 30. As described above, the volatility in the stock market will contribute to PIT revenues being lower or higher than reflected in our forecast in each fiscal year. Because Proposition 30 increases the dependence of the state budget on revenues paid by higher-income taxpayers, who receive most capital gains, it is likely to increase the volatility of revenues through 2018. Also, as we noted in the November 2012 *Voter Information Guide*, uncertainty concerning the responses of high-income taxpayers to Proposition 30's income tax increases may make these new revenues particularly difficult to estimate. These issues can easily cause actual PIT revenues to be a few billion dollars lower or higher than projections in any given year.

Facebook Stock Slump Offsets Other Projected PIT Gains. The May 2012 IPO of stock by Facebook, Inc. was plagued by

Figure 10

Capital Gains Assumed to Rise in Forecast

(Dollars in Billions)

Tax Year	California Residents—Net Capital Gains	As Percent of Personal Income
1990	$22	3.5%
1991	17	2.6
1992	17	2.5
1993	20	2.7
1994	18	2.5
1995	21	2.7
1996	33	4.0
1997	47	5.4
1998	61	6.4
1999	94	9.2
2000	120	10.6
2001	49	4.2
2002	33	2.8
2003	46	3.7
2004	75	5.8
2005	113	8.1
2006	118	7.9
2007	132	8.4
2008	56	3.5
2009	29	1.9
2010	55	3.5
2011[a]	55	3.4
2012[a,b]	93	5.4
2013[a,b]	68	3.8
2014[a]	89	4.7
2015[a]	95	4.7
2016[a]	99	4.7
2017[a]	104	4.7
2018[a]	109	4.7

[a] Forecast. For 2012 and beyond, assumes steadily increasing stock market prices.

[b] Assumes that 20 percent of capital gains that otherwise would be realized in 2013 are accelerated to 2012 due to lower current-law federal tax rates.

technical mishaps and other concerns, and the company's stock prices lagged far below budget act assumptions in the ensuing months. This forecast assumes the state's IPO-related General Fund revenues total $1.25 billion in 2011-12 and 2012-13 combined—down from the $1.9 billion assumption in the budget act. While taxpayer confidentiality laws mean that there never will be a precise estimate of this total, sharp increases in daily state tax collections following both the IPO and the settlement of restricted stock units (RSUs) by Facebook employees—as well as Facebook's public filings—suggest that most of this amount already has been collected by the state. Other revenues are likely to be collected in conjunction with future RSU settlement activity, estimated tax payments, final returns, and tax extension payments. We also assume that 2013-14 General Fund revenues related to the IPO will be $310 million.

Our forecast of 2011-12 and 2012-13 PIT revenues *not* related to the IPO are higher than those assumed in the budget act and in our office's May Revision revenue forecast. Compared to the budget act PIT assumptions, our projected increase in non-IPO PIT revenues ($473 million for the two fiscal years combined) mostly offsets our projected decrease in IPO-related PIT revenues ($626 million).

Given that future IPO-related tax collections will simply be "lumped in" with other PIT collections, this likely will be the last time that we are able to estimate specific, discrete numbers for Facebook IPO-related revenues. In the future, IPO-related RSU settlements and options also will be lumped in with other official economic data, such as personal income data released by the federal government.

Sales and Use Tax

Estimated SUT revenue totaled $18.9 billion in 2011-12, $62 million lower than the amount assumed in the 2012-13 budget. In 2012-13, we expect SUT receipts to increase 10.5 percent to $20.8 billion ($234 million above the 2012-13 budget assumption). The growth in 2012-13 is the result of (1) the temporary one-quarter cent SUT increase under Proposition 30 and (2) growth in underlying taxable sales. (Proposition 30 increases the statewide SUT for four calendar years—2013 through 2016—meaning that it affects half of fiscal year 2012-13 and all of 2013-14.) For 2013-14, we forecast SUT revenue to increase 9 percent to $22.7 billion. The SUT revenues then grow more modestly—at an annual rate of 4.6 percent over the final four years of our forecast. The slower growth in SUT receipts in the out-years also reflects the expiration of the temporary rate increase.

Trends in Taxable Sales. The main determinant of SUT receipts is taxable sales—the amount spent by individuals and businesses on goods that are subject to the SUT. Significant components of General Fund taxable sales include vehicle sales (9 percent of taxable sales), construction materials used to build residential and commercial properties (6 percent), and consumer spending on dining (12 percent), electronics (3 percent), and furniture (2 percent). About two-thirds of taxable sales are consumer spending, whereas the remainder is business-to-business transactions where the purchasing business is the final user of the product. (Business purchases that become part of a final product are not subject to the sales tax.)

Consumer and business spending on taxable items declined 14 percent in 2009, as income levels fell, savings rates climbed, and economic uncertainty shattered consumer confidence. As shown in Figure 11, however, taxable activity—measured by taxable sales as a share of personal income—has recovered strongly, in part because consumers and businesses are now making large purchases that were postponed during the recession. We expect the recent increase in taxable sales as a share of personal income to moderate throughout the rest of our forecast as businesses and consumers normalize spending patterns.

Optimism Concerning New Vehicle Sales and Housing Activity. Our current forecast of taxable sales is slightly stronger than our most recent forecast, developed for the May Revision. This improvement reflects a more optimistic outlook for new vehicle sales and housing activity over the next five years, an outlook supported by recent economic reports. For example, new vehicle sales increased 35 percent in the third quarter of 2012 (from levels a year earlier) and the S&P/Case-Shiller Index of housing prices has seen consistent gains throughout 2012. Increasing home prices and monthly rents tends to spur construction activity as developers build additional units to meet rising housing demand. We expect these trends to continue, especially given the improved outlook that many consumers have about the economy. In October, for example, the Reuters/University of Michigan Consumer Sentiment Index rose to 82.6 points, its highest level since the recession began.

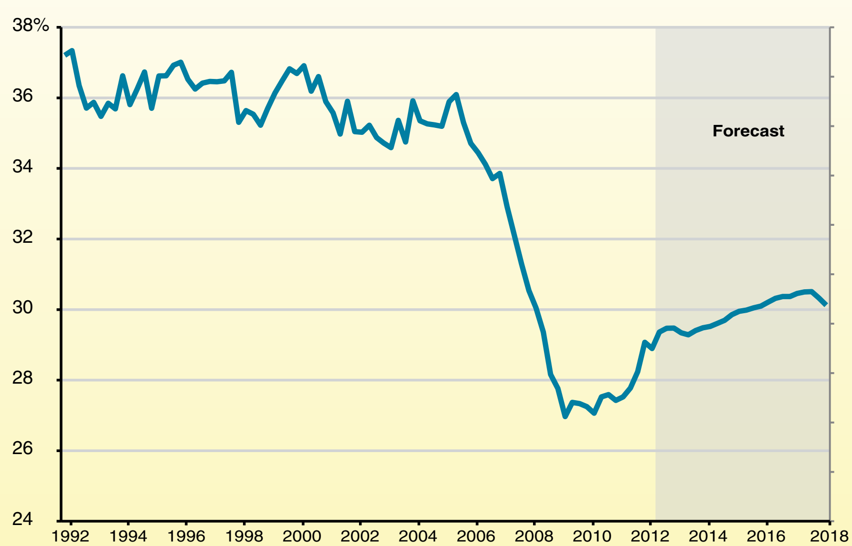
Corporation Tax

Estimated CT revenue totaled $7.6 billion in 2011-12, $605 million below the 2012-13 budget act assumption. We forecast that General Fund CT revenue will be $8.5 billion in 2012-13, $47 million above the budget assumption. This 2012-13 forecast—unlike the budget act forecast—includes additional revenue projected to be raised under the new mandatory single sales factor provisions of Proposition 39. If Proposition 39 had not passed, our 2012-13 CT projection would have been $403 million short of the budget act forecast. Below, we discuss possible reasons for this weakness in baseline CT revenues. Our forecast further reflects the assumption that CT revenue will grow from $8.5 billion in 2012-13 to $10 billion in 2017-18—an average annual growth rate of 3.2 percent during that time period. (About one-third of this growth is attributable solely to Proposition 39, given that the half-year revenue effect in 2012-13 grows to a full-year revenue effect in 2013-14 and beyond. If Proposition 39 had not passed, the growth rate would be a much weaker 2 percent per year.)

National Corporate Profit Data Was Revised Downward. The vast majority of California CT revenue is paid by multistate and multinational corporations that apportion (allocate) a share of their profits to California. The *2012-13 Budget Act* was premised on an assumption that national corporate profits had grown from $1.4 trillion in 2009 to $1.8 trillion in 2010—a 32 percent increase. (Our office's

Figure 11

Taxable Sales Are Forecast to Grow Modestly as a Share of Personal Income



May Revision estimates were based on a similar forecast for 2010.) In August, the federal Bureau of Economic Analysis revised the 2010 national corporate profits figure down to $1.7 trillion—a 27 percent increase over revised 2009 figures. This data revision results in our current forecast for national profits being about $100 billion less in each year compared to the economic forecast upon which the budget act was based. (The revision also may help explain part of the reason why CT revenues have fallen so far short of state projections over the past year.)

Flat Corporate Profits Projected. Similar to our recent forecasts, we assume weaker national profit growth in later years. We now assume profits remain relatively flat over the forecast period. Recent profit gains likely were the result of the "bounce back" after the recession and cost cutting, including flexibility in labor costs. Some corporations also have benefited from low borrowing costs, which, like labor costs, are likely to rise as the economy gains strength.

Recent Tax Policy Changes Have Reduced CT Revenues. As we described in our February 2012 publication, *The 2012-13 Budget: Economic and Revenue Update*, the state has undertaken a variety of corporate tax policy actions in recent years. Collectively, the effect of several of the state's policy actions was to accelerate CT collections from 2011 and beyond back to 2007-08, 2008-09, and 2009-10 in order to help the state's budget situation during the recession. These policy changes appear now to be reducing CT revenues, as intended. The policy actions included the suspension, for 2008 through 2011, of larger businesses' use of net operating loss deductions. In addition to these accelerations of CT revenue, the state also changed corporate tax policies in order to reduce taxes for some businesses—such as the adoption of the elective single sales factor method of profit apportionment and allowing the transfer of credits among companies treated as part of a single business group for tax purposes. In total, the major changes to CT policies likely are reducing General Fund revenues by over $2 billion per year, as of 2012.

Proposition 39 Increases CT Revenues. Proposition 39—which will affect corporations' 2013 and subsequent tax returns—partially reverses the recent policy trend of reducing CT revenues. Proposition 39 eliminates the *elective* single sales factor policy now in effect and replaces it with a *requirement* for most multistate corporations to apportion profits to California based on the single sales factor method. This will result in some corporations paying higher taxes resulting in projected half-year revenues of $450 million in 2012-13 and an estimated $1 billion per year thereafter. For the five fiscal years 2013-14 through 2017-18, however, the proposition dedicates half of the revenues—up to $550 million annually—for clean energy projects. (This latter portion of Proposition 39 revenues is not included in Proposition 98 revenue calculations in our forecast.)

Recent Policy Changes Complicate Forecasting Significantly. Our revenue forecasting models use statistical tools to identify relationships between economic and tax data in the past and then forecast how those relationships will play out in the future. These tools work best in a stable tax policy environment. Recent weakness in CT revenues—potentially related to recent policy changes—has been so significant that our confidence in standard forecasting models has declined. As with the PIT, additional data on recent years' CT collections will be available from FTB later this month. It probably will take several more years—assuming a stable policy environment in the future—in order to recalibrate and improve our forecasting models in light of the new policies in place. The CT has always been a difficult tax to forecast, with many factors influencing the amount of taxes businesses owe the state in any given year. It will remain much more difficult to forecast than usual for a few more years.

Estate Tax

Federal Actions Necessary to Resume State Tax Are Very Unlikely to Occur. In 2001, as a part of the tax reductions enacted during the Bush administration, the federal government adopted reductions over several years to its estate tax and eliminated a tax code provision known specifically in state and federal law as the "Credit for State Death Taxes." The state credit was eliminated entirely for estates of those dying after December 31, 2004. In 2010, the Congress and President Obama agreed to extend the temporary 2001 estate tax legislation—including elimination of the state death tax credit—until the end of 2012. Under current federal law, therefore, the pre–2001 estate tax regime will resume at the beginning of 2013 (part of the fiscal cliff), including the state credit.

Most observers believe that, no matter what Congress does to the estate tax in the coming months, there will no longer be a credit for state-level estate taxes. Our forecast assumes that this consensus is correct. Pursuant to Proposition 6 (1982), the state may only collect estate taxes equal to the Credit for State Death Taxes in federal law. Accordingly, our forecast assumes that the state receives no estate taxes related to deaths that occur in the future. We again advise the Legislature to assume no such revenues unless there is a clear indication from the Congress that such a tax credit will be adopted. If our assumption is wrong, the amount of funds the state will collect will depend on the details of whatever estate tax legislation is enacted at the federal level. (These additional revenues, if they were to be received, also would increase the state's Proposition 98 minimum guarantee.)

Transfers

General Fund's Budgetary Loans From Special Funds Now Total $4.3 Billion. The state has lent balances of its special funds to the General Fund in order to address budget shortfalls over the last decade. When the General Fund is directed to repay such a loan, this is booked as a transfer out of (a "negative" transfer from) the General Fund—for the repayment of principal. (The state also incurs expenditures to pay interest on these loans—generally linked to a measure of what the special fund otherwise would have earned in interest in the state investment pool.) In effect, such transfers out reduce overall General Fund revenues in the state's budgetary accounting system. Figure 8—earlier in this chapter—shows projected net transfers and loans in each fiscal year, including special fund loan repayments.

In July 2012, DOF reported that the General Fund owed $3.6 billion in loan principal repayments to special funds. Given another $713 million of new loans authorized in the 2012-13 budget plan, the General Fund now has $4.3 billion of outstanding budgetary loans from the state's special funds. (These loans were one of the components of the Governor's "wall of debt" listing.)

Forecast Assumes Loans Repaid Pursuant to Schedule Provided by Administration. The July DOF report included anticipated repayment dates for many, but not all, outstanding General Fund loans (which sometimes were based on loan repayment deadlines in prior budget acts). Our forecast generally assumes that loans are repaid on the dates that DOF listed (as modified by the 2012-13 budget package in some cases), unless we identified a specific reason why a special fund might need an earlier repayment. For example, Figure 12 (see next page) shows the special fund loans assumed in our forecast to be repaid by the end of 2013-14. In our forecast, the $4.3 billion balance described above is reduced to $3.1 billion by the end of 2013-14 and $1.2 billion by the end of 2017-18. (The $1.2 billion of remaining loans is assumed to be paid after 2017-18 in our forecast, since the DOF report includes no specific repayment dates for these.) Accordingly, to achieve the Governor's stated goal of paying down entirely this element of the wall of debt within the next few years, additional loan repayments—above the level included in our forecast—would be required.

Legislature Has Considerable Flexibility Concerning Loans Under Recent Case Law. The increased prevalence of special fund budgetary loans to the General Fund has been the subject of recent litigation. In two 2011 appellate court cases—concerning loans to the General Fund from the Contingent Fund of the Medical Board of California and the Beverage Container Recycling Fund—judges rejected claims from litigants that these particular loans compromised special fund purposes or transformed regulatory processing fees into taxes (which arguably might have required a two-thirds vote of the Legislature). In one of the cases, the court stated that allowing the special fund loans to remain in place was a "reasonable and practical result that gives the state flexibility to balance its budget in a manner that does not stymie beneficial regulation." We read these decisions to give the Legislature considerable, continuing flexibility related to special fund budgetary loans. At the same time, the decisions suggest that the Legislature has some measure of responsibility to ensure that special fund programs adequately meet the responsibilities for which the funds' revenues were levied in the first place.

Figure 12

Special Fund Loans Assumed to Be Repaid in 2012-13 and 2013-14

(In Millions)

Fund Name	Amount Outstanding
State Highway Account, State Transportation Fund	$200.0
National Mortgage Special Deposit Fund	100.0
California Beverage Container Recycling Fund	99.4
Immediate and Critical Needs Account (Judicial Branch)[a]	90.0
California Advanced Services Fund (PUC)	75.0
High-Cost Fund-B Administrative Committee Fund (PUC)	75.0
Hospital Building Fund	75.0
Renewable Resource Trust Fund	65.9
Occupancy Compliance Monitoring Account (CTCAC)	57.0
Tax Credit Allocation Fee Account (CTCAC)	48.0
Enhanced Fleet Modernization Subaccount, High Polluter Repair or Removal Account	40.0
Oil Spill Response Trust Fund	40.0
Glass Processing Fee Account	39.0
State Emergency Telephone Number Account	28.0
California Tire Recycling Management Fund	27.1
Electronic Waste Recovery and Recycling Account	27.0
PET Processing Fee Account, California Beverage Container Recycling Fund	27.0
All others	146.4
Total	**$1,259.8**

[a] Based on LAO assessment of cash flow needs. Other loan repayments based on Department of Finance report dated July 30, 2012 and loan extensions in 2012-13 budget.

CTCAC = California Tax Credit Allocation Committee; PUC = Public Utilities Commission; PET = polyethylene terephthalate.

Q3 2012

City of Atascadero Sales Tax *Update*

Fourth Quarter Receipts for Third Quarter Sales (July - September 2012)

Atascadero In Brief

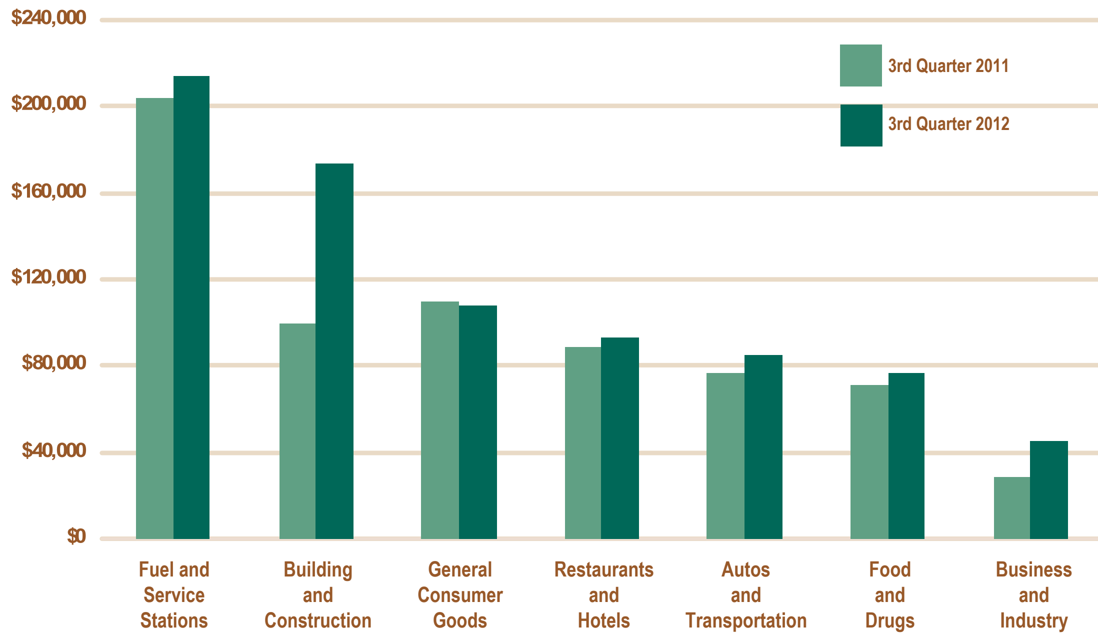
The allocation for Atascadero's July through September sales jumped 14.1% compared to the same quarter one year ago, but accounting events skewed the data. Actual sales rose 4.9% when anomalies were excluded.

The receipt of taxes due in other periods spiked returns from the building and construction sector. Business and industry group results were inflated by an adjustment that negatively impacted year-ago totals. Anomalies overstated gains from both the fuel/service station and automotive groups. A new outlet helped lift returns from restaurants-no alcohol.

Increases were partially offset by declines from some categories of general consumer goods and business closeouts that affected proceeds from hardware stores and electronics/appliances. The receipt of a double-up payment in last year's comparison period exaggerated restaurant-beer and wine losses.

Adjusted for reporting anomalies, sales and use tax receipts for all of San Luis Obispo County increased 30.9% over the same period; Central Coast regional totals were up 12.4%

Sales Tax by Major Business Group



Top 25 Producers

In Alphabetical Order

- 361 Chalk Mountain
- 7 Eleven
- Albertsons
- Arco AM PM
- Atascadero 76
- Atascadero Gas & Mart
- Atascadero Shell
- Chalk Mountain Liquor & Deli
- Circle K Union 76
- El Camino Building Supply
- Farwest Line Specialties
- Food 4 Less
- Hitching Post AM PM Mini Mart
- Home Depot
- In N Out Burgers
- K Mart
- Miners Ace Hardware
- Rite Aid
- San Anselmo Unocal 76
- Shell
- Staples
- Valley Pacific Petroleum
- Valley Speed & Marine
- Vons
- Walgreens

Revenue Comparison

Two Quarters – Fiscal Year To Date

	2011-12	2012-13
Point-of-Sale	$1,429,139	$1,548,894
County Pool	150,885	146,839
State Pool	121	472
Gross Receipts	**$1,580,145**	**$1,696,204**
Less Triple Flip*	$(395,036)	$(424,051)

**Reimbursed from county compensation fund*

Published by HdL Companies in Winter 2013
www.hdlcompanies.com | 888.861.0220

NOTES

Statewide Results

Gains in all seven of HdL's key economic groupings confirm that California's economy continues to mend. Statewide local sales and use tax revenues from transactions occurring July through September 2012 were 6.0% higher than the same quarter in 2011 after onetime accounting and reporting aberrations are factored out.

The continued strong demand for new autos exceeded analysts' expectations and generated about one-fourth of the adjusted statewide increase. Restaurant sales posted another strong quarter with receipts 6.6% higher than the same period one year ago. Use tax from the development of solar energy projects and a modest recovery in some categories of building and construction materials also contributed to the rise.

Overall sales growth was tempered by a leveling in fuel prices compared to the previous year's quarter and by a slowdown in business spending in the Silicon Valley.

The Year Ahead

Gains in sales and use tax receipts from the first half of 2013 are expected to be lower than previous quarters. Recovery from "fiscal cliff" uncertainties and its final outcome may take several months while Europe's financial woes and China's sluggish growth will temper California export activity. Fuel prices should stabilize and not generate the huge bubbles in tax revenues experienced in previous quarters.

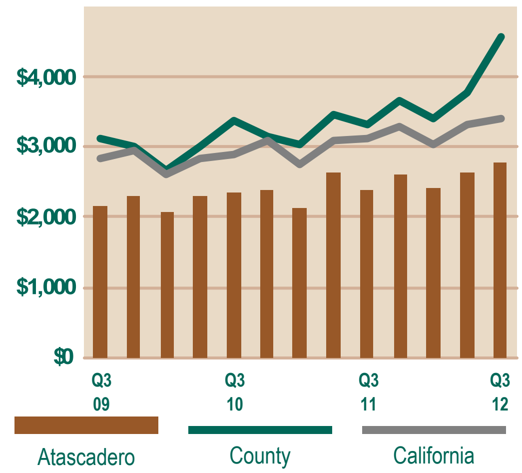
The last half of the year is predicted to resume steady, moderate growth. In November, the state's unemployment rate had already dipped to 9.8 percent, the lowest since the recession began. The recent gains are becoming more widespread among job categories and even include an increase in construction-related employment.

The state's housing market is strengthening with fewer distressed transactions and record low inventories. The median sales price of homes has increased for the last eight consecutive months of the year and building activity, particularly in the coastal areas, is expected to pick up steam in 2013. Elevated foreclosure rates in some inland regions may delay building recovery for another year or two.

Pent-up demand, record low interest rates and easing credit availability have led to robust sales of new automobiles. That demand is expected to continue for another few quarters as consumers replace older, less fuel efficient models and take advantage of lease and financing incentives being offered by manufacturers.

Wage gains from new hiring, combined with lower fuel prices and an improving housing market are incrementally boosting consumer confidence but much depends on government stewardship of the recovery. Tax increases and reduced benefits could shrink spending at the lower income levels while overly deep cutbacks in government contracts and infrastructure improvements could discourage new business investment.

Sales Per Capita



Atascadero Top 15 Business Types

Business Type	Atascadero Q3 '12	Atascadero Change	County Change	HdL State Change
Auto Repair Shops	17,017	1.4%	5.5%	2.6%
Automotive Supply Stores	23,262	7.0%	2.4%	0.8%
Boats/Motorcycles	— CONFIDENTIAL —		15.0%	5.8%
Discount Dept Stores	— CONFIDENTIAL —		9.9%	15.5%
Drug Stores	22,204	1.3%	0.4%	0.4%
Electronics/Appliance Stores	14,101	-14.1%	1.0%	-1.1%
Grocery Stores Liquor	42,502	-1.5%	-0.6%	9.6%
Hardware Stores	14,108	-20.3%	-3.0%	1.1%
Lumber/Building Materials	— CONFIDENTIAL —		37.0%	35.9%
Petroleum Prod/Equipment	— CONFIDENTIAL —		-0.5%	6.5%
Restaurants Beer And Wine	28,909	-14.7%	4.5%	2.0%
Restaurants No Alcohol	54,681	18.9%	9.6%	8.1%
Service Stations	193,607	10.1%	5.5%	1.6%
Specialty Stores	17,592	-2.0%	0.2%	0.9%
Used Automotive Dealers	17,435	-5.2%	-6.1%	11.7%
Total All Accounts	**$795,884**	**17.3%**	**37.1%**	**8.8%**
County & State Pool Allocation	**62,483**	**-15.4%**		
Gross Receipts	**$858,368**	**14.1%**		

California Forecast:
Sales Tax Trends and Economic Drivers

January 2013

HdL provides relevant information and analyses on the economic forces affecting California's local government agencies. In addition, HdL's Revenue Enhancement Services and Software help clients to maximize revenues.

HdL serves over 350 cities, counties and special districts in California and across the nation.

HdL COMPANIES

HdL COMPANIES

HdL Consensus Forecast – January 2013

STATEWIDE SALES TAX TRENDS

	2012-13	2013-14
Autos/Transportation	12.1%	4.5%

Strong sales of new automobiles are expected to continue into the first half of 2013. With the average age of vehicles on the road higher than ever, there is substantial pent-up demand for new models. Consumers are being lured to showrooms by no down payment lease deals, generous manufacturer's incentives and attractive financing options. Slower second half sales growth will trim year-over-year percentage gains.

	2012-13	2013-14
Building/Construction	4.5%	5.0%

Household formations have accelerated and unsold inventory, particularly at the low end of the market, has dropped to record lows. Construction activity for multi-family rental projects is expected to expand further in response to rising rents and tight availability of lower priced homes. Large infrastructure projects for roads and bridges are projected to contribute to gains in 2013.

	2012-13	2013-14
Business/Industry	5.7%	4.5%

Business investment in equipment and software slowed in the second half of 2012 as companies scaled back spending in response to easing demand and rising uncertainty about U.S. budget policy and the decelerating world economy. Business inventories have been on the rise amid slowing sales, a sign that companies may order fewer goods in the coming months.

	2012-13	2013-14
Food/Drugs	4.0%	3.5%

The traditional grocer used to be an anchor store; however, that situation is rapidly changing as recession-strapped consumers try to stretch their buying power. Niche stores like Trader Joes and Whole Foods are challenging traditional grocery chains and competition is growing as drug stores, gas station food marts and dollar stores expand their grocery offerings.

	2012-13	2013-14
Fuel/Service Stations	-0.7%	-6.0%

After a sharp spike in October, California gasoline prices have steadily declined as demand continues to be low and supplies remain robust. The state's strict clean air rules mandate a specially formulated blend used nowhere else in the country – an arrangement that will contribute to ongoing price volatility.

	2012-13	2013-14
General Consumer Goods	4.4%	3.0%

Consumers' willingness to spend has been strengthened by expansion in both the job and housing markets and lower prices at the pump. Much of the improvement is coming from high-end shoppers, who account for 37% of all consumer expenditures, shelling out for luxury items. Higher tax rates on upper income earners that will go into effect in 2013 could dampen future gains.

	2012-13	2013-14
Restaurants/Hotels	6.0%	4.0%

Based on surveys, two out of five consumers are not patronizing restaurants as often as they would like. Therefore, there remains substantial pent-up demand for restaurant services. Steady gains in same-store sales and increased customer traffic have been reported by restaurant operators, particularly in full and quick-service categories. Analysts expect quick-service and fast casual chains to expand over the next few years.

	2012-13	2013-14
State and County Pools	6.4%	5.0%

Private automobile transactions have been on the rise as well as equipment leases and out-of-state purchases of business equipment and supplies. The gains are expected to moderate somewhat in 2013-14.

	2012-13	2013-14
TOTAL	5.3%	2.8%

The **Proposition 172** growth factor is **4.5%** for Fiscal Year 2012-13. This factor varies from HdL's Bradley-Burns growth rates due to differing collection periods and comparisons to prior year data that include onetime payment aberrations.

BEACON ECONOMICS

National and Statewide

ECONOMIC DRIVERS

January 2013

	2012-13	2013-14
U.S. Real GDP Growth	2.3%	2.5%

Recently revised estimates show that the U.S. economy grew by 2.7% on an annualized basis—better than initially reported. However, some of those revisions came at the expense of consumption to the benefit of accumulating inventories. On the surface, this could be seen as a cause for concern for short-run growth unless incomes and retail sales continue to increase beyond the third quarter. Fortunately, income and spending were both up solidly in November indicating that future growth will continue into the fourth quarter. The fiscal cliff remains a concern and these forecasts assume that at least some tax cuts will expire in 2013.

	2012-13	2013-14
U.S. CPI Inflation	1.5%	1.8%

Inflation has yet to become a major cause for concern—in fact, consumer prices have dipped recently as energy prices have fallen. Importantly, much of the liquidity injected into the financial system over the past few years is still lingering in banks' excess reserves which should mitigate inflationary pressure over the short-run. As the economy heals and the unemployment rate falls in coming years, inflation is expected to pick up moderately though we forecast a less than 2% increase through the current and next fiscal year.

	2012-13	2013-14
California Total Nonfarm Employment Growth	2.0%	1.8%

California continues to outpace the nation overall in terms of job growth. To date, California has added back more than 575,000 jobs. Job growth has been solid in the tourism, professional and technical sectors, though virtually every private-sector industry has been adding jobs alongside these stalwarts. As tax rates rise, job growth is expected to remain relatively lackluster next year though it is expected to pick up steam in later years.

	2012-13	2013-14
California Unemployment Rate	10.1%	9.4%

In November, California's unemployment rate dipped to 9.8%, the lowest since the recession began. This is the first time in several years that California has seen single-digit unemployment. This marks a solid improvement from its peak of 12.4% in July 2010. Household employment has expanded by more than 575,000 workers as well since hitting its trough. The fact that unemployment is falling despite a growing labor force means that California is experiencing genuine improvement in its labor market. The unemployment rate is expected to continue falling into 2013-14.

	2012-13	2013-14
California Existing Home Sales	337,080	344,640

Residential real estate continued to bolster the statewide economic recovery in 2012. Existing home sales are up nearly 7% through the third quarter with every major region in the state posting increases in sales with the exception of the Inland Empire. Historically low interest rates, prices that make sense with incomes and labor markets that continue to heal have enticed new homebuyers back into the market. Sales are expected to increase in 2013-14 as the economy continues to recover gradually.

	2012-13	2013-14
California Median Existing Home Prices	$ 277,795	$ 286,430

Rising home sales in the state have led to some decent price appreciation in recent months. In the third quarter, the median sales price of an existing single-family home in California was $290,000—an increase of nearly 31% from their April 2009 trough level of $221,000. Part of this increase is due to fewer distressed sales in the mix, given that defaults and foreclosures are down dramatically from a few years ago. This has aided median sales prices. However, rising incomes and a limited inventory of homes are also driving this trend and the current forecast calls for continued, moderate growth in home prices moving forward.

	2012-13	2013-14
California Multi-Family Building Permits	64,000	86,000

Construction in California and the nation continues to improve and has accelerated in recent months. According to the U.S. Census Bureau, there have been 47,500 new residential permits issued statewide through October. That represents a 32% increase over the same period last year. Spending on construction and building materials has continued to improve. The trend of rising construction is expected to continue. Despite all of the pre-recession building that took place, California still maintains the lowest housing vacancy rate in the nation. This underlying supply constraint is expected to fuel construction over the next few years.

HdL Companies
1340 Valley Vista Drive, Suite 200
Diamond Bar, California 91765
Telephone: 909.861.4335 • 888.861.0220
Fax: 909.861.7726

California's allocation data trails actual sales activity by three to six months. HdL compensates for the lack of current information by reviewing the latest reports, statistics and perspectives from fifty or more economists, analysts and trade associations to reach a consensus on probable trends for coming quarters. The forecast is used to help project revenues based on statewide formulas and for reference in tailoring sales tax estimates appropriate to each client's specific demographics, tax base and regional trends.

"Good information leads to good decisions."

SOUTHERN CALIFORNIA OFFICE
5777 West Century Boulevard, Suite 895
Los Angeles, California 90045
Telephone: 310.571.3399
Fax: 424.646.4660
E-Fax: 888.821.4647

Beacon Economics, LLC has proven to be one of the most thorough and accurate, economic research/analytical forecasters in the country. Their evaluation of the key drivers impacting local economies and tax revenues provides additional perspective to HdL's quarterly consensus updates. The collaboration and sharing of information between Beacon Economics and HdL helps both companies enhance the accuracy of the work that they perform for their respective clients.