



CITY OF KIRKLAND
Department of Finance & Administration
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MEMORANDUM

To: David Ramsay, City Manager

From: Tracey Dunlap, Director of Finance and Administration

Date: October 25, 2006

Subject: Preliminary Annexation Long-Term Fiscal Impact Modeling

RECOMMENDATION:

Council review the long-term fiscal impact modeling description, assumptions, and policy discussion in preparation for an introductory presentation on November 8, which will be followed by a study session on December 12 to discuss draft scenario results.

BACKGROUND DISCUSSION:

In September, the City engaged Berk & Associates to create an analytical model to project the long-term fiscal impacts of annexation under a variety of different development, cost, and revenue scenarios and to assist the City in identifying strategies to address the projected financial shortfall from annexation. The information developed for the 2005 annexation forms the basic starting point for this effort, but the model also merges the City of Kirkland financial forecast projections with the Potential Annexation Area (PAA) to provide a full picture of the impacts. The model also addresses the potential benefit provided by the sales tax credit made available by the Washington State legislature to aid in annexation transition for up to a ten year period.

The analysis has been constructed and calibrated using the 2006-2012 forecast, the 2005 annexation service packages, and related land use data. The process for identifying and evaluating alternatives is described in the attached packet prepared by the consultant. This information is to provide background and context in advance of the presentation on November 8.

One of the key results of this effort to date is to bring into clear focus that, before addressing strategies for closing the annexation financial gap, that the policy discussion needs to focus on how to close the City of Kirkland's current financial gap. Once a strategy is defined in that context, the impacts of annexation can be tested and refinements to the strategy can be made. Initial modeling confirms that "closing the gap" is not likely to be accomplished by any single change in development strategy, cost structure, or revenue base but rather through a combination of changes to all three elements.

Berk & Associates expects to complete their report on this effort in the coming weeks and a draft will be provided to the City Council in advance of the December 12 study session.

Cc: Marilynne Beard, Assistant City Manager

CITY OF KIRKLAND

LONG-TERM FISCAL IMPACTS OF ANNEXATIONS

Discussion of Model Capabilities and

Approach to Annexation Analysis

October 26, 2006

DISCUSSION DRAFT

PURPOSE AND OBJECTIVES OF MODEL

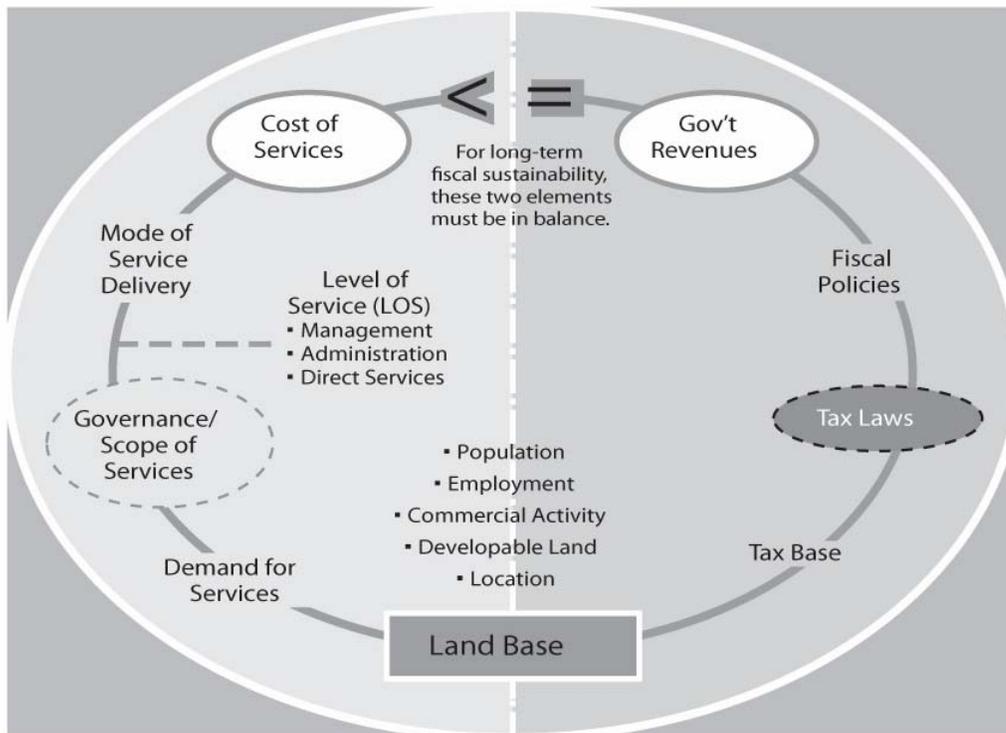
- The model is designed to estimate revenues and expenses for the current City of Kirkland as well as post-annexation versions of the city.
- While the model is not Fund-based it does isolate the components of the City's budget that are funded through general tax and fee revenues, including functions and departments within the General Fund, Street Operating Fund, Parks Maintenance Fund, Facilities Maintenance Fund, Equipment Rental Fund, and Information Technology Fund. The model does not include the utility enterprise funds, since they are not tax-supported.
- Capital cost implications are included only for the equipment, fleet and facility costs associated with increasing staff levels associated with growth or annexation. Capital implications related to new public infrastructure are excluded from the model.
- Another objective of the model is to factor in the new sales tax credit funding enacted by the State Legislature.
 - This funding is designed to assist eligible cities that annex by 2010 by providing support for up to 10 years. Therefore, the model runs through 2025, five years past the last possible year of sales tax credit funding support.
- The model has built-in flexibility that will allow city staff to support policy discussions related to fiscal issues pre- and post-annexation.
- This flexibility is derived from the model's ability to show the impacts of a variety of scenarios. City staff can vary the following:
 - Development scenarios;
 - Tax policies;
 - Cost of services including level-of-service; and
 - Annexation transition assumptions, such as the possibility of phasing in the impact over several years.

DISCUSSION DRAFT

CONCEPTUAL MODEL FRAMEWORK

- The model was developed using a conceptual Fiscal Balance Framework, which operates as follows:
 - Factors in the land base, such as population, employment, and commercial activity, drive both demand for services and the tax base.
 - Depending on a jurisdiction's scope of services and choices regarding level of service, demand for services leads to costs.
 - Depending on a jurisdiction's choices regarding fiscal and taxing policy (limited by tax laws), its tax base will lead to tax and fee revenues.

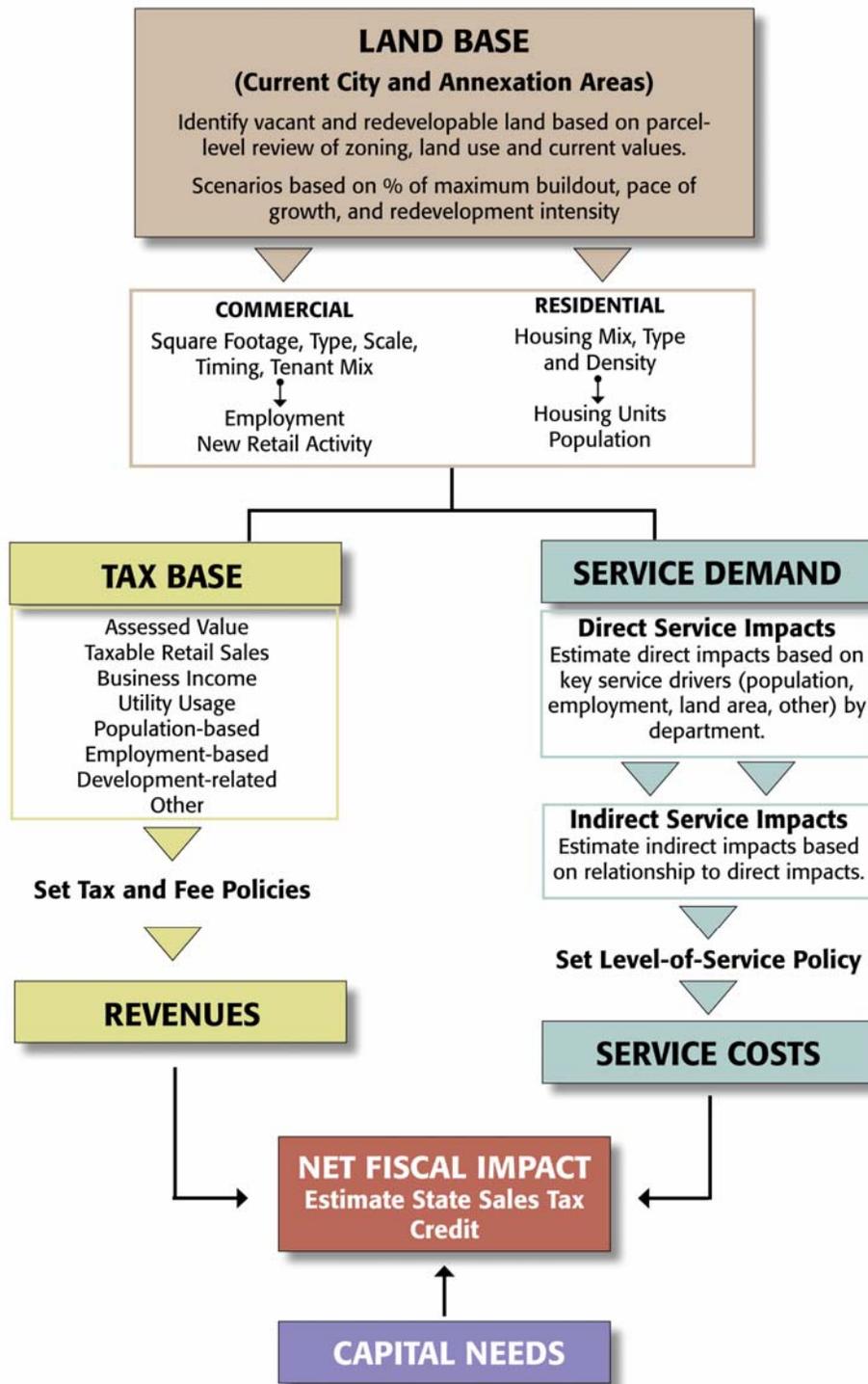
Fiscal Balance Framework



- A particular challenge for this project is the need to project land base changes over a 20-year window.

MODEL SCHEMATIC

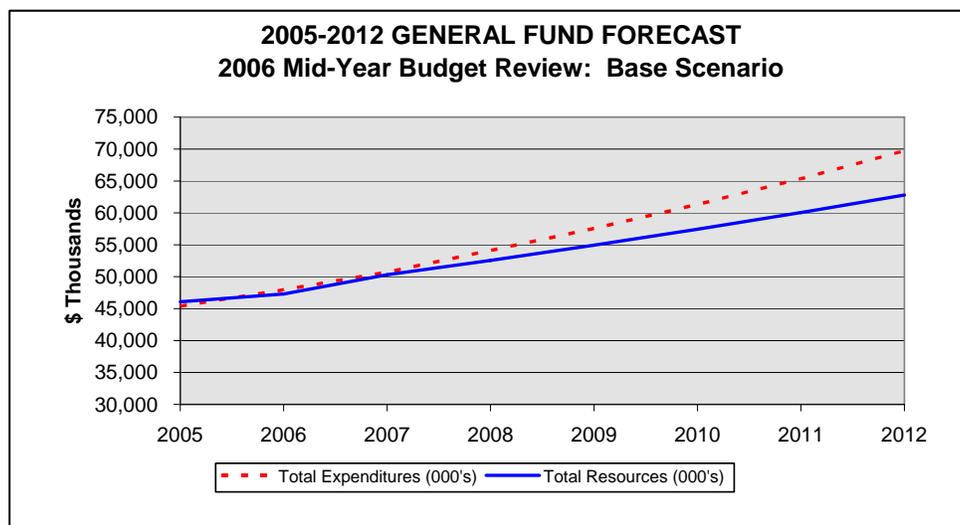
Long-Term Fiscal Model Schematic



APPROACH TO THE EVALUATION OF LONG-TERM FISCAL IMPACTS FROM ANNEXATION

- The current fiscal outlook for the City assuming continuation of current tax policy and current levels-of-service, results in ongoing budget shortfalls in the General Fund and the other general tax supported operating programs.
- The previous annexation analyses suggested that annexation of the three PAA's would result in a net loss to the City as the cost of providing services would be greater than the additional revenues from the area. These previous analyses took the approach of analyzing the hypothetical "if the area were part of the City today" what would be the impact on City finances.
- This hypothetical approach only works if the baseline outlook is balanced. If the outlook is not balanced (i.e. there are expected future deficits) then the economics of annexation will depend on how the baseline situation is addressed.

Baseline Kirkland Fiscal Outlook¹



- As a result, the annexation impacts need to be evaluated in a two step process:
 - First, develop a "balanced budget scenario" by making policy assumptions that would close the City's fiscal gap in the future.
 - Second, keeping the policy assumptions constant, layer in the annexation areas to determine whether annexation makes the base situation better or worse.

¹ Note that this graphic reflects the 2005-2012 forecast. The forecast is currently being updated to reflect 2007-2014, although the projected trend is expected to continue.

MODEL FLEXIBILITY TO SUPPORT POLICY ANALYSIS OF ANNEXATION

Three Elements Will Dictate Kirkland's Long-Term Fiscal Balance

- Balancing future budgets for the City (regardless of annexation) will depend on one or more of the following:
 - **Development.** While the City does not directly control the pace, scale or type of development activity, this will have an impact on future costs and revenues. Varying development scenarios for single family, multifamily, and commercial/industrial properties allows for the risk assessments and testing the effects of other city policies designed to affect fiscal balance.
 - **Cost factors and level of service changes.** As development and/or annexation occur, there will be increases in demands for services. The City will be making choices about the level-of-service provided.
 - **Tax policy changes.** The other major policy variable for the City to consider in balancing its budget is the tax policy, including taxes on property, businesses, and utilities.
- It is important to note that these are the factors that are in play every time the Council considers its next City budget. The question is the same – “how do we balance the budget?” – and the choices are the same – “can we afford to maintain current levels-of-service?” and “do we need to consider changes in tax policy to fund essential city services?”.
- Since this is a long-term financial planning effort, the Council will need to grapple with these issues in a somewhat more conceptual way. The immediate task is not about making decisions about how to balance future budgets, but rather to identify a range of possible policy choices that could result in a balanced city budget in order to evaluate the impact of annexation. The Council will need to determine whether the options available to them are acceptable to apply in future budgets in order to then assess whether to move forward with annexation.
- Ultimately, it is likely that a series of scenarios will be necessary to explore the range of options available to balance the baseline conditions pre-annexation and these scenarios will likely be combinations of some or all of the factors listed above. Once the Council has determined that they have a range of acceptable options to balance the city's base budget, they can evaluate whether further measures needed to balance the budget after annexation are acceptable.

DISCUSSION DRAFT

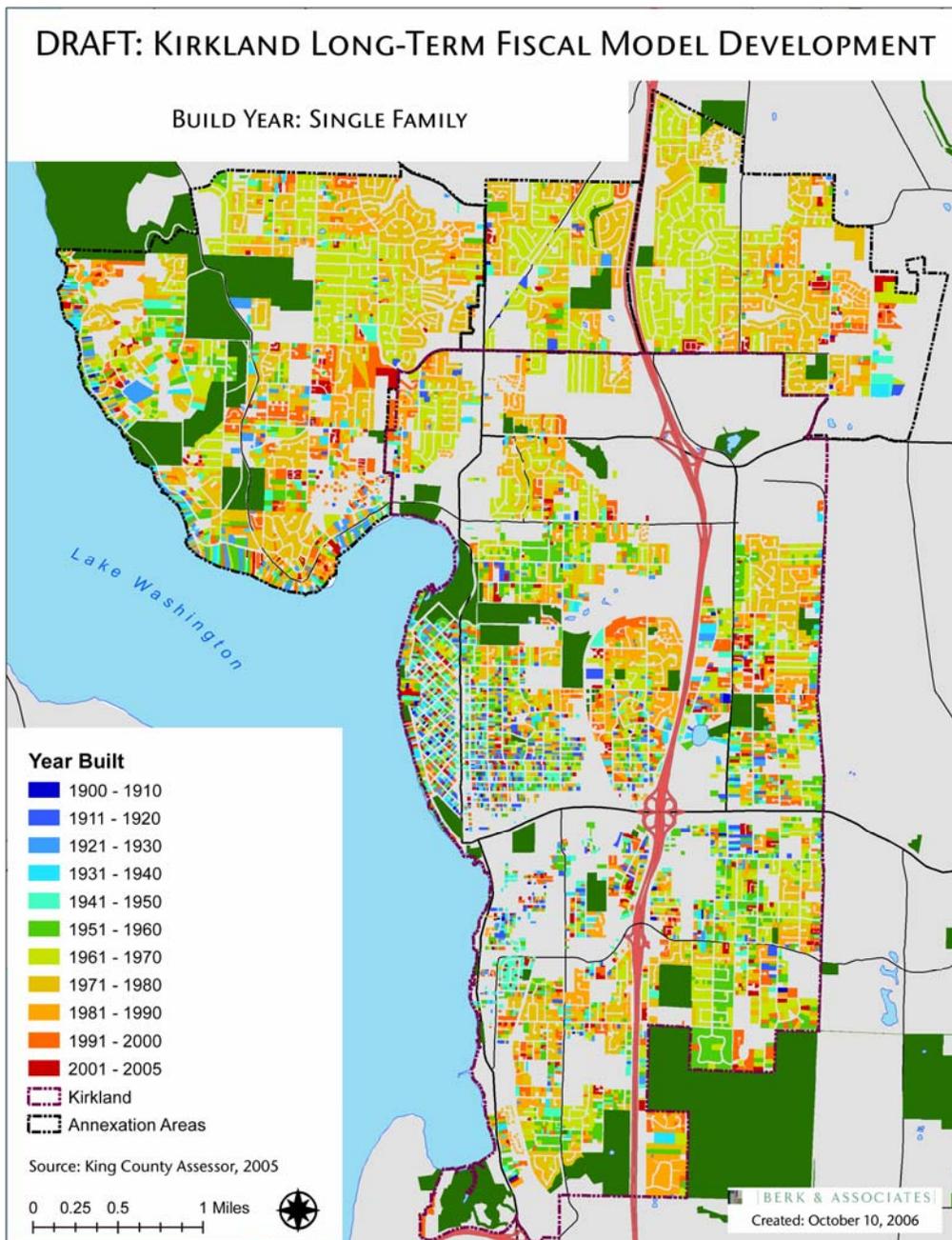
DEVELOPMENT SCENARIOS

- Both revenues and costs will be dependent on the type and quantity of development over the next 20 years. As a result, it is important to have the ability to test different development scenarios in order to evaluate the fiscal implications of growth on the City and how different growth trends affect the City's fiscal and annexation policy choices.
- The development model is based on zoning and land use information for all 22,000+ parcels in the City and PAA's, under current zoning unless otherwise noted.
- Development scenarios are constructed by choosing a "maximum development" scenario and then selecting what percent of the max will be achieved by 2025 and whether the development will be front-loaded (with a user defined share occurring within the first 8 years), back-loaded (with a user defined share occurring within the last 8 years) or occur in a relatively linear fashion.
- The model has several maximum development scenarios, each based on the current zoning in the City and PAA's. The differences are in the settings for redevelopment (low, medium and high redevelopment scenarios) and the degree to which some environmental factors (such as steep slopes) may reduce the development capacity.
- As an illustration of the maximum development concept, the following maps show the components of the development potential, with a particular focus on the single family housing component. The maps include:
 - Build Year. Shows how the average age of single family homes and how this may relate to the potential for redevelopment and reinvestment throughout the City and PAA's
 - Land Value. Show the distribution of land values throughout based on current County Assessor assessed value of land.
 - Improvement to Land Ratio. An indicator of redevelopment potential which identifies the ratio of improvement value to land value. A ratio of less than 1.0 suggests that the land is worth more than the building.
 - SF (Vacant, Subdividable, Redevelopable). Shows the single family parcels that are shown to be currently vacant, subdividable or redevelopable. The subdividable properties must be at least 2 times larger than the minimum lot size for the parcel. Redevelopable properties are shown at two different redevelopment thresholds: improvement to land ratio of 0.25 (building less than 25% of land value) and a ratio of 0.5 (building value less than 50% of land value, but more than 25%). As a point of comparison, the city's Planning Department uses 0.5 as the threshold for likely redevelopment.
 - Potential for new and redeveloped Multi-Family Units. This map shows the distribution of potential new multi-family units.
 - Potential for new and redeveloped Commercial/Industrial Square Footage. This map shows the distribution of potential commercial and industrial space.

DISCUSSION DRAFT

BUILD YEAR

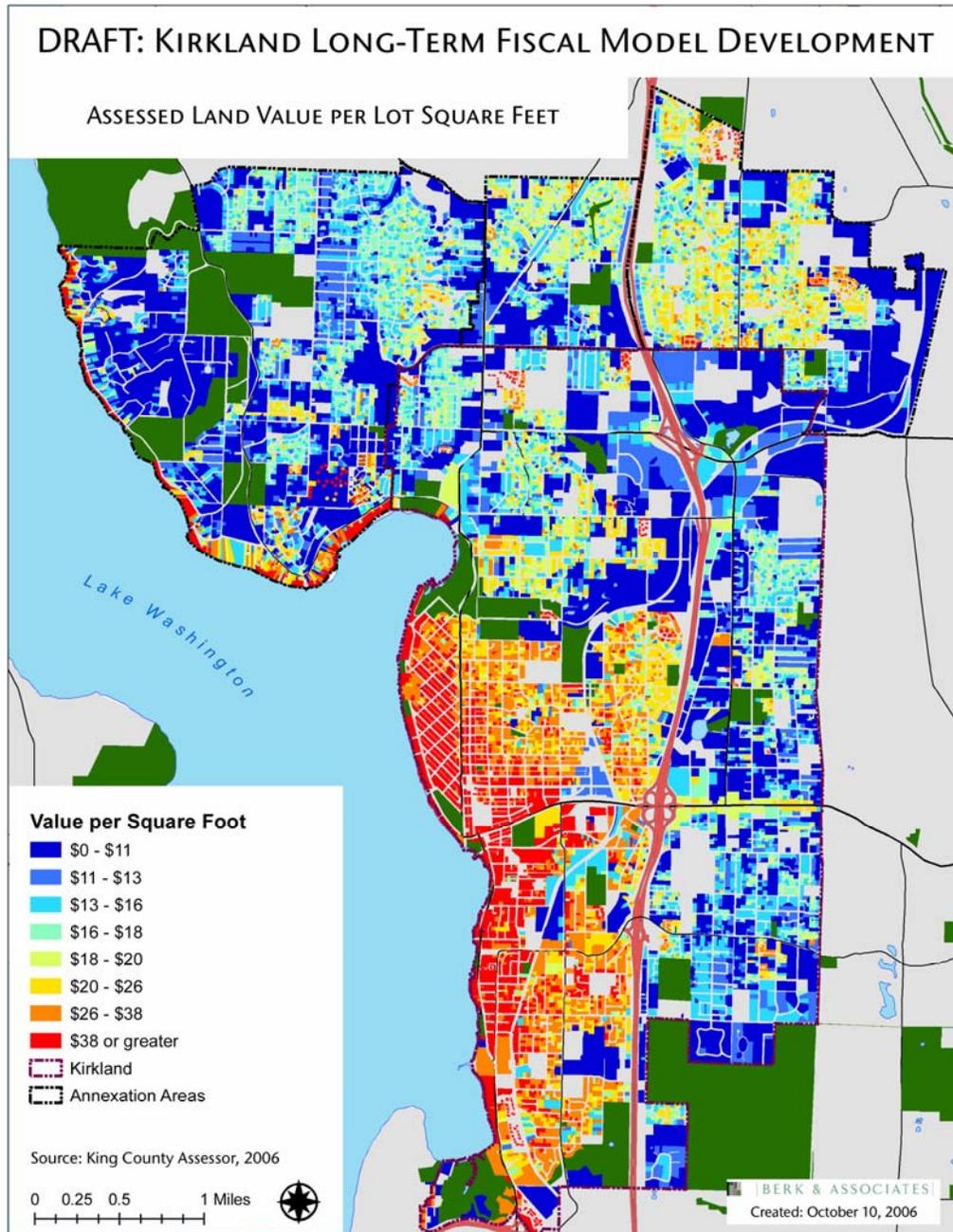
- Older single family homes are scattered throughout the City and to a less degree the PAA's, but are clearly focused in the area immediately north of downtown Kirkland.



DISCUSSION DRAFT

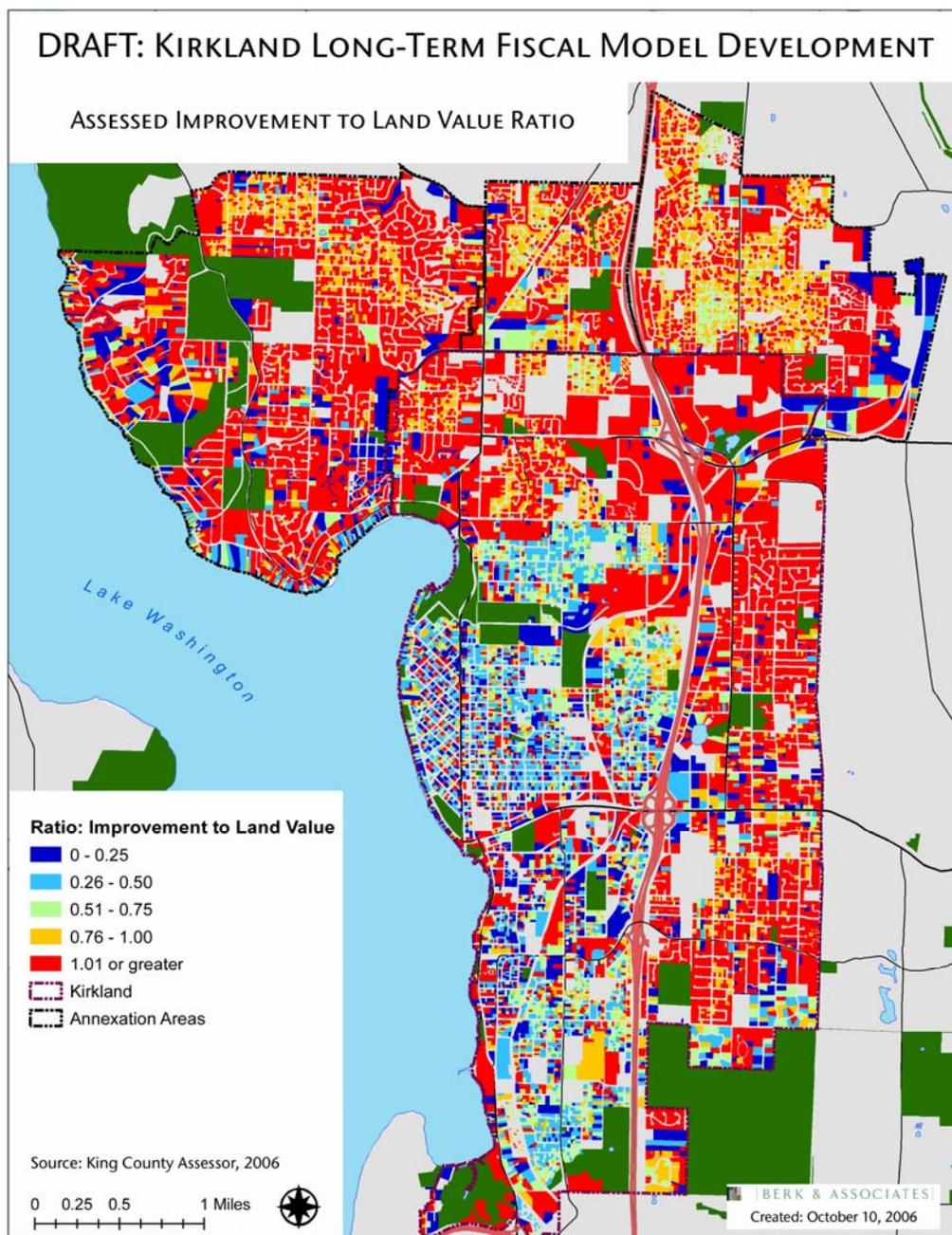
LAND VALUE

- There are clear patterns in land values on a per square foot basis, with the highest values along the water, downtown and concentrated in some of the older neighborhoods.
- There are significant differences in land values between the PAA's, areas east of I-405 and the higher value areas of the City.



IMPROVEMENT TO LAND RATIO

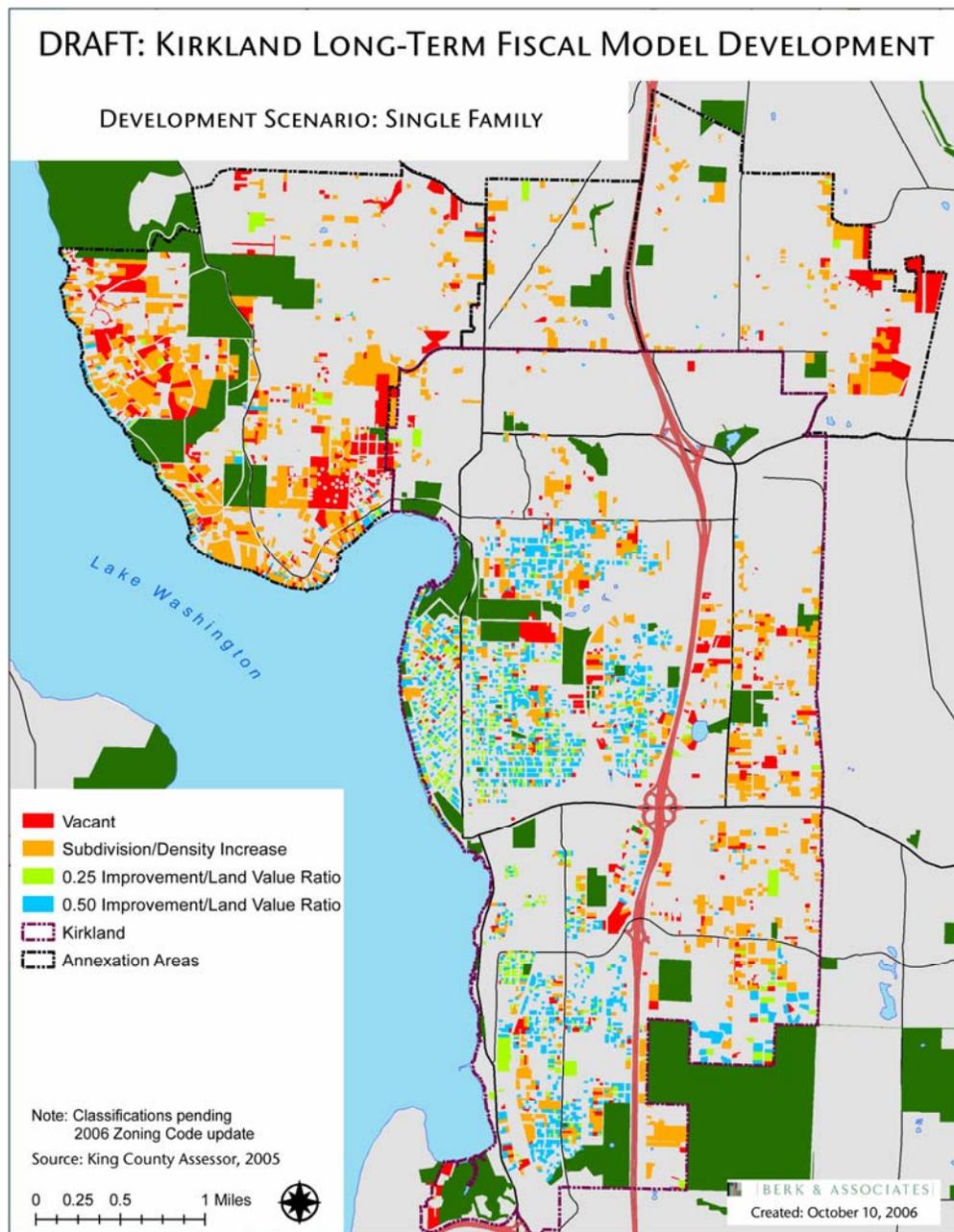
- Not surprisingly many of the areas with low improvement to land ratios are located in the high land value areas and where there are older buildings. These are the areas that are likely to experience redevelopment pressures and higher rates of reinvestment in existing buildings.



DISCUSSION DRAFT

SF (VACANT, SUBDIVIDABLE, REDEVELOPABLE)

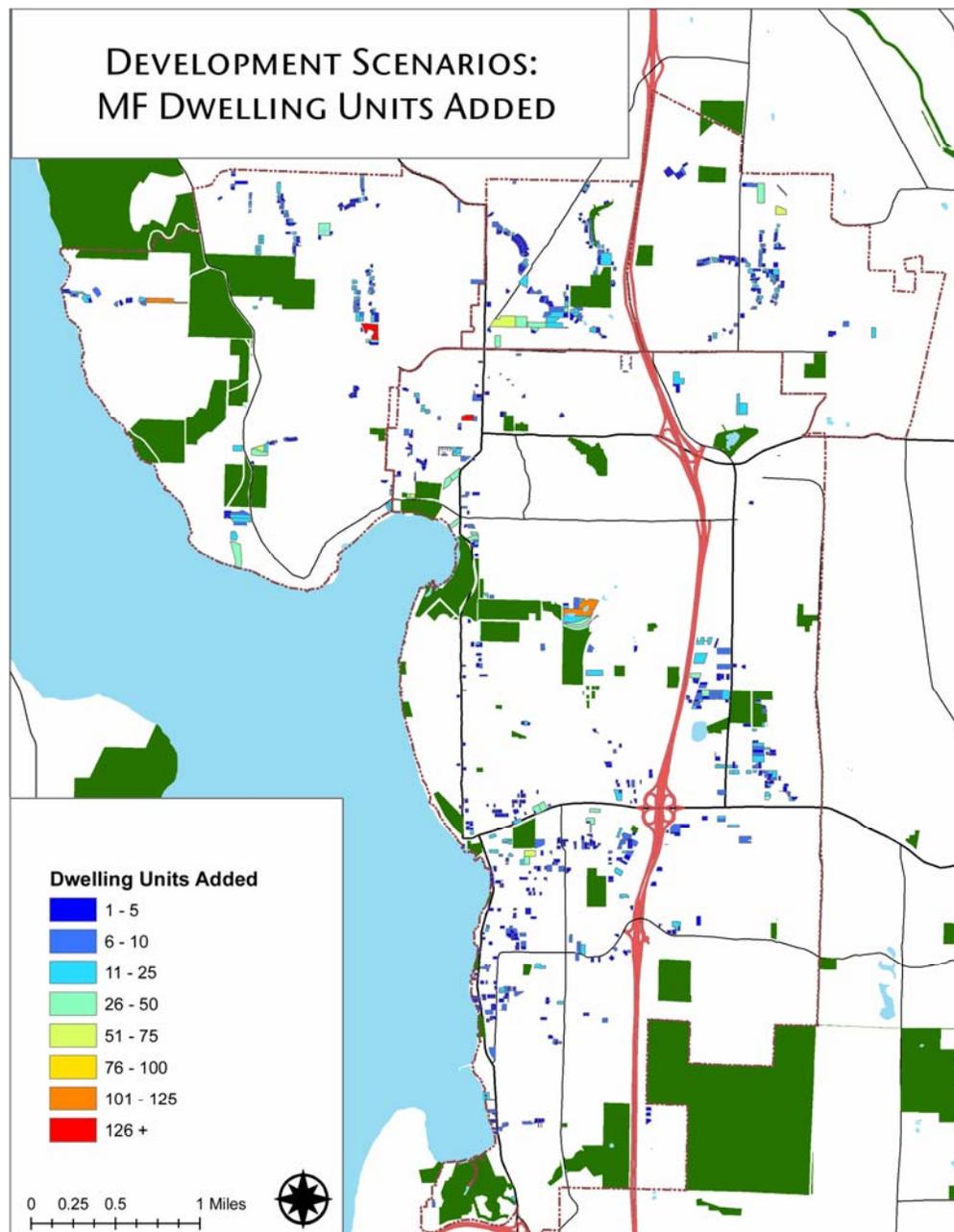
- The potential for new single-family development includes a significant number of subdividable properties in the Finn Hill and Rose Hill areas as well as redevelopment/reinvestment in the older Kirkland neighborhoods.
- A considerable number of the subdividable properties in Finn Hill are within steep slope and erosion areas, which does not necessarily reduce the development potential, but likely makes development more costly. In this case it is possible to reduce the assumed level of development in these areas.



DISCUSSION DRAFT

POTENTIAL FOR NEW AND REDEVELOPED MULTI-FAMILY UNITS

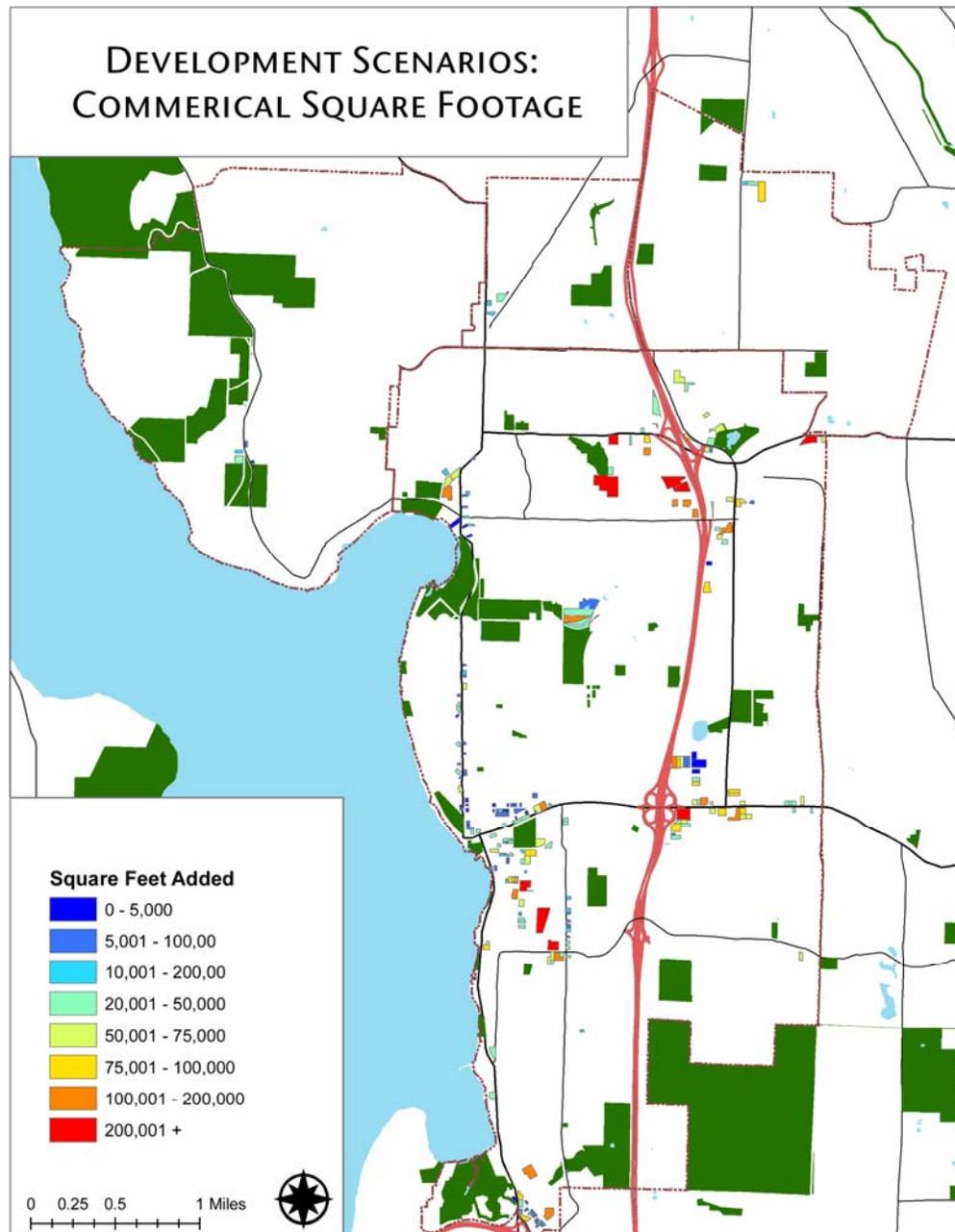
- Applying the same approach described above, results in the following distribution of potential new multifamily housing.
- The model allows for different assumptions about the mix of uses in the mixed use zones, such as higher residential or commercial mixes.



DISCUSSION DRAFT

POTENTIAL FOR NEW AND REDEVELOPED COMMERCIAL/INDUSTRIAL SQUARE FOOTAGE

- Applying the same approach described above results in the following distribution of potential new commercial activity.
- This map assumes no rezoning, though the model does allow for testing the potential of rezoning or adding density throughout the City or PAA's.



DISCUSSION DRAFT

ESTIMATING CHANGES IN DEMAND AND COST OF SERVICES

The model estimates changes in the cost of services based on relationships between direct services, such as maintenance workers or planners and underlying demographic and community changes such as increases in population, housing units, commercial activity and area.

- Costs are broken up into labor and non-labor categories.
- Non-labor costs in each department are driven by the labor costs in that department.
- Drivers for labor costs are variable in the model, and generally fall into one of four categories:
 - **Fixed.** These positions do not change over the planning horizon (for instance, there will always be one City Manager or one Police Chief).
 - **Direct.** These positions are driven directly by changes to the underlying land base of the city, such as population or employment. The relationship between demand for services and the underlying land base is largely defined based on the 2005 annexation service packages which identified how each department would be affected by growth in these key variables.
 - **Indirect (by Position).** These positions are driven by staffing levels of one or more positions in a specific department. For instance, a planning supervisor is related to the need for new associate planners, planners and senior planners.
 - **Indirect (by Department).** These positions are driven by staffing levels of one or more departments. For instance, a human resource analyst position is related to total new staffing levels in most other City departments.
- By accounting for the indirect to direct relationships, when a direct service position is added, the model ensures an increment of indirect support necessitated by the addition of the direct service.

POLICY OPTIONS TO ADDRESS COST OF SERVICES

- The policy options available to “balance the budget” include:
 - Changing assumptions about the underlying relationship between direct services and the demand drivers or between the direct staff positions and the indirect positions.
 - Changing assumptions about level-of-service. The model uses the current level-of-service to determine when new positions are needed in response to growth. It is possible to adjust the level-of-service by either reducing it (would require more growth to trigger the next staff hire) or increasing it (would require less growth to trigger the next hire).
 - Changing assumptions about the expected escalation in key cost centers, such as salary and benefit costs per person and general inflationary costs in non-labor cost categories.

DISCUSSION DRAFT

ESTIMATING TAX AND FEE REVENUES

- Tax and fee revenues are estimated based on the changes in the components of the City's tax base resulting from growth (with or without annexation). Components of growth which could influence revenue growth include population, employment, base inflation in certain components of the tax base, or land use changes,
- Each of the City's tax and fee revenue sources is separately estimated by estimating changes in the tax base and applying current tax and fee rates to generate revenue projections.
- To give the Council a full list of potential tax policy choices and the ability to model different tax policy options, the estimated tax base is included for all major potential City taxes (even those not currently imposed).

POLICY OPTIONS TO ADDRESS TAX POLICY OPTIONS

- The model has the ability to assess changes in potential tax and fee revenues on properties, businesses, and utilities by varying the rate of taxes and fees and/or varying the assumptions about growth in the various components of the tax base. For example:
 - Options are available to assess different property tax scenarios including levy lid lifts and excess levies (which would require voter approval).
 - Options are available to change the tax and fee rates of existing sources (some of which would require voter approval and others which would not).
 - Options are available to add new taxes and fees on businesses and/or residents.