



## **STAFF REPORT TO THE FINANCE COMMISSION**

**DATE:** Regular Meeting of November 20, 2024

**TO:** Members of the Finance Commission

**SUBMITTED BY:** Edwin Gato, Director of Finance

**SUBJECT:** Review of Fiscal Year (FY) 23-24 Preliminary Unaudited Year-End Result

### **RECOMMENDED ACTION:**

Receive the report on FY 23-24 Preliminary Unaudited Year-End Result

### **EXECUTIVE SUMMARY:**

This financial report provides an overview of the unaudited financial position of the General Fund and summarizes the non-general funds as of June 30, 2024. The General Fund is the primary focus of this report, as it serves as the city's main operating fund. It details the activities of the City's General Fund to offer insights into the overall fiscal condition of the city, along with a summary of the non-general funds.

### **DISCUSSION:**

We are pleased to present the unaudited General Fund and a summary of the year-end results for other funds for FY 2023-24. This report, prepared ahead of the final audit, reflects our current financial position and may be updated as the audit process continues. We expect that the final audit results will be completed by the end of December.

It is important to note that the accounting basis used for financial reporting in accordance with Generally Accepted Accounting Principles (GAAP) may differ from the basis used to prepare the budget document. For example, governmental funds are required to use the modified accrual basis of accounting for GAAP financial statements. However, these funds may adopt either the cash basis of accounting or the "cash plus encumbrances" basis for budgeting purposes. The City uses the cash plus encumbrances basis for its budget.

Discrepancies can arise between GAAP and the budgetary accounting basis due to differences in budgeting regulations, such as laws or ordinances at the state, county, city, or other jurisdictional levels. Consequently, the City bases its fiscal year budgets on cash plus encumbrances. This means certain items budgeted as expenditures, such as transfers to reserves, are recorded in the audit as balance sheet adjustments or designations of fund balance.

On June 11, 2024, the City Council developed and adopted the FY 2024-25 Budget. The estimated beginning fund balance was based on the information available at that time, specifically derived from the estimated ending fund balance for FY 2023-24. Most revenue activities are recognized after June 30 and are accrued into the previous fiscal year. While significant effort was made to create these projections, we adopted a conservative approach due to the uncertain economic climate and the possibility of a recession. Additionally, we closely managed our expenditures to minimize costs, applying even greater scrutiny as we concluded the fiscal year. As a result, we finished FY 2023-24 with a balanced budget.

**General Fund**

In FY 23-24, the General Fund revenues were significantly higher than initially estimated, while expenditures were slightly below budget. Below is a summary of the annual net results for the General Fund:

	<u>Budget</u>	<u>Actual</u>	<u>Variance</u>
<b>Beginning Available Balance</b>	<b>\$ 848,907</b>	<b>\$ 848,907</b>	<b>\$ -</b>
Revenues	19,057,965	19,547,981	490,016
Expenditures*	19,679,660	19,879,859	(200,199)
Net Annual Results	(621,695)	(331,878)	289,817
<b>Ending Available Balance</b>	<b>\$227,212</b>	<b>\$517,029</b>	<b>\$289,817</b>

\* Net, prior year outstanding encumbrances.

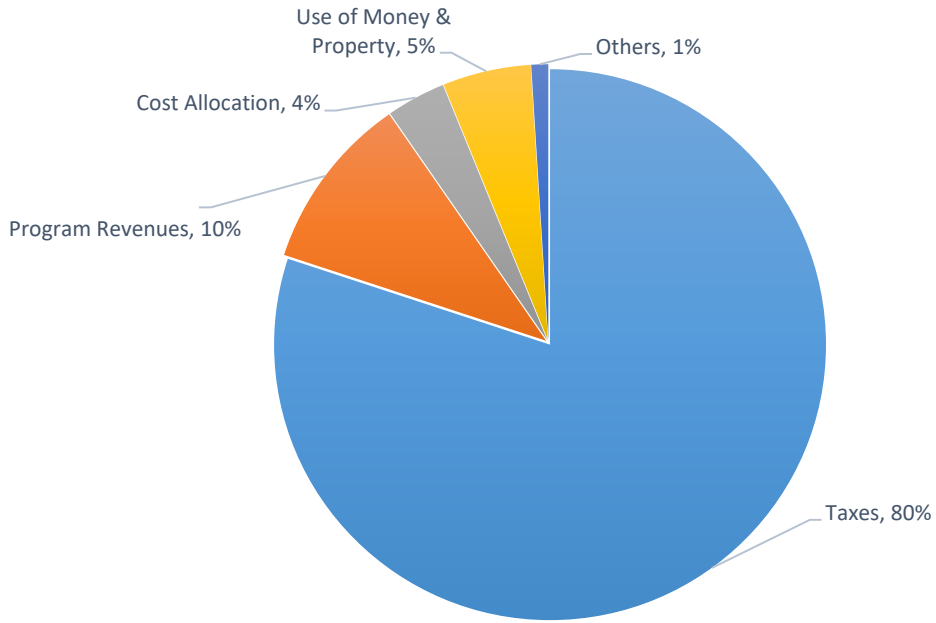
**General Fund Revenue Analysis**

The general tax revenues collected to support government functions are placed into the General Fund. Local governments need voter approval for any general taxes imposed.

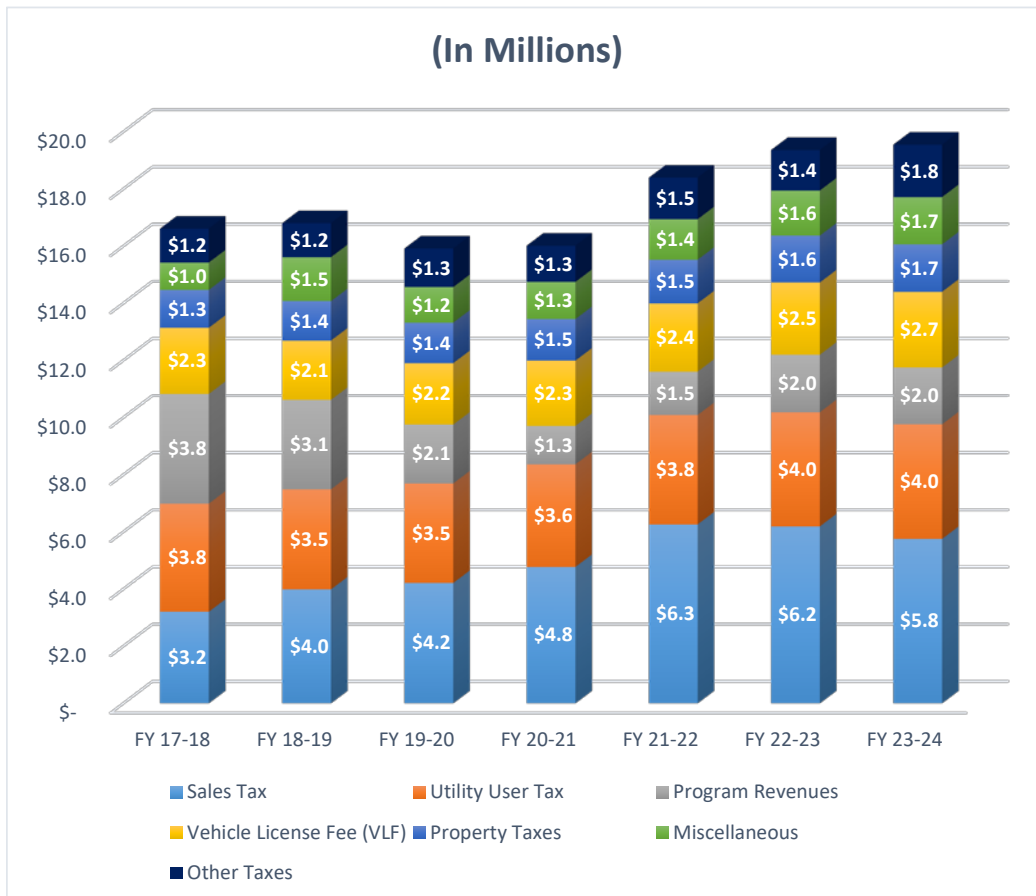
Approximately 80% of General Fund revenues are derived from general taxes in the following categories:

- Utility Users Tax (UUT)
- Sales Tax
- Property Taxes
- Vehicle License Fees (VLF)
- Business License Fees
- Document Transfer Tax
- Franchise Fees
- Transient Occupancy Tax

## General Fund Revenues by Category



The chart below shows the comparison of General Fund ongoing revenues compared to prior years:



The chart above clearly illustrates that our general fund revenues have seen a flattening of revenues in comparison to the previous year and a modest increase of 3.4% compared to the budget. This growth is driven by several key factors, including enhanced Utility User Tax (UUT) revenues, increased investment income, and the continued successful reopening of Parks and Recreation programs. It's important to highlight that the City is taking a prudent approach to budgeting in light of economic uncertainties that could prompt a recession. This strategic caution helps ensure our financial stability and prepares us for any challenges ahead.

### Sales Tax

Sales taxes are the backbone of the City's General Fund, providing essential revenue that is collected monthly from the State. However, we've recently encountered a shortfall in our tax revenue, which is down by 6.9% and projected to flatten in the near future. This decline can be traced back to a decrease in consumer spending and a return on pre-pandemic purchasing habits that had temporarily shifted.

It's crucial to understand that the City's sales tax revenue heavily depends on the small number of key businesses, particularly those involved in business-to-business transactions. Remarkably, the top three contributors alone account for over 50% of our total sales tax revenue. This concentration raises concerns, as any fluctuations in these revenue sources could critically affect funding for essential programs and services that our community depends on. Below is a detailed summary of the City's sales tax revenues, categorized by business type:



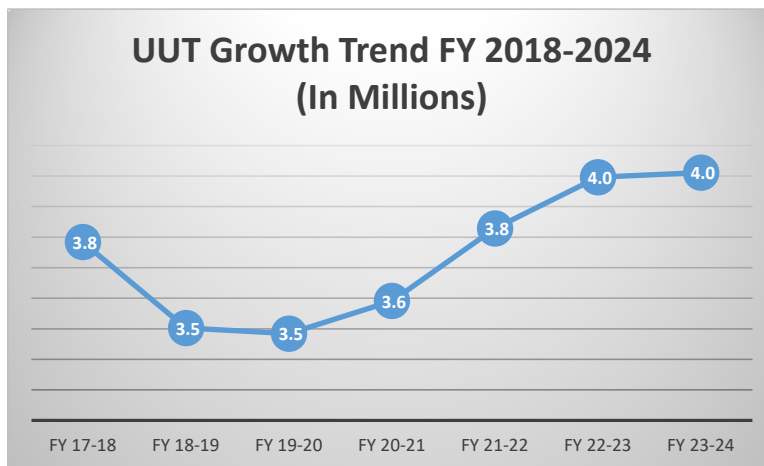
The City's sales tax base has demonstrated remarkable resilience, outpacing many other communities thanks to its strategic emphasis on business-to-business transactions and the booming home improvement sector. In 2022, Hercules achieved impressive growth in total

sales tax revenues, as shown in the chart above. While this momentum is promising, it's vital to acknowledge that growth has started to slow in 2023 and is expected to continue into 2024, primarily due to inflation-related challenges. To sustain our positive trajectory and empower local businesses, it is essential that we confront these issues directly. By working together with the Community, we can ensure a vibrant economic future for Hercules.

### *Utility Users Tax (UUT)*

The City enforces a Utility User's Tax (UUT) on the consumption of essential utility services, including electricity, gas, water, sewer, telephone, and cable television. The City has the authority to determine the tax rate and the purpose for which the revenue generated will be utilized. The tax rate is currently at 8%, calculated as a percentage of gross receipts; this tax adjusts based on consumer consumption. As of June 30, 2024, the City has collected \$4 million of revenues from UUT. Moreover, with the approval of Measure N on November 8, 2022, the UUT will continue at its current rate, ensuring vital services remain funded until it is either terminated by voter decision or repealed by the City Council. This stability supports our community's ongoing needs.

The following is the history of total revenues from UUT collected by each fiscal year:



### *Property Tax*

The City's portion of the base 1% property tax rate accounts for just over 5% of the total property taxes, which is lower than most other jurisdictions. As of June 30, 2024, the property tax and related revenues collected—both secured and unsecured—exceeded the budgeted amounts for the current year. Future growth in assessed values, which is capped by State Proposition 13 at an annual increase of 2%, will only come from property turnover or new developments being added to the tax roll.

The following chart illustrates the weighted average distribution of Hercules' property tax by agency:

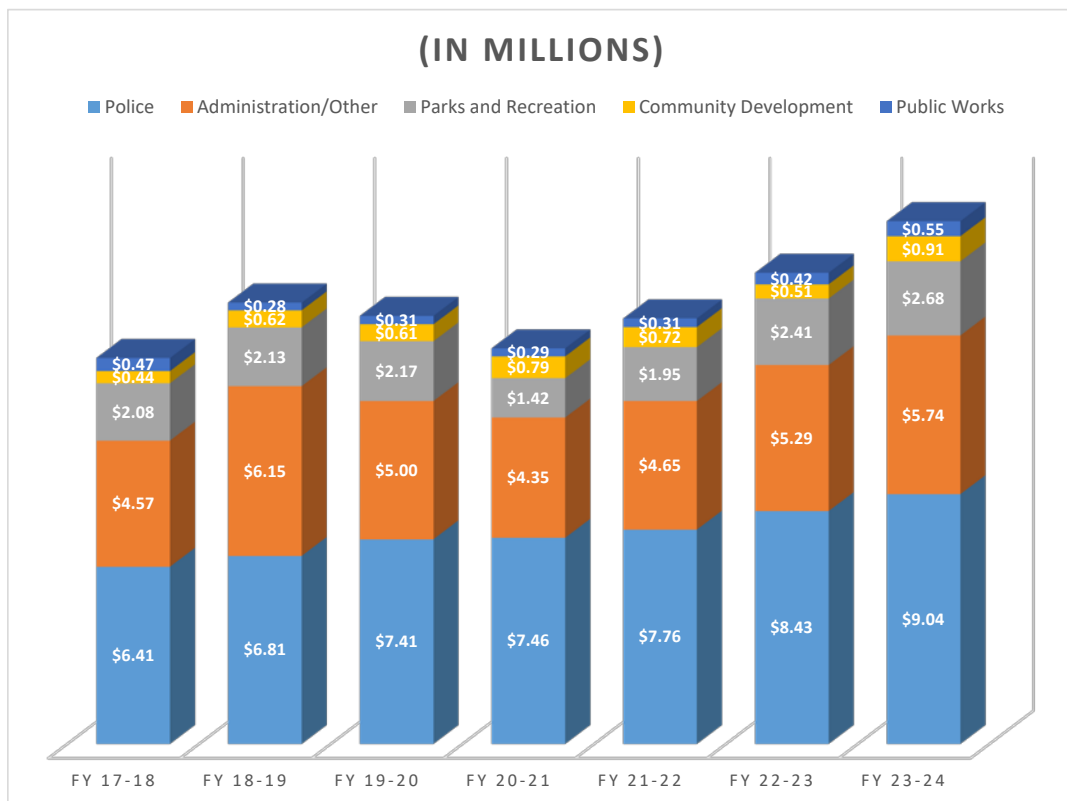
West Contra Costa Unified	30.9%
K-12 Schools ERAF	16.1%
County General	15.9%
Rodeo Hercules Fire	9.2%
Hercules General Fund	5.4%
Contra Costa Community College	5.3%
East Bay Regional Park	3.5%
John Swett Unified	3.1%
Community College ERAF	2.4%
West Contra Costa Health Care	1.8%
Others	6.4%
<b>Total:</b>	<b>100.0%</b>

### *Parks and Recreation Program Revenues*

The Parks & Recreation program, which was closed during the pandemic, has made a robust resurgence over the past couple of years and is steadily returning to full operation. Impressively, actual program revenues soared to \$348,000, exceeding projections by 27%. This remarkable achievement clearly demonstrates the program's successful reopening and its positive impact on the community.

### General Fund - Expenditure Analysis

The chart below compares ongoing General Fund expenditures to previous years:



This section offers a detailed overview of expenditures from the General Fund, encompassing encumbrances—these are essential obligations like purchase orders or contracts already included in the budget, with some funds reserved for their fulfillment. The fiscal year 2023-2024 budget stands at an impressive \$20.1 million, of which \$19 million is designated for ongoing expenses and \$1 million is earmarked for one-time costs. Due to efficient financial management by departments, our operating expenses have remained below budget, showcasing our commitment to responsible spending. For a concise summary of the year-to-date status of General Fund expenditures, please refer to Attachment 1.

Although Parks & Recreation expenditure has exceeded the budget by approximately \$180,000, it's important to note that this was effectively counterbalanced by increased program fee revenues from our fully reopened programs, demonstrating our ability to adapt and thrive.

### General Fund – Net Annual Results and Available Fund Balance

The General Fund successfully ended the year with a positive net outcome and a balanced budget, reflecting responsible financial management. In light of this achievement, the City Council has proactively amended the financial policy regarding the allocation of the General Fund surplus, which will be implemented once the final audit is complete. This surplus will be designated for key priorities that benefit our community, ensuring that these funds are put to the best possible use:

- 25% to the Pension (Section 115 Trust)
- 25% to the operating reserve until it reaches 25% of total operating expenses
- 50% to address unmet and deferred infrastructure and maintenance needs.

### General Fund Operating Reserve

The General Fund Operating Reserve is a crucial safety net for the general fund, akin to a savings account that safeguards our financial health. Over the years, this reserve has steadily increased due to revenues consistently outpacing expenditures, largely due to one-time savings and unexpected revenue boosts. As of June 30, 2024, our General Fund Operating Reserve has reached an impressive \$4.8 million, representing 25% of total expenditures—demonstrating our commitment to fiscal responsibility and compliance with the reserve policy. This robust position empowers us to face future challenges with confidence.

### Non-General Funds

#### SEWER ENTERPRISE FUND

The Enterprise Fund group oversees the City's Sewer Fund, which necessitates thorough reporting on essential proprietary fund balances, such as cash, reserves, fixed assets, and long-term debt. Ensuring we have adequate resources to successfully complete ongoing projects and programs while meeting our debt service obligations on time is critical. As of



June 30, 2024, the Sewer Fund concluded the fiscal year with a robust available cash balance of \$17.4 million. This considerable sum is strategically directed towards important capital projects, particularly the lower trunk main at Sycamore Avenue.

Recognizing the urgency for a forward-thinking financial strategy, the City acquired Willdan's services to conduct a comprehensive financial health study of the sewer system. This study reveals a pressing need for significant rate increases, primarily due to the lack of adjustments since 2014 and the impact of inflation over the years. To safeguard our financial stability, it is paramount to maintain a debt service coverage ratio of at least 1.20, as required by our bond covenant. Furthermore, we must tackle the rising costs of equipment, materials, personnel, and reserve fund necessities to preserve and enhance our sewer infrastructure for the long term. Staff will return to the City Council to present the findings of the sewer financial health study and discuss a potential rate increase that will ensure our community's future sustainability.

### SPECIAL REVENUE FUNDS

The Special Revenue Funds play a crucial role in supporting essential projects, driven by grants and specific funding sources designated for targeted purposes, such as transportation improvements and building permit activities, along with other vital programs. These funds are governed by restrictions, requiring a distinct approach to tracking revenues and expenditure, separate from the City's primary operating fund, the General Fund.

As of June 30, 2024, we are pleased to report that there are sufficient funds available to complete our ongoing projects and programs. However, we still need to address challenges related to Victoria by the Bay Lighting and Landscaping Assessment District (LLAD) and the Stormwater Fund, both of which currently have negative fund balances.

Our team has proactively developed a strategic plan aimed at either enhancing tax revenues or cutting costs to resolve these deficits. Unfortunately, the proposed assessment increase for Victoria by the Bay LLAD was rejected by property owners. The staff is currently collaborating with the Council to create a plan to eliminate this deficit and will present our recommendations to the Council in January.

Furthermore, the potential for launching new programs or projects is contingent upon securing future funding sources. Importantly, the Special Revenue Funds hold a collective balance of \$6.8 million as of June 30, 2024, enabling us to continue making significant progress in our community.

### CAPITAL PROJECT FUNDS

The Capital Project funds play a vital role in supporting community growth, drawing revenue from fees tied to new development, the Gas Tax, and Regional Measure J. Unlike the City's other operating funds, these revenues and expenditures are structured differently. Because these funds are allocated over multiple years, it's essential to acknowledge that projects may occasionally experience cost overruns. These overruns often stem from initial cost underestimations and unexpected changes that emerge during project execution.



To counteract this risk, the Finance Department actively collaborates with various departments, implementing robust processes designed to eliminate overspending. This proactive approach includes routinely updating project balances and ensuring that sufficient contingencies are established prior to starting any project. As of June 30, 2024, the Capital Improvement Projects Funds incurred an aggregate expense of \$16.3 million, as demonstrated in Attachment 3. Importantly, there is ample funding available to successfully complete these critical projects for our community.

#### DEBT SERVICE FUNDS

The Debt Service Funds group accounts for the long-term debt of the City. As of June 30, 2024, the unaudited fund balances across all debt service funds amounted to \$2.2 million. We ensure that sufficient funds are transferred from various sources to meet debt service obligations as they come due. The specific funding source depends on the purpose of the debt.

#### INTERNAL SERVICE FUNDS

The Internal Service Funds (ISF) group plays a crucial role in ensuring our organization's sustainability by accumulating reserves specifically for vehicle replacement, technology and equipment upgrades, and essential facility maintenance. These funds generate revenue through administrative cost recovery charges to other funds, mainly the General Fund. As of June 30, 2024, our prudent financial management has resulted in a robust fund balance of \$1.3 million, positioning us well for future strategic investments and operational efficiency.

#### FIDUCIARY FUNDS

The Fiduciary Funds group encompasses the assessment district bond, which is not a liability for the City, as well as a trust fund specifically created for Other Post-Employment Benefits (OPEB). This structure ensures responsible financial management and commitment to fulfilling future obligations to employees.

#### SUCCESSOR AGENCY

The Successor Agency operates as a distinct entity separate from the City and is recorded in separate trust funds. These funds manage the tax increment revenues received and cover payments for items approved by the Oversight Board in the Required Obligation Payment Schedule (ROPS). The primary responsibility of the Successor Agency is to wind down the affairs of the former Redevelopment Agency and to settle any debts incurred by that agency.

#### **FISCAL IMPACT OF RECOMMENDATION:**

The review of the FY 23-24 Unaudited Year-End Result serves as a vital informational report, highlighting key insights and there is no immediate fiscal impact.

#### **ATTACHMENTS:**

1. Unaudited General Fund Year End Results Summary as of June 30, 2024
2. Unaudited All Funds Year End Results Summary as of June 30, 2024
3. Unaudited Capital Projects to date Summary as of June 30, 2024

