ATTACHMENT 1

City Manager's Budget Transmittal Letter

June 8, 2021

Honorable Mayor and Members of the City Council:

It is my pleasure to submit the Fiscal Year 2021-22 Operations and Maintenance Budget (O&M) as well as the five-year Capital Improvement Program (CIP) for the City of San Marcos.

As we seem to be exiting a 15 month long pandemic and the significant restrictions that have been placed on the general population and the business and institutional communities, it's starting to feel like an economic rebound is underway. That certainly seems positive and in many ways is, yet, at the same time, there are some warning signs that we need to pay attention to, especially with respect to the possibility of economy wide inflation and how that will impact our normal expenditures.

As I mentioned in last year's transmittal letter, I usually discuss some of the macro economic statistics that we see and how they color our approach to the budget. This year, again, I'm not sure I see any real value in that as economic statistical comparisons to 2019 or 2020 in this time of re-emergence don't seem particularly useful.

I do think that it is noteworthy to mention a few points. At this time last year, the unemployment rate was about 30%. The figure for San Diego for March 2021 was 6.9% which certainly is an improvement and it seems likely there is room for more improvement as the summer progresses. On the other hand, the Consumer Price Index showed an annual rise of 4.1% for March of this year and energy costs, in particular, led the way with the local energy index rising 16.3% for the two month period ending in March. Both electricity and gasoline rose by similar rates. It's kind of difficult to try to predict how the economy will exit the pandemic and how the pace of returning to normal activities will go, but it seems pretty obvious that there is significant pent up demand for entertainment and social interaction away from computer screens.

From the City's financial perspective, the key challenge for us remains the recovery of rental revenue that took such a hit over the past year. We are seeing signs of improvement, but it will likely be slow and may take a few fiscal years to get back to our pre-pandemic rental revenue levels. The receipt of the American Rescue Plan Act (ARPA) funds certainly assist in replacing some of the revenue we've lost and help us get back closer to the same footing we were on in terms of staffing and employee compensation as we were at prior to the pandemic. We certainly hope that by the time the ARPA funds have been fully expended by the end of 2024 that our revenue picture will have recovered to where it was prior to March of 2020.

As the Council will recall, we adopted the Fiscal Year 2020-21 budget with a deficit of nearly $2.7 million). The Council approved the use of reserves to plug that deficit. Prior to the adoption that budget, the Council had also approved the use of $3 million in reserves for our Business Sustainability Program. The combination of those two actions brought our available liquid reserves down to approximately 33% of the FY 2020-21 budgeted expenditures. Shortly after the budget was adopted, the City was provided with funding from the Federal Cares Act, first from the County and then from the State. We utilized those funds for a variety of direct COVID-19 expenses which helped offset general fund costs we experienced. The lion's share of those funds, nearly $2 million, went to convert Business Sustainability Program loans to grants. That enabled us to recover two-thirds of the reserve funds we used on that program.

As FY 2020-21 progressed, we identified some one-time revenue opportunities as well as continued to ratchet down expenditures as it was clear that the pandemic and associated shutdowns would continue for quite a long time. We had also assumed a certain number of employees would separate from the City and that happened at a higher rate than we projected and the accompanying hiring freeze generated significant budgetary savings. Lastly, sales tax payments remained fairly steady through the course of FY 2020-21, mostly attributable to on-line sales. That was not something that was all that predictable in the spring of 2020. Given all of those circumstances, we are exiting FY 2020-21 in a much stronger position than we had anticipated. As we discussed at the workshop meeting on May 25, 2021, we project that we will end the current fiscal year with a reserve level of about 49.5%, well above the Council policy of 40%. This translates into about $6.7 million of funding availability and as discussed at the May 25th workshop, we propose to utilize those "excess" reserve funds as following:

- Reimburse city employees for their 10% wage reduction ($1 million)
- Dedicate funds to our three internal infrastructure funds ($4.7 million)
- Replace $1 million removed from the General Plan Update project ($1 million)

Being able to undertake those items allow us start FY 2021-22 in much closer to a normal spot, though, as you will see, we continue to carry forward a projected deficit which I will discuss below.

To turn our attention to Fiscal Year 2021- 22, we start with the premise that as society in general re-opens and re-engages, we need to likewise be ready to provide the levels of service we were pre-pandemic. This means allowing positions to be refilled at a faster pace. We have carried many vacant positions through the pandemic and have used some of the staffing changes to realign our operations. We won't be able to get back to 2019 levels without filling many of the positions that we have held vacant. We will also end the furlough program and bring all of our full time employees back to a normal 80 hour work week. The combination of those two items should allow us to get back to a comparable level of service though it will take some time to fill all the needed vacant positions and bring those new employees up to speed.

While we start to incur these additional personnel costs, those will exceed the pace of our recovering revenues, in particular our rent revenues. At the same time, we need to keep in mind that as we start to see recovery in rent by way of new leases, most, if not all of those, will come with some capital costs whether it's in the form of tenant improvement costs that we incur directly, allowances for tenant improvements that we provide to new or renewing tenants or potentially lower rent amounts (this seems quite likely in the office space environment). These additional personnel costs fully account for the projected deficit, i.e. we could minimize that deficit by maintaining our current staffing posture and renegotiate a shorter work week. Whether the latter is a reasonable possibility seems dubious at best and public at large will be expecting a return to pre-pandemic normal sooner rather than later.

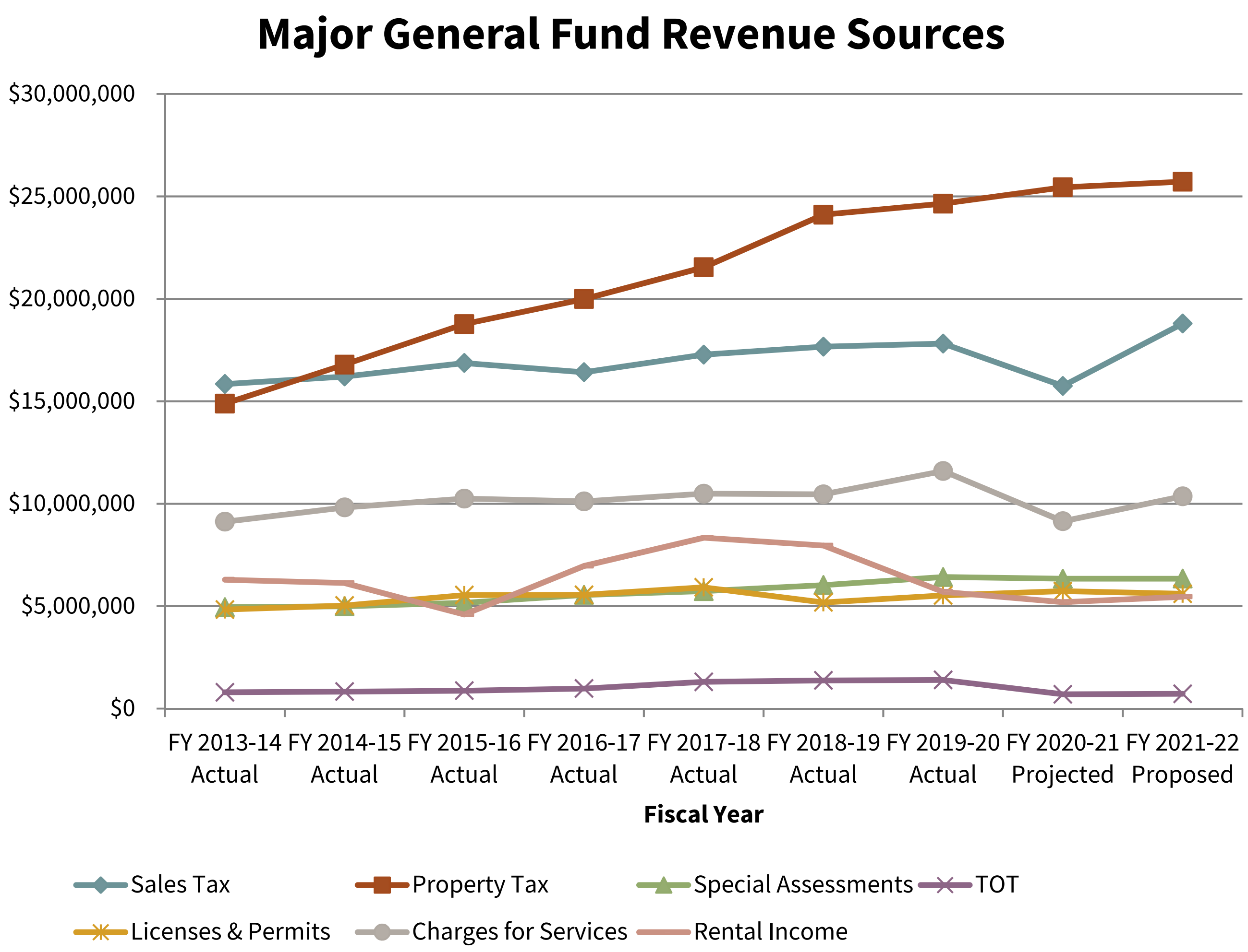
The good news in all of this from the City's budgetary perspective is the arrival of funds via the Federal government's American Rescue Plan Act (ARPA). Under the legislation that was enacted was a provision that allows cities that can demonstrate that the pandemic caused a loss of general revenues, to use those funds to make up for such losses. San Marcos will receive about $18.2 million over the next two years and we can demonstrate via the federal formulation of lost revenue that we experienced about a $5 million loss in revenue. This will allow us to eliminate the deficit contained within this budget when we bring the appropriation of the first $9.1 million of ARPA funds to City Council in July of this year.

GENERAL FUND

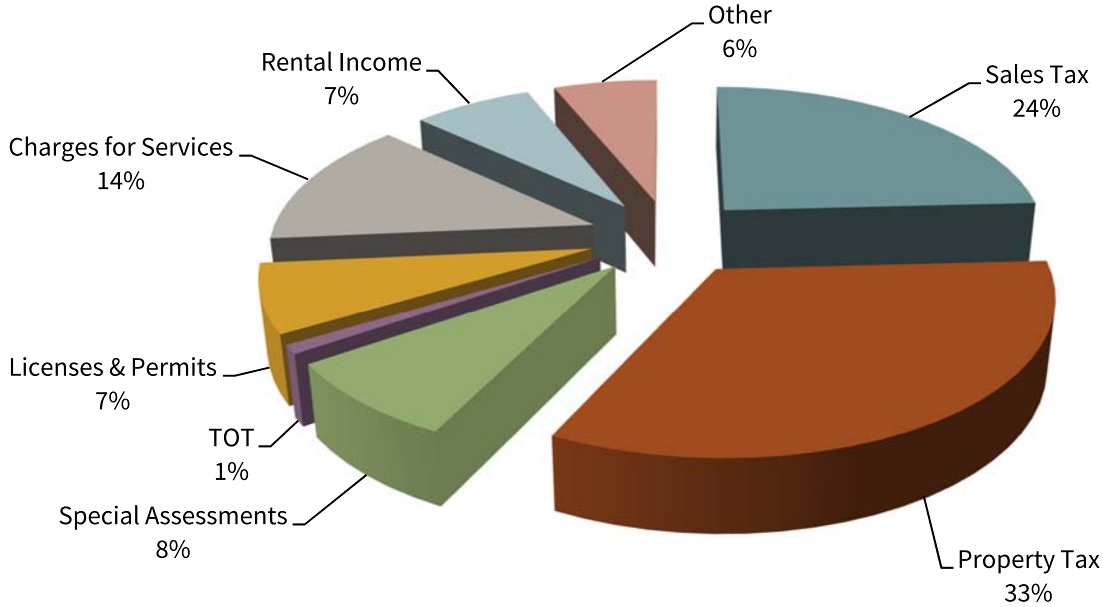
The recommended Fiscal Year 2021- 22 budget is not balanced and we recommend the use of up to $2,561,391 from the General Fund Reserve to balance the budget in accordance with the Council's adopted and amended General Fund Reserve Policy. It is highly unlikely we will actually use any of those reserves due to the ARPA funds availability as discussed above.

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 2021-22 budget.



FY 2021-22 Major General Fund Revenue Sources



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 9% of General Fund revenue, down from the 12.5% that we projected in adopting the FY 2019-20 budget. This diverse revenue base has typically enabled the City to weather the recession storms, maintain service levels and invest in long-term rehabilitation and replacement needs. In the current economic issues related to the pandemic, the drop in rental revenue is the primary cause for the deficit situation we are experiencing.

Expenditures

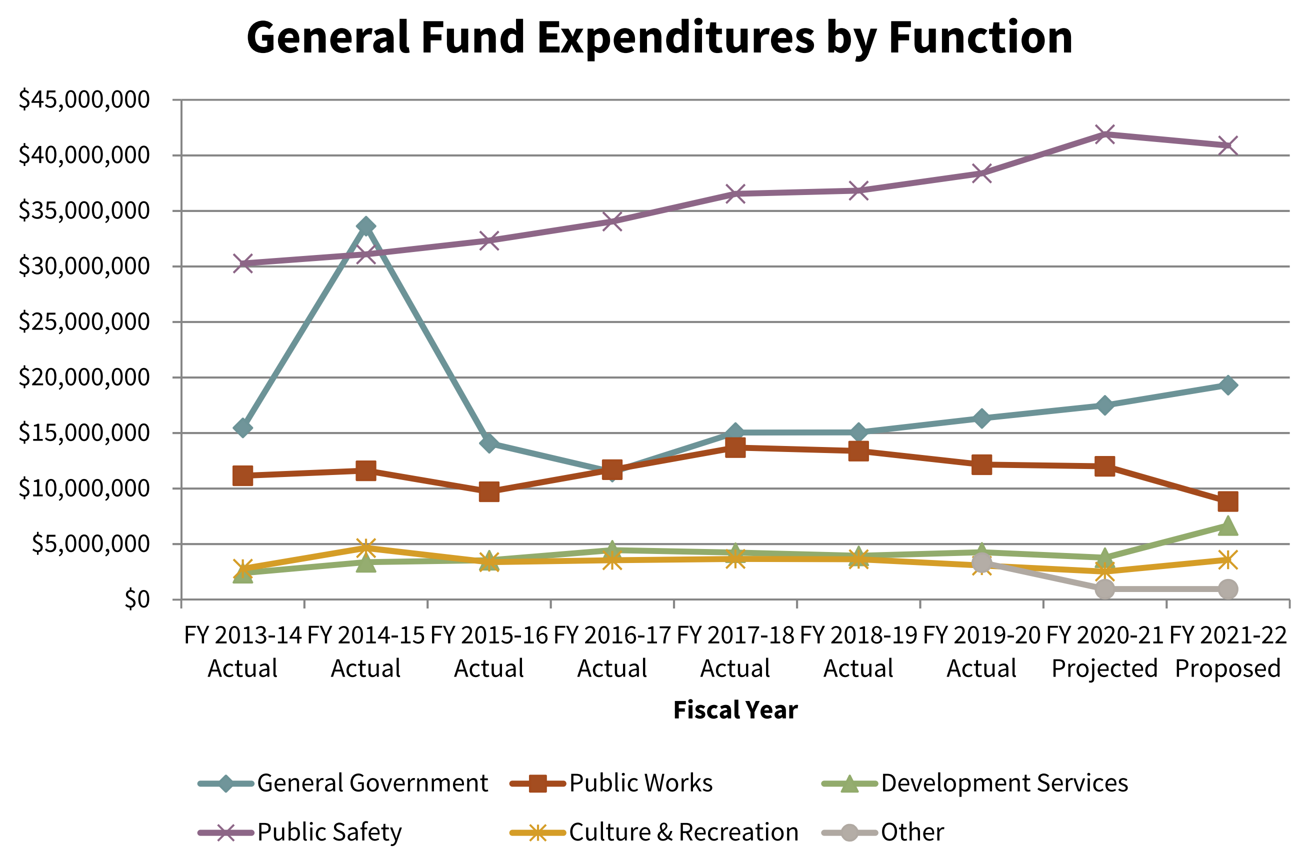
General Fund expenditures had held fairly steady and generally grown with inflation rates in the years preceding the pandemic. With the significant drop in revenue, we needed to also reduce expenditures as much as we could while still keeping the most critical areas of our operations such as public safety and public works functioning as close to pre-pandemic levels as possible. As a result, the adopted FY 2020- 21 budget was more than $4 million lower than our FY 2019-20 expenditures and over $6 million less than departments requested at the start of the FY 2020-21 budget process.

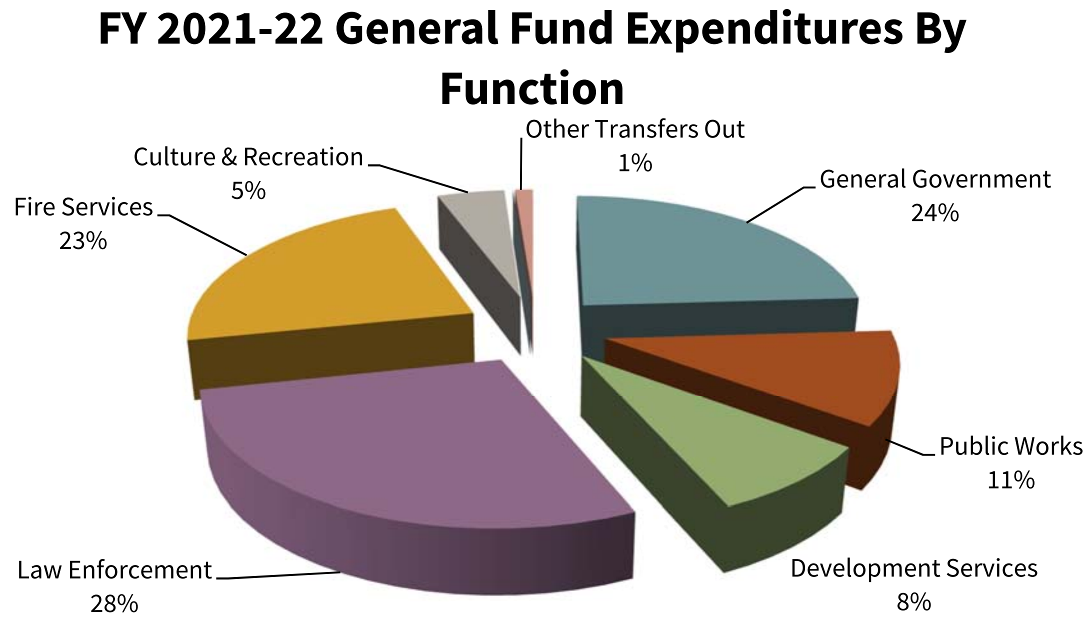
As we started the FY 2021-22 budget, we were anticipating an expenditure level pretty consistent with the prior year's amount and toward the end of calendar year 2020, departments were instructed to develop plans for further reductions. At that time, there was very little light at the end of the tunnel as the COVID case rates exploded, significant lockdowns were reinstituted, the ability to get vaccines out to the public was in question and there was no such thing as ARPA.

The situation started to improve in the February/March timeframe as it became clear that the vaccination program was quickly gaining speed and the federal government enacted the ARPA legislation. With these two key elements in mind, it also became clear that the kind of near draconian expenditure reductions we were planning for would not be necessary and, conversely, as the spring progressed with case rates dropping and vaccinations increasing, the possibility of a more normal year seemed possible. It didn't make any sense, especially with the funds arriving via ARPA to maintain those cuts. Given that, this budget recommends expenditures about 6% higher than the original adopted FY 2020-21 budget. It should be noted that our recommended $80.3 million budget is about $5 million less than we would have expected it to be had there been no pandemic.

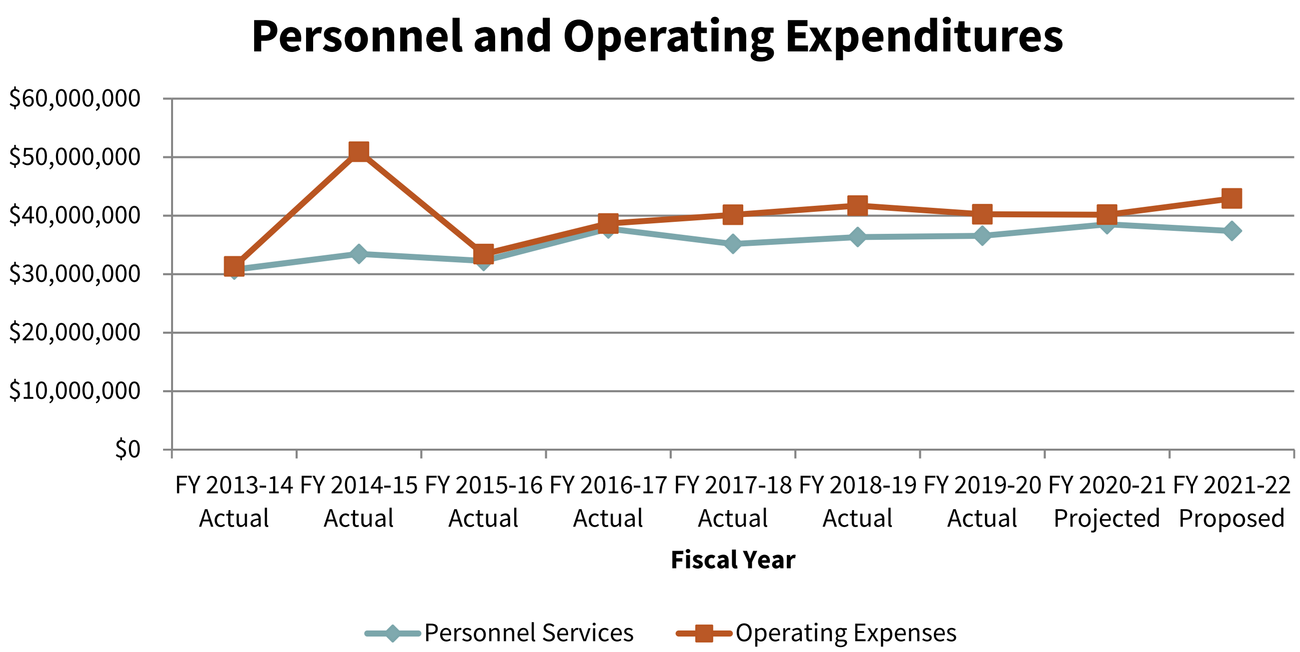
In terms of items that are responsible for the increase, they are essentially the normal annual cost increases for the Sheriff's contract (a 4.5% increase this year), restoration of the vacant Traffic Deputy position, normal pension cost increases, restoration of a full 80 hour work week for all our full time employees, an easing of the hiring freeze, the restoration of most of our parks and recreation programs and other normal cost increases. The FY 2021-22 budget also does not provide any funding for our internal infrastructure funds though they are receiving a much needed infusion as a result of us ending FY 2020-21 with a reserve level significantly above the minimum 40% level required by Council policy.

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 2014-15 was predominantly related to the Winco/Hobby Lobby and DMV investments.





The following graph and table depicts the amounts of the total General Fund budget the categories of personnel services and operating expenditures represent (FY 2014-15 operational spike reflects Winco/Hobby Lobby/DMV investments; FY 2016-17 personnel spike reflects a one-time pension payment):



FY 2021 - 22 Personnel Expenses		
Category	**Total Amount Budgeted**	**Percent of Total GF Budget**
Salaries and Wages	$23,127,395	28.80%
Health Benefits	$3,451,018	4.30%
Retirement Benefits	$9,239,040	11.50%
Other	$1,556,331	1.94%
Total	$37,373,784	46.54%

The total share of the City's General Fund budget made up by personnel expenses is down from 47.18% to 46.54%, which represents a $1.1 million reduction. Personnel costs had been on a slight downward trend from 49.11% in FY 2015-16 to 47.32% in FY 2017-18. It ticked up slightly to 47.44% in FY 2018-19 and saw another, somewhat larger move upward in FY 2019-20 to 48.57%. Last year, these costs fell to 47.18% with the pandemic. The past two years are an anomaly in this area and this current downward trend is likely not sustainable and we should expect to see these costs tick back up as we move back to full staffing.

The budget reflects the 2.0% cost of labor increases that are part of the City's memorandums of understandings (MOU) with its non-safety employee groups and 2.75% increases in safety employees. With respect to our MOU's, each has a four-year term ending in 2023 and each contains increased employee contributions to their pension which results in all staff receiving a net 5% increase over the four year terms. It also reflects a slight decrease (4%) in health care costs and larger increase (8.8%) in pensions, largely attributable to the restoration of a full 80 hour work week as well as an increase in our annual unfunded liability payment costs. Pensions continue to present a significant challenge to the budget and managing those challenges in the long term will continue to be a matter of high importance in the coming years, particularly if the CalPERS investment portfolio performance lags as the economy and market. Earlier this year, CalPERS reinitiated discussions regarding lowering the discount rate (the rate of investment return they assume they will generate). It seems inevitable that the rate will be lowered again and that will cause additional costs on cities though it will likely improve the fiscal health of the system overall.

Other Expenditure Highlights:

While the budget from an operational standpoint does not contain any enhancements, there are some noteworthy items. The Sheriff's contract increase of 4.5% results in $915,318 of higher law enforcement costs compared to the FY 2020-21 adopted budget. Some of that increase is offset by cost sharing of one School Resource Officer (SRO) with the San Marcos Unified School District (SMUSD) and an additional SRO being entirely paid for by a grant secured by SMUSD. The grant for this last SRO is due to expire on June 30, 2021 and as of the writing of this, we are awaiting word from SMUSD on whether they wish to keep the position and provide the entire amount of funding. Also in the Public Safety area, after years of increasing fire/ambulance call volumes, we experienced a significant drop in calls for service in the very early portions of the pandemic and stay at home orders. Those calls volumes bounced back as last year went on and we are returning to a more normal pre-pandemic call volume level.

The recommended budget does depart from the Council's adopted fiscal management policy in terms of the annual transfer from the General Fund to the Infrastructure, Facilities and Vehicle Equipment Fund. That transfer, based on the policy, would have been calculated on 5.6% of the FY 2019-20 adopted budget. In FY 2019-20 and FY 2020-21, the Council adopted budget did not adhere to that year's goal of 4.6% and 5.1% due to expenditure increases in the Sheriff's contract, personnel costs, particularly pension increases, and the reduced transfer from Creekside Marketplace in FY 2019-20 and the significant deficit in FY 2020-21. Given the significant revenue impact of the pandemic, this budget does not recommend making any contribution to those funds, however, we are recommending over $4.7 million be placed in those funds via the "excess" reserve levels we realized at the end of FY 2020-21.

The infrastructure funds do still contain an overall healthy fund balance. As part of this budget, we are recommending moving funds from the City Infrastructure Replacement/Rehabilitation Fund (Fund 604) to the Vehicle and Equipment Acquisition/Replacement Fund (Fund 602). This will enable us to continue to move forward on our short-term needs and still maintain our ability to keep important projects moving forward. The transfer from Fund 604 to Fund 602 is recommended to be $400,000.

The table below provides a summary of the status of each of the infrastructure Funds, collectively:

City Infrastructure Fund			
FY 2021-22	Vehicles and Equipment	City Facilities	City Infrastructure
Projected Starting Balance	$2,261,789	$4,093,581	$4,610,011
Proposed Additional Funding	$0	$0	$0
Proposed Inter-fund Transfer	$400,000	$0	($400,000)
Proposed Expenditures	($2,633,746)	($380,000)	($674,000)
Previously Encumbered/New CIP Appropriation	$0	($1,556,591)	($1,897,103)
Projected Ending Balance	$28,043	$2,156,990	$1,638,908
Total Projected Ending Fund Balance	***$3,823,940***		

As the table indicates, even with the $0 funding levels proposed for FY 2021-22, we are able to fund all of the requested projects. Most importantly, it's taken several years to get caught up in terms of vehicle and equipment replacement and by targeting the funding for FY 2021-22 there, we do not lose ground in that area and are able to undertake the identified projects in the facilities and infrastructure budget. It's also worthwhile to note that the remaining $3.8 million in projected year end fund balance does not count toward the City's 40% General Fund Reserve policy requirement. If these general funds were added to the General Fund, our projected FY 2021-22 reserve level would be at 44% of the FY 2021-22 recommended budget.

CAPITAL IMPROVEMENT PROGRAM

Over the past several years, we have refined the Capital Improvement Program (CIP) to provide a more accurate representation of the City's actual five-year capital program. For years we have written about one very significant project that would move forward to the construction phase, the Creek District. That year finally arrived in FY 2019-20 and that project is currently under construction. Due to the size, complexity and likely duration of the Creek District components, the balance of the FY 2021-22 CIP is relatively moderate.

The total new appropriations recommended for Fiscal Year 2021-22 for CIP projects is $6.7 million. The Creek project itself only accounts for $100,000 of that within the environmental monitoring of the program, as planned. The remainder of the Creek project is sufficiently funded at this time.

The bulk of the $6.7 million included in the FY 2021-22 CIP budget is the $4.4 million appropriated for various street projects. Half of that is for the future reconstruction of San Marcos Boulevard from Grand Avenue to Rancho Santa Fe. A Construction start date for this project is still several years away. Another key roadway project is the start of the planning/design of improvements to Olive Street and Sycamore Street near Walnut Grove Park. Both streets have bridge structures that need to be addressed and both also have challenging creek and alignment issues. The initial funding recommended in this year's budget gets us started on what will likely be a multi-year effort.

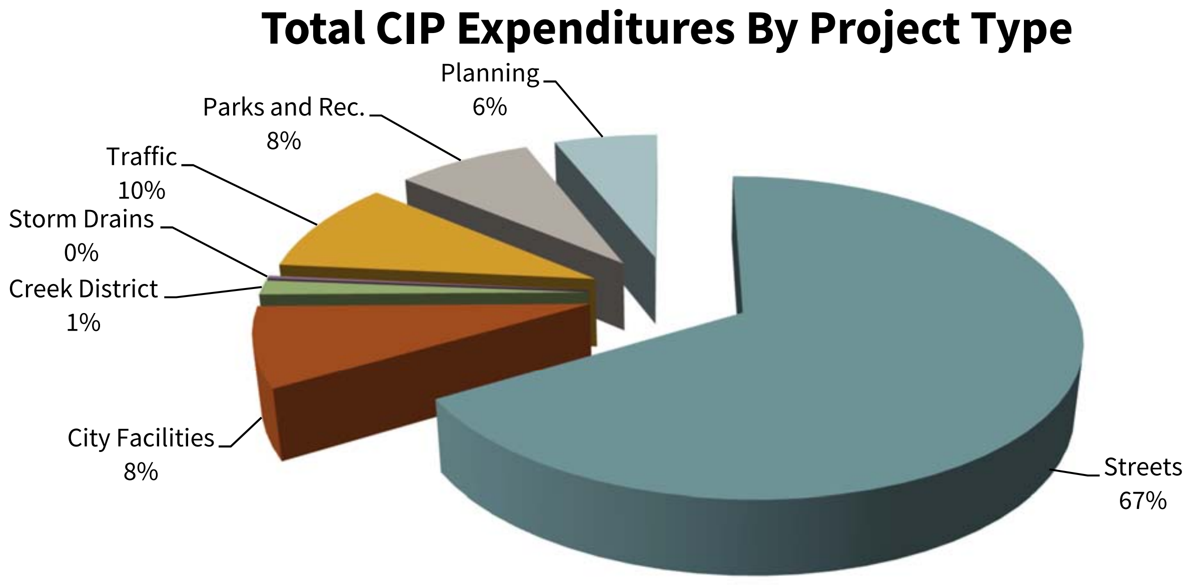
Additional street/traffic projects make up another $1.9 million of the total FY 2021-22 CIP appropriation. This means that street/traffic improvements, leaving aside the Creek District projects, make up 76% of the CIP appropriations in FY 2021-22. Parks projects account for an additional $0.5 million, City facilities account for $.55 million and planning and storm drains make up the remaining $0.4 million balance.

As the Council knows, many capital projects span multiple fiscal years and funding in FY 2021-22 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.

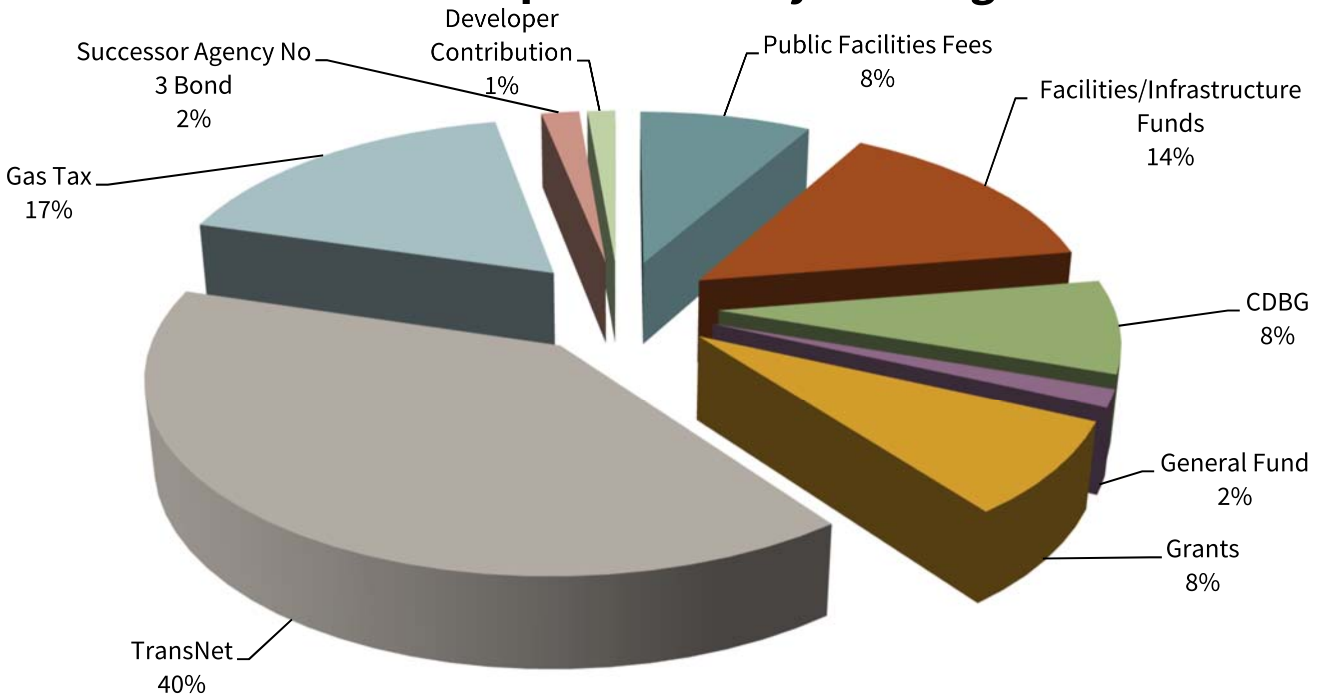
Some of the major non-Creek District projects that are still in progress are:

- Rancho Coronado Park ($1.5 million)
- South Lake Community Park ($1.6 million)
- South Santa Fe – Smilax to Bosstick ($7.2 million)
- Woodland Parkway SR 78 Interchange and Barham Road Widening ($17.4 million)
- San Marcos Boulevard at Discovery Street Intersection Improvements ($3.4 million)
- San Marcos Boulevard Reconstruction ($11.6 million)
- Barham and Twin Oaks Improvements (By Developer) ($8.5 million)
- Richmar Park Phase 2 ($.8 million)
- Connors Park Synthetic Turf Replacement ($.8 million)
- Civic Center and SMETC Complex Improvements ($1 million)
- Citywide ADA Improvements ($3.3 million)
- Annual Surface Seal ($2.0 million)
- Mission/Mulberry Drainage Improvements ($1.8 million)
- Traffic Management System Enhancement ($.5 million)
- Bradley Park Pump Track (.2 million)
- Sunset and Mission Sports Park Synthetic Turf (.4 million)

The following charts depict each of the project types and their percentage of the total CIP budget as well as the percentage of CIP expenditures by funding source.



FY 2021-22 CIP Expenditures By Funding Source



In the Planning/Grant/Other category, the projects include:

- Electronic Plan Review
- General Plan Update
- Trash Amendment
- Asset Management

As stated above, the Creek District makes up a significant portion of the five-year CIP. The total five-year program starting in FY 2020-21 and extending through FY 2024-2025 is $216,444,939. The Creek District projects make up $109,063,436 or 50% of the total CIP. The main projects in the Creek District are:

- Via Vera Cruz Bridge ($38.4 million)
- Bent Avenue Bridge ($28.0 million)
- Discovery Street Widening and Flood Control ($11.6 million)
- Creekside Drive and Grading ($14.6 million)
- Promenade Construction ($4.3 million)
- Environmental Habitat and Mitigation Establishment ($12.0 million)

CONCLUSION

The City's finances remain in a strong condition despite the challenges posed by the pandemic. Despite the significant effect the pandemic has had on our revenues and the need to adopt deficit budgets for the past two years, through generation of alternate revenue sources, significant belt tightening on normal expenditures and the assistance of our entire workforce in agreeing to personnel cost reductions, we are emerging from the pandemic on solid financial ground. We were able to erase the deficit the Council approved for FY 2021-22 and, in fact, ended with a reserve level above the Council policy which enabled us to reimburse the staff for their pandemic concessions, add significantly to our infrastructure funds and reallocate funding taken from the General Plan Update and allow that project to recommence.

For FY 2021-22 while we are recommending an operating budget deficit, we expect to bring forward the appropriation of the first tranche of ARPA funds and utilize a portion of them to make up for the revenue we've clearly lost. That will bring our FY 2021-22 budget into balance and will hopefully provide us with the breathing time we need to get our revenues back where they were pre-pandemic.

The Council's General Fund Reserve Policy has been adhered to and the use of reserves to balance the budget due to unanticipated General Fund revenue reductions is clearly contemplated in the General Fund Reserve Policy. It will be management's goal to minimize the use of those reserves to the extent practical without significantly reducing service levels.

For all of us, these past two budget processes have been something we've never seen before. Through it all, our staff has done fantastic work both in the day to day of providing high quality municipal services but also in making sure we stayed financially healthy and are ready to transition back to normal quickly. We have accomplished that and are ready to move forward again.

I'd like to express my appreciation to all of our Department and Division Directors and especially their budget staff. We started this process in October of 2020, unaware of many of the variables that would unfold over the subsequent months and planned for the worst. We are all thankful that the worst did not materialize and that we can move forward confidently. It's my view that we have presented a budget to you that brings our service levels back to where they were in the beginning of 2020 and we have a very solid foundation to build off of.

I would also like to thank our employee groups and, indeed, all of our employees. It is gratifying to work in a place where all of the employees understand and are willing to pitch in to help the City maintain its financial health. For those non-safety employees who quickly accepted a reduced work week and the corresponding drop in pay to those safety employees who, by the very nature of their emergency responder status could not reduce hours, voluntarily offered the City some cost savings to help us meet this challenge, it speaks of a healthy organization and a dedicated workforce. To be able to end this year and make everyone whole again was not something any of us thought would be possible and is certainly the right thing to do.

I would especially like to express my appreciation to Lisa Fowler, Finance Director, Donna Apar, Assistant Finance Director, Angelica Cuffari-Pagan, Management Analyst and Jeffrey Jorgensen, Accountant, for their efforts on this budget. To do a budget remotely without the ability to have the give and take that an in person meeting affords remained quite a challenge.

Lastly, I would also like to express my appreciation to the City Council and the Budget Review Committee for providing the patience, 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.

I strongly encourage the City Council to adopt this budget and turn the page forward.

Sincerely,

Jack Griffin, City Manager