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EXECUTIVE SUMMARY

The Road to Recovery is Slow, But Steady



The City of Santa Barbara is slowly working its way out of one of the most difficult fiscal environments in the past thirty years. This situation has been caused by an uncertain national and state economy, rising costs, and the worst California state budget crisis since the Great Depression. Due to these factors, the Council adopted only a one-year financial plan in fiscal year 2004, and we are proposing a one-year budget for fiscal year 2005. This is in lieu of the customary two-year plan proposed for Council consideration.

However, the national and local economies are now showing signs of a moderate recovery. Key revenues tied to local economic conditions, such as sales taxes and transient occupancy taxes, posted moderate gains in fiscal year 2004 and are expected to increase moderately in fiscal year 2005. The table below summarizes the growth rates from fiscal year 2001 through fiscal year 2005.

Both sales tax and transient occupancy tax revenues were dramatically impacted by the events of September 11, 2001, and the ensuing economic downturn. As shown in the table on the right, this led to declines in fiscal year 2002 and only nominal growth in fiscal year 2003. For fiscal year 2005, these revenues are estimated to grow 4%. Overall, the outlook is favorable as economic conditions continue to improve.

Fiscal Year	Sales & Use	Transient Occupancy
2001	5.4%	8.3%
2002	-4.1%	-3.3%
2003	2.2%	0.3%
2004	2.8%	5.1%
2005 *	4.0%	4.0%

* Projected

Rising Costs Still a Challenge

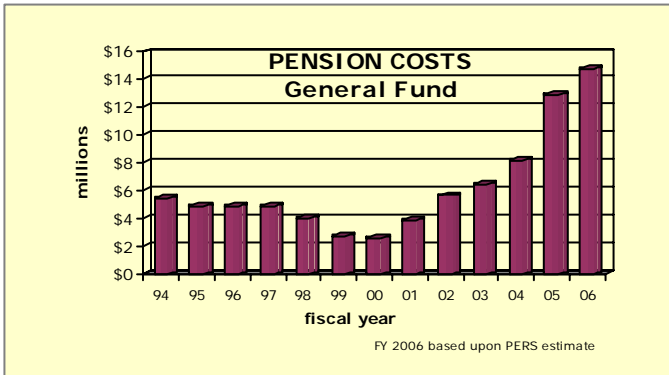
Rising costs still present the biggest challenge to the City. Over the last several years, the City has been plagued with cost increases in virtually all categories of benefits provided to City employees, including health insurance, retirement, and workers' compensation. The City avoided significant increases in fiscal year 2004 by changing health insurance providers. In addition, after three years of sharp increases, workers' compensation costs seem to have stabilized. However, increased benefits levels and investment losses incurred by the Public Employees Retirement System (PERS) have led to substantial increases to required contributions by the City on behalf of City employees. In fiscal year 2004, required contributions by the General Fund increased \$1.9 million. In fiscal year 2005, required



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contributions will increase by \$4.8 million, for a total projected annual cost of \$12.9 million (see chart below).



In the General Fund, salaries and benefits total 76% of the operating budget. As of June 30, 2004, existing contracts with most of the City's bargaining units expired, and the remaining contracts expire early in fiscal year 2005. Due to the increased PERS costs noted above and its impact on overall City spending, the adopted budget contains no provision for employee salary increases next year.

Agreement Reached Between Governor and Local Governments

After considerable debate and much consternation, the Governor and legislature reached an agreement on the State budget on July 27, 2004. One of the significant issues delaying a budget agreement was the level of protection of local revenues proposed and sought by the Governor and local government officials. Many democratic legislators favored an alternative proposal that only protected local revenues in the aggregate while still allowing State to re-allocate revenue among cities, counties, schools and special districts. The legislature, in the end, accepted the Governor's proposal, with minor changes. The agreement calls for a Constitutional amendment to be placed on the November 2004 ballot protecting local government revenues from future State raids. Only a declaration of a fiscal emergency by the Governor and a 2/3 vote of the legislature would allow the State from impacting local revenues in the future, but would require repayment with interest. The Governor has agreed to actively campaign for passage of the ballot measure. If passed, the measure would secure the remaining vehicle license fee (VLF), property taxes and sales taxes from future take-away or reallocation. The agreement also guarantees repayment of the local VLF revenues taken by the State in fiscal year 2004 and payment for all unpaid State mandated reimbursements.

In return, local governments will contribute \$1.3 billion in both fiscal year 2005 and 2006 to help balance the State's budget. For the City of Santa Barbara, this would result in a \$1,251,763 loss of revenue in each of the next two years; and the City's Redevelopment Agency would lose \$1,303,704 in each of the next two years.

As of the printing of this document, the State budget has not been officially approved. It still requires approval by the legislature, signature of the Governor, and approval of all



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implementing legislation, including the official language of the proposed Constitutional amendment. In addition, the measure still must be approved by voters in November. Nonetheless, Local governments were very leashed with the agreement and see this a major victory in a long battle over local control of revenues.

Long-Term Budget Strategies Proving Effective

In the wake of the September 11, 2001 terrorist attacks, our City began planning for the long-term impacts of declining revenues and increasing health, property, liability and workers' compensation costs. The attendant economic downturn and stock market decline led to unprecedented increases to retirement contributions. On top of these challenges, the state began grappling with its largest deficit in history.



Santa Barbara's "soft-landing strategy" calls for the orderly transition to a smaller organization, the reduction of overall costs, and the prudent use of reserves. This approach has allowed us to evaluate City

services and make the necessary adjustments, while minimizing the impact on our staffing and community services. We have also evaluated fees and charges to ensure they are in line with the costs of providing the related services.

In fiscal years 2003 and 2004, the City implemented \$4 million in budget adjustments by reducing expenditures, adjusting revenues, and eliminating more than 30 full-time equivalent positions. An additional \$2 million in budget adjustments has been incorporated in the fiscal year 2005 adopted budget. Approximately \$1.5 million of these adjustments represents reduced departmental spending, which includes the elimination of an additional 11.9 full-time equivalent positions.

The City's long-term strategy is proving effective in reducing costs, minimizing impacts to our community and staff, and preserving cash reserves. Additional adjustments and use of reserves are anticipated through fiscal year 2008 to address the remaining structural imbalance.



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And the Beat Goes On



Despite this difficult fiscal environment, the City continues to provide all essential community services in accordance with the City of Santa Barbara's trademark standard of excellence. The impacts of budget and staff reductions have meant only minimal reductions in services, many of which have been transparent to the community.

Santa Barbara in the meantime continues moving forward with key initiatives and projects. Major improvements totaling \$18.5 million are planned to begin next year at the El Estero Wastewater Treatment Facility. These improvements are in addition to major work begun this year at the Cater Water Treatment Facility, and the replacement of the open Sheffield Reservoir with two 6.5 million-gallon underground tanks.

The City has recently implemented a *Neighborhood Improvement Program* that involves several departments, addressing quality-of-life issues in our community. As an example, a recent and extensive neighborhood clean-up effort involved equipment and personnel from Public Works, Parks and Recreation, Police, Fire, Community Development, Caltrans, and the City Administrator's Office. In addition to towing away a number of abandoned vehicles, the City removed garbage, debris, human waste, trees, and brush totaling about 85 tons. There is much more to be done, including working with property owners to correct a number of zoning and building code violations. The *Neighborhood Improvement Program* is a work-in-progress effort to resolve unsatisfactory conditions that have been in place for several years.

The Redevelopment Agency recently sold \$34.8 million in tax allocation bonds to fund several major projects, including downtown sidewalk improvements, restoration of the Carrillo Recreation Center, rehabilitation of the Fire Headquarters building, construction of downtown and waterfront restrooms, and supplemental funding for the construction of Granada Garage.

The Water Quality Improvement and Creeks Restoration Program –now in its third year – is funded by 2% additional in transient occupancy taxes, which was approved by City of Santa Barbara voters in November 2000. Restoration of Old Mission Creek at Bohnett Park was recently completed, the restoration of the Arroyo Burro Estuary begins early next fiscal year, and an aggressive public outreach educational program is being implemented.

Even in the face of financial challenges, Santa Barbara is making tremendous progress on many fronts: upgrading the City's infrastructure, improving our environment, supporting new cultural facilities, addressing housing and transportation issues, updating our long-term planning documents and implementing strategies to improve our neighborhoods. Additionally,



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City staff is committed to improving the high-quality services our residents and businesses enjoy. The next fiscal year promises to bring both challenges and opportunities.

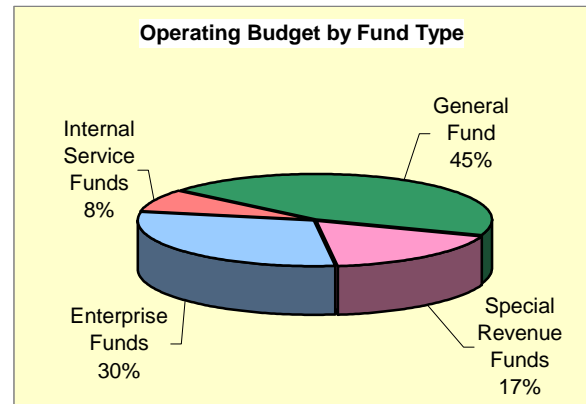
BUDGET HIGHLIGHTS

Wide Range of Services Provided

The City of Santa Barbara provides a full range of services to the community, including police and fire protection, parks and recreation, library, planning, streets maintenance, parking, water, wastewater and refuse, a regional airport, a harbor and waterfront.

The fiscal year 2005 adopted budget includes a total operating budget of \$196.6 million and a citywide capital program of \$28 million. The General Fund, which includes traditional local government services, is composed of an \$87.2 million operating budget and a \$1.3 million capital program.

In addition to the General Fund, the City has a number of other funds used to account for various activities. Special revenue funds, totaling \$34.4 million (17%), are used to account for revenues legally restricted for a specific purpose. Enterprise funds, totaling \$59.3 million (30%), are used to account for the activities of the City operates in a manner similar to the private sector, including water, wastewater, airport, golf, downtown parking, and waterfront operations. Finally, internal service funds, totaling \$15.7 million (8%) are used to account for services provided internally to City departments and programs, such as Information Systems and Risk Management services.



General Fund Revenues Show Signs of Recovery

Total General Fund revenues are estimated at \$83.4 million, up \$3.9 million (4.9%) over fiscal year 2004 adopted revenues of \$79.5 million. Of this total growth, \$2.4 million is attributable to projected growth in tax revenues.



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As a destination point for tourists and visitors, the City's General Fund receives a substantial portion of its revenues from sales and transient occupancy taxes (TOT). Combined, these two revenues make up 35% of total General Fund revenues. For fiscal year 2005, after three years of sluggish growth, both sales tax and TOT revenues are estimated to grow 4%, generating almost \$1.4 million in revenues above the fiscal year 2004 adopted budget.

	Fiscal Year				
	2002 Actual	2003 Actual	2004 Adopted	2004 Projected	2005 Adopted
Sales and Use	\$17,511,104	\$17,903,527	\$18,042,000	18,264,267	\$18,994,900
Utility Users	4,997,803 ⁽¹⁾	5,443,005 ⁽¹⁾	5,607,700	5,480,200	5,837,700
Property	9,513,754	10,373,212	10,992,200	11,099,337	11,299,100
Transient Occupancy	9,837,862	9,864,403	10,273,900	10,273,900	10,684,900
Business License	1,769,599	1,831,973	1,876,300	1,915,000	1,982,500
Real Prop. Transfer	307,319	874,582	408,000	600,000	618,000
TOTALS	\$43,937,441	\$46,290,702	\$47,200,100	\$47,632,704	\$49,417,100

⁽¹⁾ Adjusted to reflect change in accounting whereby, beginning in fiscal year 2004, the restricted portion (50%) of utility users tax is now received directly in the Streets Fund.

Despite the sluggish economy, property tax revenues continue to be strong. Between fiscal year 1999 and 2003, property tax revenues grew an average of 8.5% per year. In fiscal year 2004, we project a 7% growth and an additional 7% growth in fiscal year 2005. Note the fiscal year 2005 property tax estimate of \$11,876,332 was been reduced by \$577,232 to \$11,299,100 to account for the property tax shift included in the Governor's State budget proposal released in January 2004, resulting in budgeted growth in the adopted 2005 budget of only 1.8%. The adopted budget does not reflect the impact of the subsequent agreement between the Governor and local governments reached in July 2004.

General Fund Fees and Charges Designed to Keep Pace with Costs

Next year, revenues from fees and charges are estimated at \$8.7 million. With an estimated operating budget of \$87.2 million, only approximately 10% of operating costs are recovered

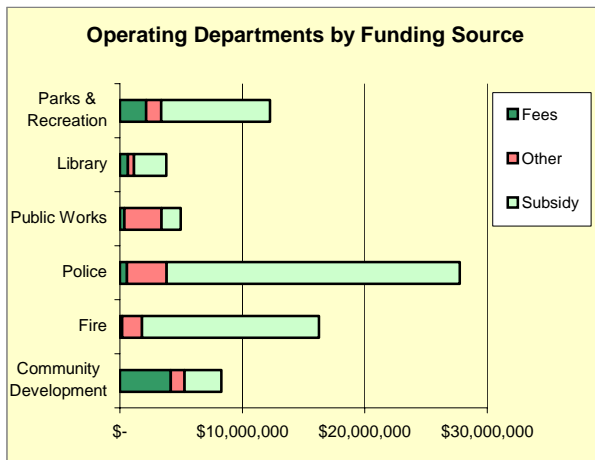


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from fees and charges. The vast majority (70%) of operating costs are subsidized from taxes and other non-departmental revenues.

The chart below shows the fiscal year adopted budgets of General Fund operating departments by funding source. As can be seen from the chart, the Police Department receives the largest share of the overall subsidy, and recovers only 2% of its costs from fees. In contrast, Community Development, which includes planning, building & safety and housing, recovers



over 50% of its costs from fees. Historically, growth in tax revenues outpaced growth in costs and fees were not closely evaluated. However, with costs sharply increasing over the last several years, and with the impacts of the economic downturn on key revenues, fees have become a more important funding source.

In fiscal year 2004, the City completed a fee study that determined the full cost of each program and activity and the level of recovery from fees and charges. General Fund departments used the information from

this study in developing fiscal year 2005 fees and service charges. In general, the fees have been adjusted to ensure they keep pace with costs and to move closer to an appropriate level of cost recovery from fees based on community needs, public policy and program priorities.

Multi-Year Plan Includes Additional Use of General Fund Reserves

In 1996, the City Council established minimum reserve levels for all operating funds, including the General Fund. Pursuant to the adopted resolution, the General Fund currently maintains three separate reserves:

- Emergency Reserve – Set at 15% of the adopted operating budget, established to respond to natural disasters, such as floods, earthquakes, etc.
- Economic Contingency Reserve – Set at 10% of the adopted operating budget, established to provide for unique one-time costs and maintenance of City services, and to permit orderly adjustments during periods of reductions.
- Capital Reserve – Set at \$1 million, established to fund unexpected and unforeseen capital expenditures.



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In addition to the required reserves defined above, the General Fund has historically accumulated reserves above policy requirements as a result of favorable budget variances. These reserves have enabled the City to fund the annual General Fund capital program and other one-time costs.

The table below shows a summarized version of the City's General Fund multi-year forecast. It includes the actual results of fiscal year 2003, projected results for the fiscal year 2004, and the adopted fiscal year 2005 estimates. Fiscal years 2006 through 2008 are based on revenue and expenditure growth assumptions.

City of Santa Barbara Multi-Year Forecast General Fund						
	FY 2003 Actual	FY 2004 Projected	FY 2005 Adopted	FY 2006 Estimated	FY 2007 Estimated	FY 2008 Estimated
Total Revenues	\$ 84,065,940	\$ 80,048,022	\$ 82,758,682	\$ 86,069,029	\$ 92,463,553	\$ 94,394,096
Total Expenditures	82,869,262	81,615,040	87,179,436	90,728,759	93,464,788	96,288,858
Revenues Over (Under) Expend	1,196,678	(1,567,018)	(4,420,754)	(4,659,730)	(1,001,235)	(1,894,762)
Anticipated Year-End Variance	-	1,000,000	2,179,486	2,268,219	2,336,620	2,407,221
Operating Surplus (Deficit)	1,196,678	(567,018)	(2,241,268)	(2,391,511)	1,335,385	512,459
Cumulative Future Budget Adj.	-	-	-	500,000	500,000	500,000
Expected Oper. Surplus (Deficit)	1,196,678	(567,018)	(2,241,268)	(1,891,511)	1,835,385	1,012,459
Capital Program	(2,233,730)	(1,015,150)	(427,400)	(750,000)	(750,000)	(750,000)
Net Addition to (Use of)						
Reserves	(1,037,052)	(1,582,168)	(2,668,668)	(2,641,511)	1,085,385	262,459
Beginning Reserves Balance	30,441,123	29,404,071	27,821,903	25,153,235	22,511,724	23,597,109
Ending Reserves Balance	<u>\$ 29,404,071</u>	<u>\$ 27,821,903</u>	<u>\$ 25,153,235</u>	<u>\$ 22,511,724</u>	<u>\$ 23,597,109</u>	<u>\$ 23,859,568</u>
Required Reserves	\$ 21,218,950	\$ 22,794,859	\$ 23,682,190	\$ 24,303,697	\$ 25,009,715	\$ 25,731,880
Reserves Over (Under) Policy	8,185,121	5,027,044	1,471,045	(1,791,973)	(1,412,606)	(1,872,312)
Total Reserves	<u>\$ 29,404,071</u>	<u>\$ 27,821,903</u>	<u>\$ 25,153,235</u>	<u>\$ 22,511,724</u>	<u>\$ 23,597,109</u>	<u>\$ 23,859,568</u>

In November 2003, when budget decisions were being made for fiscal year 2005, the City's multi-year forecast showed a General Fund structural deficit of approximately \$3.5 million, with the deficit growing to \$4 million in fiscal year 2006. Without corrective action, the structural deficit would fully consume reserves above policy as well as the economic contingency reserve by fiscal year 2008.

In order to address the structural deficit, the fiscal year 2005 adopted budget includes \$2 million in adjustments (primarily expenditure reductions) and includes the use of \$1.6 million of reserves. Through fiscal year 2008, an additional \$500,000 in adjustments is planned. In



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In addition, the capital program has been scaled down beginning in fiscal year 2005. Using this approach, the General Fund would be balanced by fiscal year 2007, which means that revenues will be sufficient to cover operating and capital expenses.

Although not evident in the table on the preceding page, General Fund departments already implemented a total of approximately \$4 million in budget adjustments in fiscal years 2003 and 2004. Therefore, between fiscal year 2003 and 2008, a total of \$6.5 million in budget adjustments will have been made, and a total of \$6.8 million in reserves will have been consumed for both operations and capital. This is consistent with our plan to balance the impacts to programs and services with the prudent use of reserves as the City transitions out of the difficult fiscal period.

The multi-year forecast contains three key assumptions:

- (1) No salary increases will be provided to employees in fiscal year 2005. The forecast does assume modest salary increases during the remainder of the planning period.
- (2) The fiscal year 2005 adopted budget column in the forecast has been adjusted for the State budget deal between the Governor and State legislators announced in late July. The impact to the City is the loss of \$1.3 million in both fiscal year 2005 and 2006.
- (3) The local economy will continue to recover and local tax revenues will grow at moderate rates.

Funding Improvements to Water and Wastewater Facilities

Many of the City's water and wastewater facilities are in need of major rehabilitation due to aging and new State and Federal requirements. Beginning in fiscal year 2004 and over the next 5-10 years, major capital improvements are planned to improve our facilities as well as to comply with the stricter water quality standards.

In the Water Fund, major improvements to the William B. Cater Water Treatment Plant (see aerial photo) began this year and will continue over the next several years, at a total cost of approximately \$20 million. The plant, which was built in 1964, supplies water to the City of Santa Barbara, Montecito Water District and Carpinteria Valley Water District. The improvements involve the replacement of aging equipment, changes needed to meet upcoming drinking water standards mandated by the Federal Safe Drinking Water Act,





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and increasing the reliability, efficiency and security of the entire water treatment operation. The improvements are being funded from a State Department of Water Resources loan, repayable over 20 years.

In the Wastewater Fund, a strategic plan for the rehabilitation of the El Estero Wastewater Treatment Plant was completed in January 2003. Nine projects costing \$18.5 million were identified as having the highest priority, and are scheduled to begin in fiscal year 2005. These projects will be funded from the planned issuance of long-term debt in June 2004, which will be repaid over 25 years. The issuance of long-term debt will enable the Wastewater Fund to maintain required reserve balances and spread the cost of the improvements over the estimated useful life of the projects.

As a result of these major investments in upgrading the City's water and wastewater systems, Council adopted increases to both water and wastewater rates to ensure the viability of the operations, as recommended by the City's Water Commission.

Santa Barbara Airline Terminal Expansion Project Taking Flight

The Airport is moving forward with the expansion of the airline terminal. The growth in passenger volumes over the last ten years and the additional security need have resulted in severe overcrowding and lack of space for airline and airport operations.



The Airline Terminal Expansion Project will be funded from a combination of federal grants, bond financing and airport revenues. A financial feasibility study determined that these funding sources would enable the Airport to finance a \$55 million project, which includes the terminal expansion, roadway improvements, increased parking facilities, and an aircraft-parking ramp.

The next phase of work will be development of the Program Criteria Document. This is the detailed road map the design team will follow in designing the project. This document will set forth the project budget, the building size, all technical information on square footage, space for the various uses in the terminal, and parking gate layout.



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MAJOR PRIORITIES AND WORK EFFORTS

Major Planning Efforts Underway

Next year staff will begin work to update the City's General Plan, which contains many important goals and policies for growth management and land use planning in our community. Measure E, which in 1989 amended the City's Charter that provides the basis for the City's Growth Management Strategies, has a 2010 expiration date. This effort will require considerable time and resources over the next six years. When complete we will have the framework for land use decisions through 2030. The City is committed to the foundation policy of "living within our resources" and will seek active participation from the community in what we expect to be a meaningful process.



City Turns Its Attention to Improving Local Neighborhoods

In response to a growing awareness that the delivery of City services needed to be restructured to improve the quality of life in our inner-city neighborhoods, the City recently implemented a Neighborhood Improvement Program, as discussed earlier. This program is a high priority for the City. The goals of the Program include increasing the effectiveness and efficiency of services provided by City departments, creating more positive impacts in higher-density neighborhoods, engaging neighborhood residents and community groups to improve the quality of life in their neighborhoods, and increasing building and zoning enforcement efforts.

Preserving the Environment a Top Priority

Three years ago, Santa Barbara voters approved Measure B, which increased the transient occupancy tax rate from 10% to 12%, to fund water quality improvements and creeks restoration programs. This was a significant milestone as it provided a dedicated and ongoing funding source to address water quality issues in the community.



In January 2004, the City celebrated the completion of the Old Mission Creek Restoration Project at Bohnett Park, funded in part by Measure B funds. The goal of the project was to restore native habitat and improve water quality, while providing a safe and healthy place for residents to enjoy their

local creek. The project leveraged Measure B funds, with more than half of the \$788,000 cost



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funded through State grants. Next year, the restoration of the Arroyo Burro Estuary is planned. The project, estimated at \$1.2 million, is expected to be funded from State grants.

Measure B funds are also helping to pay for expanded residential street sweeping efforts to both the east and west sides. Next year, staff proposes to look at the feasibility of continued expansion of street sweeping to other City neighborhoods. The street sweeping program not only improves the cleanliness of neighborhood streets, but it also helps reduce the amount of debris and contaminants that find their way into creeks and ultimately local beaches.

Another effort helping to preserve the environment is the Solid Waste Recycling Program. Implemented in September 2002, the program's main objective is to have the City of Santa Barbara become the recycling leader in the State of California. Council's goal includes reaching diversion rates of 60% by the year 2005 and 70% by the year 2010.

City Looks to Further Increase Affordable Housing Stock

The City and Redevelopment Agency, in partnership with the Santa Barbara Housing Authority and other non-profit housing developers, have achieved many successes in increasing the number of affordable units in the City. Currently, 12% of the City's housing stock has an affordability component. Examples of projects recently completed and underway include the following:



- The City's Housing Authority recently completed construction of Casa De Las Fuentes (see photo), an award-winning housing complex on 355 West Carrillo Street, which includes 42 studio and one-bedroom apartments for downtown workers (see photo above). The Redevelopment Agency provided \$1.9 million in grant and loan funds for acquisition and construction plus \$600,000 in HELP funds for short-term financing.
- The City and the Redevelopment Agency are proceeding with the most significant affordable housing development to be built on the South Coast. Mercy Housing California and St. Vincent's Institution are developing 75 low-income family apartments and 95 low-income senior apartments on the 19-acre St. Vincent's School campus at Highway 154 and Calle Real. The development will be financially supported by the City and County of Santa Barbara as a regional response to affordable housing needs. Project construction will begin in the latter months of 2004.
- The City Council and Redevelopment Agency Board took two significant actions in fiscal year 2004 to move forward the review of a proposed project at 617 Garden Street for a Mental Health Association (MHA) administrative and program center with 50 units of



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affordable housing. Twenty-five of the units would be for very-low-income MHA clients, and 25 for low-income, downtown workers.

- With City and Housing Authority assistance, Habitat for Humanity is developing three "sweat-equity," low-income, first time homeowner units at 3965 Via Lucero. The buyers will join community volunteers using donated materials to build the units, which will be preserved as affordable units for subsequent buyers.

In addition to the projects noted above, Council recently approved a draft Inclusionary Housing Program, that will require all new residential ownership projects of 10 or more units to set aside 15% of the units for affordable- to middle-income households.

In February 2004, the City Council approved the new Housing Element of the General Plan. The Housing Element is an important component of the General Plan as it establishes strategies for new housing programs and planning efforts for the next five years. The Housing Element contains more than 100 implementation strategies to meet the goals included in the plan.



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