City Council Policy Session

City of Phoenix

City Council Report

Agenda Date: 1/10/2017, **Item No.** 2

2017-18 Early Budget Status Update

The purpose of this report is to provide City Council with an update on the 2017-18 budget development process and to begin discussing items that will have a significant impact on the overall budget status for the upcoming fiscal year. These items will be discussed in greater detail in the February 2017 Five-Year General Fund Forecast.

THIS ITEM IS FOR INFORMATION AND DISCUSSION.

Summary

The projected budget balance range for 2017-18 has been refined information over the past 10 months as we have gained more information. This is a normal progression in refining our estimates each year:

- February 2016 five-year forecast: ($9 million) to ($30 million)
- September 2016 fiscal year-end update: +$1.5 million to ($19.5 million)
- January 2017 early budget status report: $0 to ($5 million)

Looking ahead, the five main areas that will impact the budget are:

- Contingency Fund Level
- GF Revenue Outlook
- Infrastructure and Capital Needs
- Service Levels
- Employee Compensation and Increasing Pension Costs

Detail

The February 2016 Five-Year Forecast predicted a GF budget deficit of ($9M) to ($30M) for fiscal year 2017-18. However, in September the Budget & Research Department reported that the GF ended FY 2015-16 with a fund balance that was $10.5 million higher than estimated. The higher than expected fund balance provided the resources needed to adjust the potential budget range to between +$1.5M to ($19.5M).

Since the September 2016 report to Council, staff has worked to update revenue and expenditure estimates for 2016-17 and establish initial estimates for 2017-18. This important process will continue over the next few months; however, we wanted to provide the Council with an update on our progress thus far and to discuss several factors that will have the most significant influence on the budget status for 2017-18 and beyond.

Based on the higher than anticipated beginning balance and the analysis completed to date, staff currently estimates the budget status for FY 2017-18 to be within a range of balanced to a deficit of ($5M). Our regular, continued work on revenues and expenditures over the next few months will continue to adjust the range until we have a final status in March 2017 for the Trial Budget.

While many variables ultimately influence the budget, it is our opinion that the following five items will be the main critical factors to evaluate in the next few months as staff develops the Five-Year General Fund Forecast and the Trial Budget to be presented in March. The five areas to be addressed include:

- Contingency Fund Level
- GF Revenue Outlook
- Infrastructure and Capital Needs
- Service Levels
- Employee Compensation and Increasing Pension Costs

Contingency Fund Level

Every year we budget a Contingency Fund which provides resources as a cushion against unexpected issues during the year. Each year since 2009-10, the Contingency Fund has been increased incrementally, from about 2.5% to its current and highest level of 4%, or approximately $48M. The goal has been to grow the Contingency Fund to 5% as a financial "best practice". As we move forward in the budget development process, we can assess how much we grow the Contingency Level as a means to address any budgetary shortfall.

GF Revenue Outlook

The 2016-17 year-to-date (YTD) GF revenue collections at 4 months were $319.7 million or 1.7% more than 2015-16 collections of $314.4 million. As a result, revenue collections through four months are trending closely to budgeted revenue; however, there are several areas of concern related to the GF revenue outlook for this fiscal year and next fiscal year.

The first area of concern that could adversely affect the GF revenue outlook is Transaction Privilege Tax (TPT) collections changes by the State of Arizona. Effective Jan. 1, 2017 the Arizona Department of Revenue (ADOR) began collecting all city transaction privilege (sales) tax. Some taxpayers remitted city tax to ADOR in advance of this date, which has created timing issues that impact the reported monthly figures. There is also concern among cities and towns that the resources remitted by ADOR could be less than the amounts collected by the cities prior to TPT Reform. Staff will continue to monitor this issue as any change could have a material impact on City Sales Tax collections going forward.

The second area of concern that could adversely affect the GF revenue outlook going forward is the future allocation of state-shared revenue, which is now based on annual population adjustments. State-shared sales tax is distributed to cities and towns based on relative population share. While Phoenix's population has grown over the years, our relative population share decreased from 30.3% in 2010 to 28.8% in 2015, negatively affecting state sales tax revenues. Historically, adjustments to the revenue sharing formula were based on census data which changed only every five or ten years. Now, annual population adjustments to the revenue sharing formula could make state-shared revenues more volatile.

Because of these concerns and because at this point in the year we only have four months of activity, GF revenue collections will be closely monitored through the remainder of the holiday season before we finalize our revenue projections.

Infrastructure and Capital Needs

Each year, the budget has to accommodate needed capital projects. The city's GF departments operate a large number of facilities in order to provide services to the residents of Phoenix. As these facilities age, they require significant investments for maintenance and general repairs. For example, Phoenix City Hall is approaching 25 years old and systems need to be addressed. For the past few months Budget and Research and Finance staff have been working with Public Works staff to identify significant maintenance and other capital projects that must be addressed in the near future. These projects include the Phoenix City Hall elevator modernization, Phoenix City Hall fire/life safety system upgrade, and a badging and security system upgrade.

In addition to these facility projects there are other projects like the Fire computer aided dispatch (CAD) system, a citywide closed circuit television security system and fuel storage tank replacements that will require a significant increase in the GF to complete. Additionally, the accelerated hiring in Police and Fire are also placing a significant burden on both department's aging vehicle fleet. Funding will be needed to replace aging patrol cars and fire apparatus over the next few fiscal years.

Staff will return to Council later this year with additional information about these projects and potential funding options. It is likely that this will include a recommendation to issue debt if needed, given the scope and magnitude of the projects being evaluated.

Service Levels

For more than 35 years, the city has conducted an annual Program Budget Review process to evaluate services, an essential step in the city's zero-based budgeting process. Departments conduct a systematic review of programs at current service levels, identify innovative service delivery changes that enable greater efficiency, evaluate priorities and recommend any changes to services. The process also is important in determining possible changes to programs to address reduced resources, increased costs and/or other factors. As in past years, all GF departments will submit potential programmatic expenditure reductions for consideration should budget reductions be necessary. The potential reductions are in areas that would result in the least possible impact to the community and reflect the lowest priority programs within each department.

Although it is unlikely that the full range of potential reductions would be required, it is important that a full range of realistic potential options be available for discussion. Identifying more proposals than needed provides flexibility for the City Council and management to quickly deal with any unforeseen budgetary problems. It also allows us to build a secondary budget reduction list to address any potential cuts to state-shared revenue that may arise during the legislative session.

Employee Compensation and Increasing Pension Costs

Last year city management recommended and City Council approved three-year labor contracts that restored employee concessions totaling 4.2%. The agreements include restoration of 1.9% in FY 2016-17; 1.0% in FY 2017-18; and 1.3% in FY 2018-19. The 2016-17 budget included set-asides to address the first two years of the three-year agreements totaling $50M. Funding for the third and final year of the contracts will cost an estimated $44M in FY 2018-19. The impact that these agreements will have on the GF budget for FY 2018-19 and beyond will be reflected in the February 2017 Five-Year GF Forecast.

GF pension costs in COPERS are expected to increase by about $1M as compared to the current year budget. This minimal growth is due to the impact of pension reform, as well as recent actuarial changes, plan earnings and payroll growth. More detailed projections for COPERS-related costs in future years are currently being developed based on recently received actuarial reports. These projections will be discussed in

greater detail during next month's Five-Year GF Forecast.

The GF costs for sworn Police and Fire pensions will increase by about $57M in FY 2017-18 as compared to the current year budget. This growth is tied to recent actuarial changes, plan earnings, payroll growth, repealed pension reform measures from the State Supreme Court decisions, and to some extent early results of pension reform. The increasing public safety pension costs will add significant pressure to the GF budget going forward. Additionally, these increases also are expected to impact the number of sworn police officers and firefighters that can be sustained with existing resources. Detailed projections for the next few years are currently being developed and will be included as discussion points in next month's Five-Year GF Forecast and the Public Safety Specialty Funds Balancing Plan Update.

Responsible Department

This item is submitted by City Manager Ed Zuercher and the Budget and Research Department.