June 14, 2016

Honorable Mayor and Members of the City Council:

It is my pleasure to submit the Fiscal Years 2016 - 17 Operations and Maintenance Budget (O&M) as well as the five-year Capital Improvement Program Budget (CIP) for the City of San Marcos.

As you'll recall, over the past few years, we have strived to make our budget document more transparent, comprehensive and easier to use and that effort continues with this budget. We think we've made significant improvements over the past few years and this year's budget format is substantially similar to last fiscal year. Also, early in the next fiscal year, we will be providing for the Council a five year fiscal projection for City operations. Our view is that once we have the Fiscal Year 2016 – 17 budget adopted, we will have the proper baseline from which to start that five year forecast.

We have continued to include in this year's budget a column showing the departmental budget requests and the City Manager's recommendation. Prior budgets did not provide the departmental request information. Over the past three years, we have had each department make a presentation to the Budget Review Committee providing an overview of their budget and operations and highlighting specific requests that they made. This year the presentations focused on the major new requests or significant adjustments a department may have been seeking. Including those amounts in the budget reports will also provide the City Council with some insight as to what areas of departmental operations directors viewed as requiring additional funding. Unlike last year, many of the departmental requests did not make it into the City Manager's recommended budget. In some instances, we asked departments to accelerate items that could be undertaken prior to the end of Fiscal Year 2015 – 16, particularly one time items, as we had some available savings in the current year and Fiscal Year 2016 – 17 is more constrained by some operational increases that will be discussed below. In many instances, departmental requests were not funded or were partially funded. While this can be frustrating at the department level, it provides important information in terms of overall city priorities and can provide guidance for spending adjustments mid-year or in future fiscal years. In most instances the departmental request and the City Manager recommendation will match, however, there will be some areas where my recommendation will differ.

From a big picture/national economic perspective, the economic activity remains slow. It is concerning that just as we finished the budget the United States Commerce Department reported that the U.S. economy grew by 0.8% in the first quarter of 2016 after a small increase of 1.4% in the fourth quarter of 2015. On June 3rd, the Wall Street Journal reported that the US job market grew by only 38,000 jobs, the weakest month since September 2010. The unemployment rate

1 Civic Center Drive | San Marcos, CA 92069-2918 | (760) 744-1050 | (760) 744-9520 Fax | www.san-marcos.net

also dropped and most economists view that as a significant number of unemployed persons exiting the job market.

In our particular case, we see slow and steady growth at this point. This points us toward maintaining a conservative outlook, particularly with respect to revenues. The meandering economy seems to be borne out by the relatively slow rate of wage inflation. Based on our employee group memorandums of understanding, our staff will see a 2% cost of labor increases in FY 2016 – 17. That low growth in wages supports the notion that the economy continues to recover very slowly. As you'll recall, our perscribed wage indexes for establishing cost of labor increases include both public and private sector industries and should be a reliable snapshot of the growth of the economy from a wages perspective.

We are seeing small to moderate growth in a number of our major revenue categories including property and sales tax. Rental income is relatively flat except at Creekside Marketplace where a full year of rental revenue will be coming in from Winco and Hobby Lobby. We will also see a full year of revenue from the new DMV facility on Rancheros Drive. At City Hall, we continue to have a higher than typical vacancy rate. That was exacerbated by the departure of US Colleges, due to a bankruptcy, as a tenant, somewhat unexpectedly. Council approved a mid-year appropriation to demo and perform some spec space improvements to that suite that will hopefully position the City to appeal to a wider range of potential tenants.

National, statewide and regional economic indicators are mixed. The unemployment rate in California dropped 1.2% from April of 2014 through April of 2016. Fortunately, San Diego continues to outperform the state overall. The San Diego County preliminary unemployment rate for April of 2016 was 4.5%, slightly better than the same month in 2015 and below the statewide rate of 5.2%. The labor force participation rate in California remains steady at about 62%, however, this steadiness is not a positive note as the participation rate of 61.8% in April of 2014 marked the lowest rate since April of 1976. The April rate of 62.0% indicates a lack of full time job growth and that long term unemployed persons continue to find it difficult to attain employment. The California Composite Index of Consumer Sentiment dropped through 2015 after reaching a ten year high in December of 2014. This downward trend seems to accurately reflect the flat level of sales tax over the past 12 to 18 months.

As with past years, the economic data is a mixed bag which makes it difficult to draw any concrete or semi-concrete conclusions. This supports our continued slow and steady approach to the budget. While you will note that the recommended budget does contain a number of additional items, our overall general fund operating spending growth compared to our FY 15 – 16 year end projection is 2% or approximately $1.4 million. This is a much smaller increase that the FY 15 – 16 budget was compared to FY 14 – 15. Of further interest, the recommended FY 16 – 17 budget is only 1.5% higher than the amended FY 15 – 16 budget.

Lastly, on the economic front, the San Diego Union Tribune reported in April of this year that the median San Diego County home price of $478,000 was the highest value since August of 2007, indicating that home prices have substantially recovered from the burst housing bubble of 2007 – 2010. San Diego continues to be one of the least affordable housing markets with middle income earners paying on average 53% of their monthly income on housing. Any significant or protracted economic downturn could have a more pronounced impact on high cost housing markets such as ours.

In developing the budget for Fiscal Year 2016 – 17, the first thing we did was to build on the City Council's adopted policy of directing general funds toward infrastructure, City facilities and vehicles and equipment replacement and rehabilitation. As the Council knows, the Fiscal Management Policy it adopted in 2015 provided that 2.6% of the adopted FY 14 – 15 General Fund budget or $1,648,506 in the FY 2015 – 16 be budgeted for this purpose. The policy escalates that set aside each year. The recommended FY 16 – 17 budget sets aside 3.1% of the adopted FY 15 – 16 budget or $2,023,167 toward that purpose. The increase from FY 15 – 16 to FY 16 – 17 is $374,661 which is an increase over the prior year of 22%, the single largest significant line item increase in the budget. That is not an insignificant fact and demonstrates the staff's and the Council's commitment to closing that infrastructure funding gap. You'll see that set aside on the General Fund Expenditure Page (page 1), General Fund Summary Page (page 6) and you'll note the allocations of those funds in Fund Numbers 602, 603 and 604 (pages 103 – 108).

In addition to the annual operational transfer, the City realized a significant one-time revenue item in the settlement of a long-term legal matter. That settlement resulted in nearly $1.6 million of one-time revenues coming into the General Fund. Under the Council's adopted Fiscal Management Policy, those funds will also be distributed to the replacement/rehabilitation funds.

The Affordable Care Act continues to present challenges that require both additional financial resources as well as significant additional administrative effort. One of the interesting aspects of the Affordable Care Act was that it was supposed to reduce administrative burdens on the insurance industry and, potentially, employers as well. The opposite is true for the City and likely any employer that has both full and part time employees. The changes in the definitions of those terms have required us to look very carefully at the way we utilize and manage part time employees. This year, we are recommending converting 14 part time positions in Public Works to 3 full time positions. This will result in fewer work hours available to Public Works. The management and replacement of those part time positions continue to be more difficult. Public Works proposed this change and coupled it with out-sourcing some additional maintenance activities. This is a difficult situation for those part time employees, but it was becoming increasingly burdensome and inefficient to continue under that structure. The change will result in a modest budget savings, and will likely increase efficiency both in the field and the administrative office. We continue to try to be more strategic in how we use part time staff and recognize that the fiscal risks associated with the Affordable Care Act, and recent increases in the minimum wage state wide, make the management of some part time staff untenable or less fiscally efficient.

The City's financial outlook remains quite strong. The General Fund summary page shows a surplus for the end of Fiscal Year 2015 – 16 of over $3.6 million. Roughly $1.6 million of that is from the one-time legal settlement discussed above, resulting in an approximate $2 million operating surplus in FY 15 – 16. Year end expenditures are projected to be approximately

$390,000 below the Council approved amended budget. The Council's adopted Fiscal Management Policy provides that any year end operating surpluses (assuming the minimum 40% reserve level is met) be distributed to our rehabilitation and replacement funds. The budget presented to you assigns those one-time funds from the legal settlement (roughly $1.6 million) to those funds. Staff intends to return to Council with an item to allocate the final operating surplus in late summer/early fall after FY 15 – 16 has been closed and the actual operating surplus is known. This will not in any way slow down progress on any projects and will avoid having to do multiple actions on allocating those surplus funds.

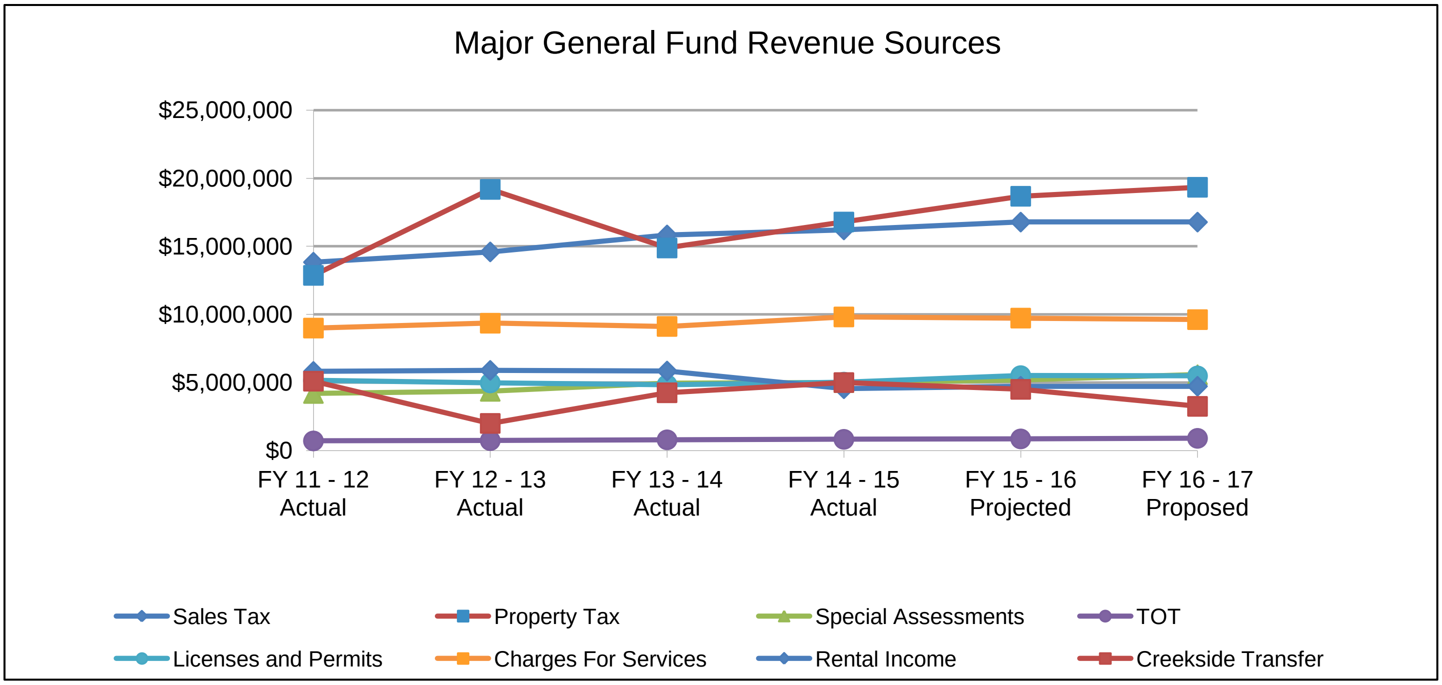
We are projecting that we will end Fiscal Year 2015 – 16 with a General Fund liquid reserve level of $29,584,865 or 44.2% of the original FY 15 – 16 General Fund budget and 42.7% of the recommended FY 16 – 17 General Fund budget. As discussed above, staff will return to Council with a recommendation on allocating that portion of the reserves that exceed the Council policy after the books on FY 15 – 16 are closed later this summer.

GENERAL FUND

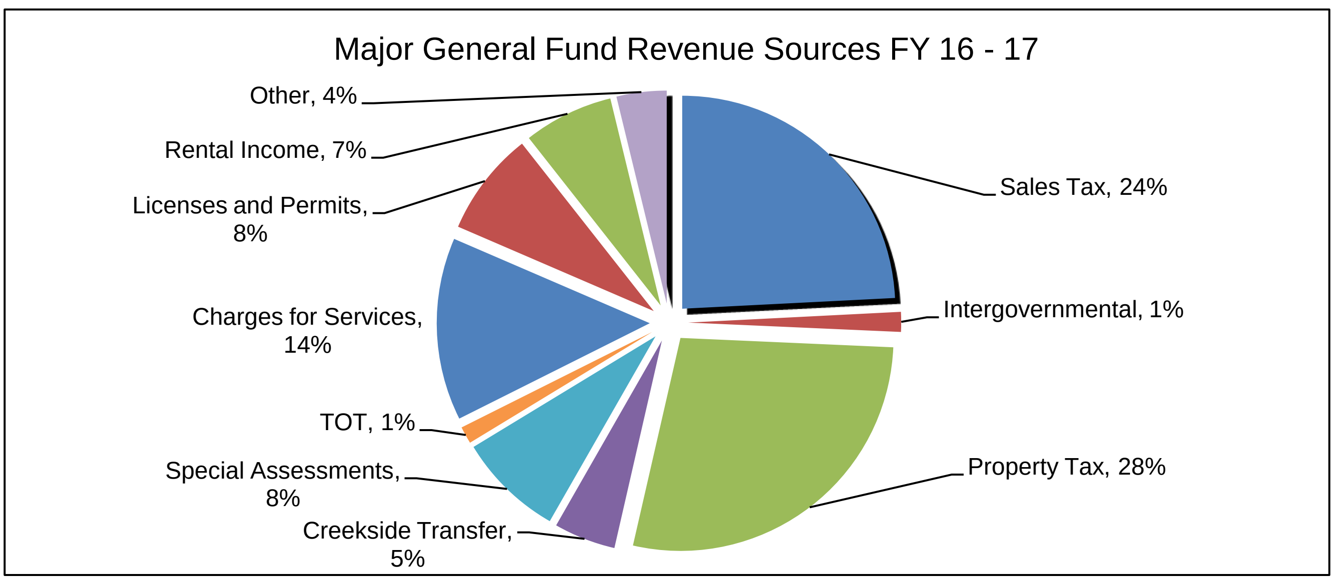
The recommended Fiscal Year 2016 – 17 budget is balanced and in compliance with the Council's amended General Fund Reserve Policy.

Revenues

In terms of revenues, below is a chart which shows trends in our major revenue sources as well as a chart showing the breakdown by percentage of those major revenue sources in the FY 16 - 17 budget.

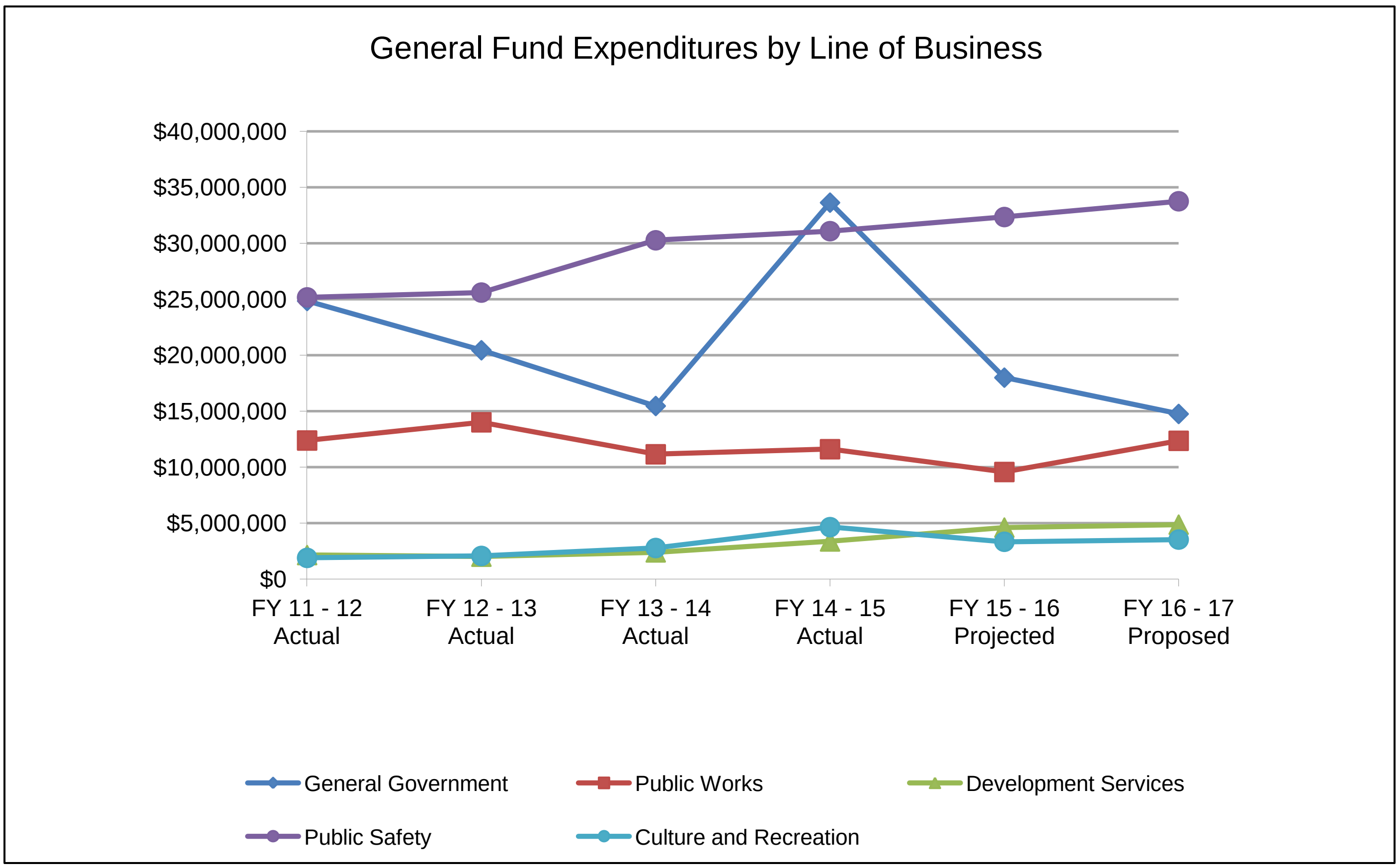


The City benefits from a diverse revenue base. Between rental income from City Hall and other land holdings as well as Creekside Marketplace, rental revenue accounts for 12% of General Fund revenue. This diverse revenue base has enabled the City to weather the recession storm, maintain service levels and invest in long-term rehabilitation and replacement needs.

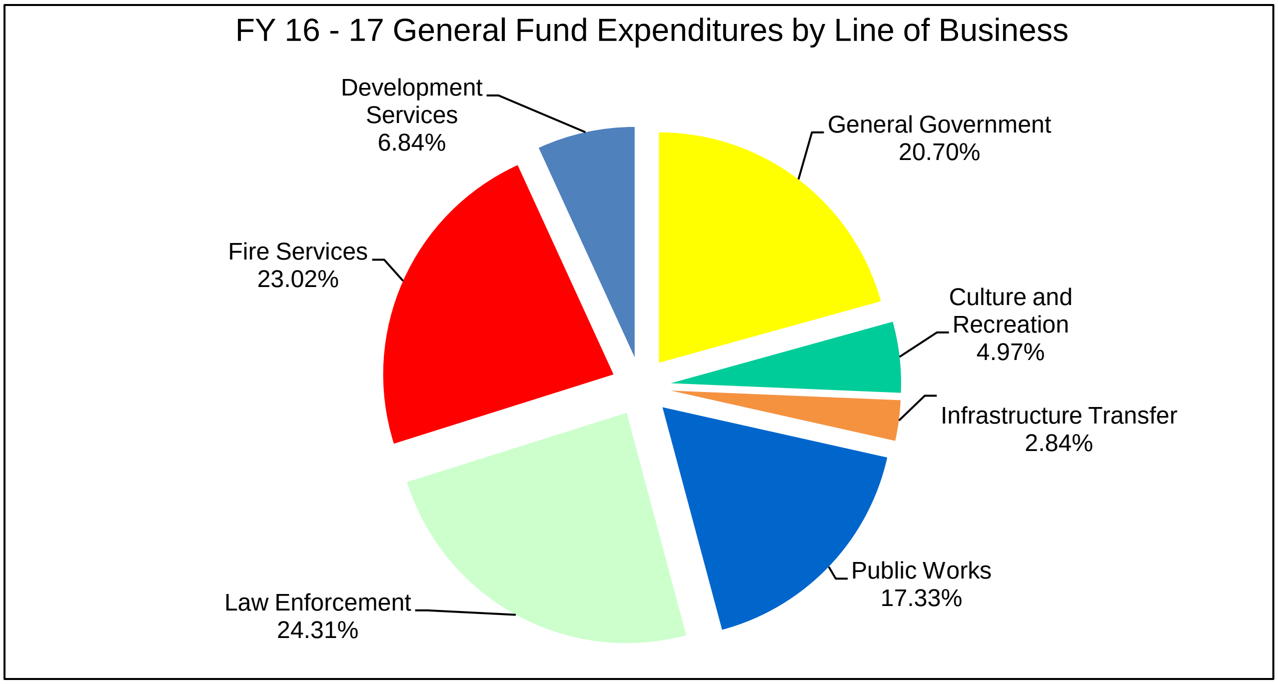


Expenditures

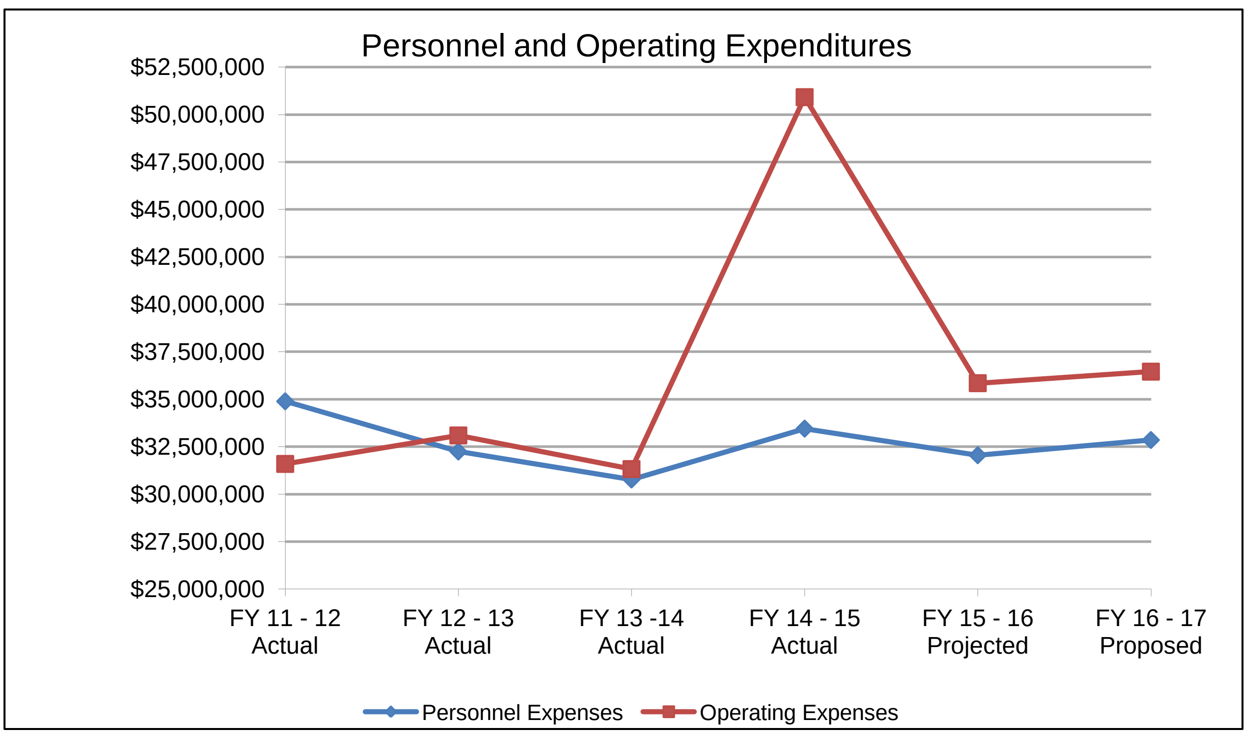
General Fund expenditures have remained steady over the past few years. The City has attempted to "hold the line" on expenditures through the recession and while there has been some downward movement, the City has been generally able to maintain service levels. In FY 2016 – 17, the City will be reorganizing Real Property Services and Public Works by transferring the building and facility maintenance function to Public Works. The table below reflects the move of staff and operations out of Real Property Services to Public Works and respective drop and increase in those department's budgets (RPS was included in General Government). The following charts show General Fund expenditures over the past several years by lines of business and in terms of personnel and operational costs. The spike in General Government in FY 14 – 15 was predominantly related to the Winco/Hobby Lobby and DMV investments.



Prior to FY 13 - 14, all city employee benefits were budgeted within General Government. In FY 13 - 14, those costs have been spread to each department.



The following table depicts the amounts of the total General Fund budget the categories of personnel services and operating expenditures represent (FY 14 – 15 spike reflects Winco/Hobby Lobby and DMV investments):



FY 16 - 17 Personnel Expenses		
Category	**Total Amount Budgeted**	**Percent of Total GF Budget**
Salaries and Wages	$22,249,483	32.10%
Health Benefits	$3,016,540	4.35%
Retirement Benefits	$6,218,686	8.97%
Other	$1,367,588	1.97%
Total	$32,852,297	47.39%

The total share of the City's General Fund budget made up by personnel expenses have been on a slight downward trend from 49.09% in FY 14 – 15 to 48.39% in FY 15 – 16 to 47.39% in proposed FY 16 – 17. While seemingly small from a percentage perspective, if the FY 16 – 17 share was the same as FY 14 – 15, personnel costs would be $1.17 million higher.

The budget reflects the 2.0% cost of labor increases that are part of the City's memorandums of understanding with its employee groups. It also reflects projected increases in health care and pension costs. It also reflects the conversion of some part time positions to full time as part of our attempt to better manage our operations in light of challenges posed by the Affordable Care Act regarding part time employees.

Other Expenditure Highlights:

While the budget from an operational standpoint does not contain a large number of major enhancements, there are some noteworthy items. The Sheriff contract increased by roughly 4.8%, resulting in an increase in law enforcement costs of approximately $780,000. Also in the Public Safety area, the City, like most cities, has seen significant increases in calls for service for fire and emergency medical services. This has caused an increase in dispatch services call and medical supplies. The City also engaged in a comprehensive insurance review of its assets resulting in higher property insurance premiums. In FY 15 – 16, the City received a sizable refund in its liability insurance premiums which is not available in FY 16 – 17, resulting in unavoidable increases there. From a staffing perspective, only one new full time position is being recommended, a new Storm Water Management Inspector. The budget assumes that position will be brought on board mid-year. There is also the conversion of 14 part time maintenance worker positions in Public Works to three full time positions. That change has a negligible budgetary impact.

There are a number of personnel and non-personnel items of note in the budget. The recommended budget includes an increase in our Workers Compensation funding of nearly $93,000 over the FY 15 – 16 budget. This reflects a greater number of work related injuries over the past couple of years. The City has a robust safety and training program, but injuries still happen and tend to fluctuate over time. In the Finance/IT area, we have a new financing payment of $208,000 as part of a very low interest financing we undertook last year to make significant improvements in the backbone hardware side of our IT department this year. In Real Property Services, we have seen a fairly substantial increase in Security Guard Services. That increase in budget from FY 15 – 16 to FY 16 – 17 is $45,230. The increase is due to increases in the hourly rates our selected security firm pays.

In Public Works, Fleet Maintenance, there is an overall reduction in the budget of approximately $190,000. This reflects lower fuel prices and less maintenance for our smaller vehicle fleet as we transition to full implementation of the vehicle leasing program. For Public Works, Parks and Landscaping, the overall budget increased by about $40,000. The contract maintenance services in this area increased by $206,000, which was offset by savings elsewhere in the unit.

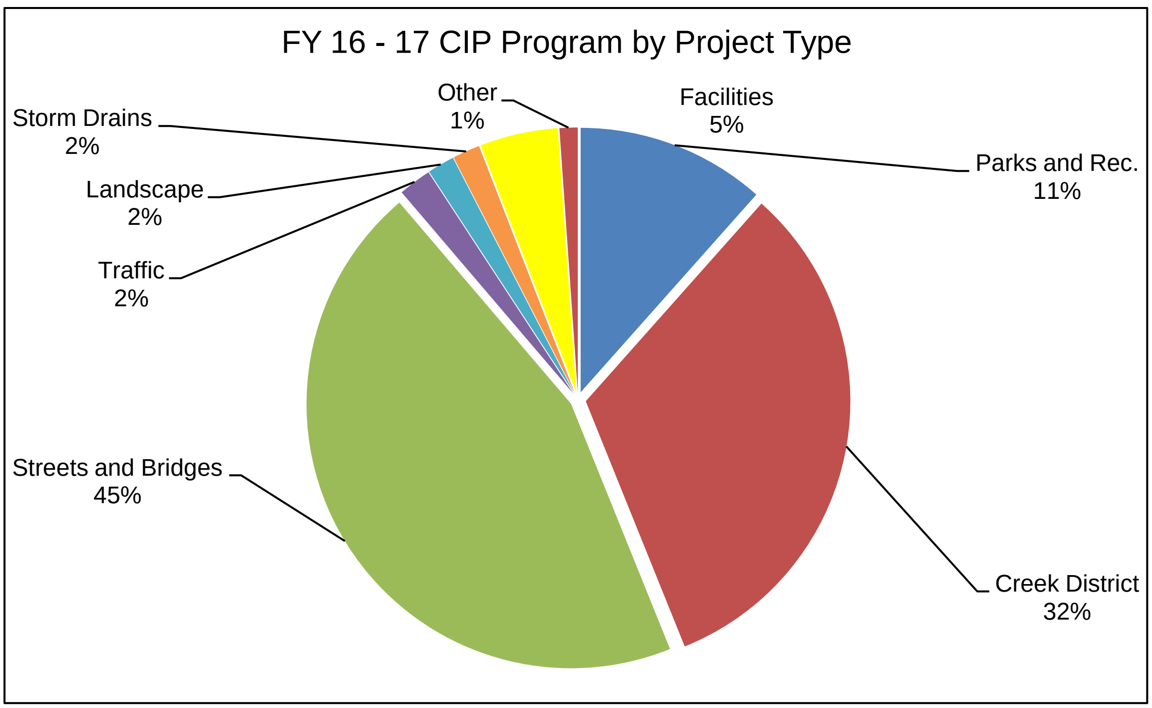
In Fire, as discussed above, we continue to see double digit percentage increases in calls for service which impacts our costs both directly and indirectly. One of the direct impacts is central dispatch services. While the cost per call is remaining at $61/call, the increased volume has caused us to increase the dispatch budget by $187,422. On the law enforcement side, discussions have started with respect to the allocation of resources. In particular, as the City has grown, the demand for traffic enforcement staffing has increased. Actual traffic staffing has not been adjusted since 2000. Before recommending additional resources be budgeted, staff will work the Sheriff command staff to assess whether our current resources are allocated as efficiently as possible. We may find through that effort that additional resources are needed as trade-offs in areas of focus may be unacceptable. Staff expects that we will pilot a reallocation program to test any possible changes. For informational purposes, the fully loaded cost of an additional traffic deputy is $190,987.

As discussed above, the largest single increase from a percentage basis to the general fund budget follows the Council’s adoption of a new Fiscal Management Policy in May of last year which directed staff to include a general fund contribution of 2.6% of last year’s adopted budget to our three rehabilitation and replacement funds (Infrastructure, City Facility and Vehicles and Equipment). As discussed earlier, in addition to the actual work that this funding will support, our Capital Improvement Program contains funding to undertake a comprehensive Asset Management Program. The Council’s Fiscal Management Policy directs staff to try to increase that annual set aside amount by a minimum of 0.5% per year with a goal of getting to 6 to 10% of the operating budget in ten years. For FY 16 – 17, at 3.1% of the adopted FY 15 – 16 budget, this amount increased by $374,661 to $2,023,167, a 22% increase. The long term impact of this policy change will result in the investment of numerous millions of dollars in our aging infrastructure over time and the Asset Management Program we intend to develop will be a critical tool in determining how to spend those funds as wisely as possible.

CAPITAL IMPROVEMENT PROJECTS BUDGET

With this budget the City continues to fine tune the manner in which we budget for capital projects. As the Council may recall, it has been the practice going back many years to "re-appropriate" funds to projects in successive years. This practice essentially results in the same dollars being appropriated (not spent) more than once. That practice does not make sense and the funds appropriated for a project should happen once and then stay with that project through its life. In this year's CIP, the major change was adding more information to the detailed project sheets. This year, those pages include columns indicating Budget Amounts to Date and Adjusted Project Costs.

The total funding for Fiscal Year 16 - 17 for CIP projects is $18.1 million. The following chart depicts each of the project types and their percentage of the total CIP budget.



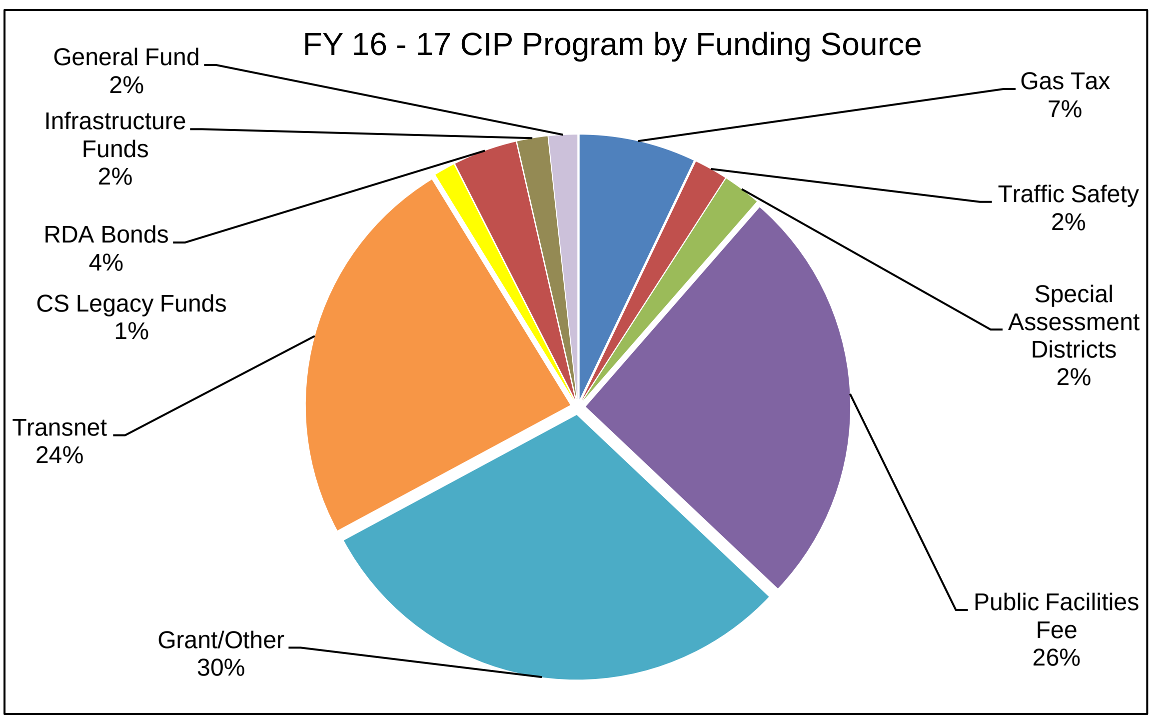
As the above graph indicates, 32% of the FY 16 – 17 CIP is focused on Creek District infrastructure.

As the Council knows, many capital projects span multiple fiscal years and funding in FY 16 – 17 is based on staff's best estimate of what will be spent in that fiscal year. Some projects will require future appropriations as they move from planning to design to construction.

Some of the major non-Creek District projects that are still in progress are:

- Palomar Station Pedestrian Bridge ($5.55 million)
- Rancho Coronado Park ($5.68 million)
- South Lake Community Park ($4.11 million)
- Richmar Park ($2.09 million)
- Channel Widening South of Grand Avenue ($3.90 million)
- SR – 78 Eastbound Auxiliary Lane Improvement ($13.75 million)
- Armorlite Drive Smart Growth Complete Street ($3.53 million)
- South Santa Fe – Smilax to Bosstick ($6.60 million)
- Woodland Parkway SR 78 Interchange and Barham Road Widening ($42.65 million)
- 2016 and 2017 Pavement Seals and Rehabilitation ($6.52 million)
- San Marcos Boulevard at Discovery Street Intersection Improvements ($2.61 million)
- Citywide ADA Infrastructure Improvements ($3.10 million)

The graph below depicts the various funding sources that the City is utilizing for the FY 2016 – 17 CIP.



In the Grant/Other category, Woodland Parkway Interchange/Barham Road Widening and Creek District projects make up the bulk of that category.

As the Council is aware, the Creek District makes up a significant portion of the five year CIP. The total five year program starting in FY 2015 -16 and extending through FY 2020 – 2021 is

$197,242,324. The Creek District projects make up $86,949,523 or 44% of the total CIP. The main projects in the Creek District are:

- Via Vera Cruz Bridge ($26,391,190)
- Bent Avenue Bridge ($20,059,823)
- Discovery Street Widening and Flood Control ($11,914,021)
- Infrastructure Planning and Grading ($11,648,000)
- Promenade Construction ($3,478,760)
- Environmental Habitat and Mitigation Establishment ($13,457,729)

CONCLUSION

The City's finances remain in strong condition. The Council's General Fund Reserve and Fiscal Management Policies have been adhered to and while there are challenges facing the City in Fiscal Year 2016 - 17, the continued recovery of the economy has resulted in an uptick in revenues that are able to keep pace with cost increases, fund both the rehabilitation and replacement efforts per Council policy and make some minor operational enhancements. A solid foundation exists for providing quality services while still preparing for the future. Through streamlined processes, new work procedures, and better use of technology, we have been able to maintain critical programs and carry out important infrastructure projects.

I'd like to express my appreciation to all of our Department and Division Directors and especially their budget staff. We continue to try to improve not only the budget document, but our budgeting processes as well and the efforts of all of our departmental staff have resulted in a much better budget development process and improved budget document.

I would especially like to express my appreciation to Laura Rocha, Finance Director and Alan Stutler, Budget and Revenue Officer as well as the Budget Review Committee for their efforts on improving our budget program.

I would also like to express my appreciation to the City Council for providing the leadership and support necessary to pursue and achieve our goals and to City staff for their commitment in providing top-quality services to the community. Our combined efforts are critical to the City's success.

Sincerely,

Jack Griffin
City Manager