



**CITY OF KIRKLAND**  
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## **MEMORANDUM**

**To:** Dave Ramsay, City Manager  
**From:** Marilynne Beard, Assistant City Manager  
**Date:** November 30, 2006  
**Subject:** ANNEXATION PROCESS UPDATE

### **RECOMMENDATION:**

Council receive an update on the annexation decision-making timeline and a briefing on the financial model.

### **BACKGROUND DISCUSSION:**

The City Council is engaged in a four-phase decision making process regarding the potential annexation of Finn Hill, Upper Juanita and Kingsgate. The first phase consisted of a community outreach effort to the Kirkland community and a long term financial forecast for the annexation area. Phase one was estimated to conclude by late 2006 or early 2007. Although both the outreach and fiscal model projects are still underway, the consultants' original scope of work is largely completed. We are now in the process of presenting the results to the City Council.

### **Community Outreach**

The objective of the community outreach process was to begin an annexation dialogue with Kirkland residents and to identify concerns and questions they had about the potential annexation. The Council received a summary of the community outreach project at their November 21<sup>st</sup> meeting including the major themes and recommended follow-up. At that meeting, Council agreed that further outreach was needed before a phase one decision could be made. Specifically, they asked that the results of the fiscal study be shared with the Kirkland community and that another round of comment take place.

### **Financial Study**

The purpose of the financial study was to reassess the fiscal impact of annexation given the newly-adopted legislation providing state funding for ten years. The Council wanted to understand the long term financial impacts of annexation and to identify strategies for addressing the City's financial condition at the end of the ten-year State funding period. The Council received an initial briefing about the financial model at their November 8<sup>th</sup> meeting. The number and complexity of the issues are such that staff recommends the discussion span several Council study sessions that will necessarily extend into January.

## Community Questions Related to the Financial Analysis

Council asked that staff relate the feedback received from the public outreach effort to the answers provided by the financial model. In fact, the financial model should be able to generally answer a number of the questions posed regarding the financial implications of annexation and even the benefits to Kirkland. The following excerpts from the listening log are questions that can be addressed using the fiscal model.

- What is included in the \$4.8 financial gap anticipated from annexation? Would the \$4.8 million gap be an annual deficit?
- How much does the gap close with State funding?
- Isn't the deficit likely to be higher in 10 years (considering inflation)? How will the extra deficit be covered?
- If revenue from the potential annexation area cannot fund the remaining gap (cover the remaining deficit after receiving State funding), wouldn't the City be forced to reduce services to existing Kirkland residents or raise taxes in the City?
- Is there a cost-of-living escalation rate linked to the State funding?
- Is there potential for revenue building in the PAA (i.e., building more expensive houses to build the tax base)?
- At the end of ten years what impact would the financial gap have on households?
- Is the City also considering long-term capital needs in the economic study? Will funds for long-term capital improvements for Kirkland be a factor in making a decision on annexation?
- What is the financial risk for the city and taxpayers?
- Why would the city even consider this when it sounds like a fiscal loser?
- What is the benefit of annexing to Kirkland residents?
- Does Kirkland look carefully at existing expenses and the levels of service they fund to look for opportunities to be more efficient, maybe adjust levels of services in order to close the funding gap?

Some of these questions can be answered very explicitly (e.g. Would the gap be larger in ten years?) and others can be answered only generally (Wouldn't the City reduce services or raise taxes?). At this point, the Council can see how the annexation would impact Kirkland's current and future financial condition and under what conditions it improves or worsen City finances. The model also informs the Council about the tools they have available to address the City's financial situation (with or without annexation) and the relative impact of each. When the Council has had an opportunity to fully discuss the financial analysis

and use the model, the objective is that they would have sufficient information about future options to make a decision about proceeding to phase two.

### **Proposed Revised Process and Timeline**

Based on the Council's request for additional outreach activities and time needed to fully discuss the financial analysis, staff developed a revised timeline for phase one of the annexation decision process (see attached timeline). The revised timeline details the recommended time frame and steps for completing phase one:

December 12	Council Study Session – Fiscal Model
January 1-15	Council Special Study Session – Fiscal Model
January/February	Kirkland Outreach/Financial Information
February	Public Forum
March	Phase One Go/No Go Decision

Staff will work with the City's communications consultants to design the extended outreach process.

The slight delay in the phase one decision still allows for a 2008 election and a 2009 effective date. Specific dates would be determined if the City Council decides to proceed with the annexation process and will be dependent on the timing of future phases.

### Annexation Timeline

(Scenario 2 Updated -- August 2008 Election/Implement Tax After Effective Date)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	
2006							Phase 1						
							Communication with Kirkland						
							Budget						
2007	Go/No Go to Phase 2*		Phase 2										
	Kirkland Public Involvement		Continue Communication with Kirkland and Expand to PAA										
			Departments Begin Preliminary Planning, Develop Zoning and Work on Operational Plans with King County										
			Negotiate Planning ILA with King County			Go/No Go to Phase 3**							
			Phase 3										
2008	Dec 12 -- Financial Model Introduction Jan 1-15 -- Special Study Session(s) on Financial Model Jan/Feb -- Kirkland Outreach and Financial Briefing Feb -- Public Forum Feb/Mar -- Phase 1 Go/No Go Decision												
	Phase 3 (continued)												
	Approve Zoning		Proceed to Boundary Review Board			Set Election Date							
							Pre-Election Communication		Election***				
	Continue Implementation Planning									Phase 4			
2009	Phase 4 (continued)												
			Effective Date										
	Continue Hiring		Departments Begin Service Delivery										
							Enact Local Sales Tax						

\*If "Go" then proceed to ILA negotiation with King County to establish timeline and funding commitment

\*\*If "Go" then proceed to election and select election date

\*\*\*If annexation measure passes, Council to adopt ordinance accepting annexation.



## **MEMORANDUM**

**To:** David Ramsay, City Manager

**From:** Tracey Dunlap, Director of Finance and Administration

**Date:** December 4, 2006

**Subject:** Annexation Fiscal Analysis

### **RECOMMENDATION:**

Council receive the preliminary draft findings of the Annexation Fiscal Model and an introduction to the policy framework.

### **BACKGROUND DISCUSSION:**

#### *Introduction*

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 analysis 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. An overview of the key concepts and policy options in the model was presented to the City Council on November 8.

Attachment A contains the draft summary of findings prepared by Berk & Associates, which describes the fiscal model and discusses the key assumptions, policy choices, and preliminary draft results.

#### *Why are we looking at annexation now?*

In 2005, the City evaluated the potential annexation and determined that the fiscal deficit projected at that time was a substantial obstacle to annexation. In the meantime, the Washington State Legislature enacted a sales tax credit funding mechanism to encourage annexation. To qualify for this ten year sales tax credit, the annexation must commence by 2010. The magnitude of the sales tax credit warranted revisiting and refinement of the annexation analysis to determine if it sufficiently mitigated concerns related to the fiscal deficit.

*How does this evaluation differ from previous annexation studies, especially the work completed in 2005?*

The 2005 work involved estimating the incremental budget impacts of serving the PAA and estimated the annual operating cost and revenues. The current fiscal analysis looks at the potential annexation area (PAA) over the 2010-2025 time period, as well as the City's overall financial condition for the same period of time. The fiscal study combines the work done in 2005 with a detailed financial projection over time for the entire City, with or without annexation. The importance of analyzing the PAA within the context of the overall City budget lies in the interrelationship between the two. The measures that the City Council takes to address the fiscal deficit in the PAA impact the City as a whole and vice versa. As a result, a review of the City's current financial forecast is a necessary first step.

*What is the City's current fiscal forecast?*

The City's financial forecast demonstrates an existing structural imbalance between revenues and expenditures. The financial forecast for the current Kirkland boundaries has not fundamentally changed from that presented as part of the budget process over the years because the City's financial position has not fundamentally changed. Like most local governments, expenditures are increasing faster than revenues. Like most other local governments the deficit is addressed incrementally – one year at a time (or two years in the biennial budget) because the City Council is required to pass a balanced budget each year. The City's fiscal policies call for ongoing revenues to match ongoing expenditures in the budget. Each budget period, the City Council approves a balanced budget by taking a variety of actions that are appropriate at that time that mitigate the factors causing the structural imbalance that exists in the tax-supported services and to address service level needs identified at that time. The table on the following page summarizes the actions that Council took to balance the budget over the past five to ten years.

The causes of Kirkland's structural imbalance are largely the same as for most local governments. The combined effects of a stalled economy beginning in 2002 with voter-approved initiatives that eliminated some revenue sources and limited others created a "one-two punch" to Kirkland's otherwise stable and diversified revenue base. On the other side of the ledger, increases in health care costs and cost of living adjustments have resulted in growth in employee costs beyond normal inflation. Employee costs account for nearly 70% of General Fund expenditures. At the same time, citizen expectations for services have not wavered. Council has recognized the need for additional staffing in critical areas, such as public safety and development services, but recent budget processes have necessarily focused on maintenance of existing services. Over the years, the Council has made expenditure (and service level) reductions, raised taxes, and benefited from economic growth in order to balance the budget. The financial forecast provides a useful perspective on the City's financial future, however, its accuracy fades past the first few years. The forecast demonstrates the City's future constraints, but does not dictate future actions. Each budget cycle, the City Council must take actions that are appropriate for that time, taking into consideration factors that changed from the prior forecasts (e.g. voter initiatives, economic downturns or upturns, changes in the retail business base, etc.).

Strategy	< 1999	1999	2000	2001	2002	2003	2004	2005- 06
<b>New revenue source:</b>								
Surface water management fee	X							X
Revenue generating regulatory license fee						X		
Surface water utility tax					X			
Cost of service interfund charge	X							
<b>Increased tax rate or fee:</b>								
Increased property tax rate	X		X			X	X	X
Increased utility tax rate						X		X
Increased parking fines			X		X			
Increased development fees		X	X		X			
<b>Changes to sales tax:</b>								
Reduced CIP allocation			X					
Reduced sales tax lag to 1 year								X
<b>Used one-time revenue source:</b>								
Sales tax audit proceeds							X	
Interest income								X
<b>Planned use of Rainy Day reserve</b>						X	X	X
<b>Expenditure reductions</b>					X	X	X	
<b>Other strategies:</b>								
Used new construction growth	X	X						
Reduced budgeted benefit rate to citywide average					X			X
Reduction in state retirement rates					X			

*Does annexation make the City's fiscal forecast better or worse?*

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.

In the near term (and without the State sales tax credit), annexation increases the City's fiscal gap primarily due to the facilities needs required to provide services in the PAA. However, with the sales tax credit, the gap in the PAA can be narrowed or eliminated through strategic financial management, the combined City and PAA "gap" is not as large as the current City gap over time. In other words, if the City can maximize the sales tax credit, it helps to address the PAA gap in the first ten years after annexation and the PAA helps reduce the future deficit of the City. During the same ten-year period when the state sales tax revenue is available, the City will be faced with a series of decisions to address its own structural gap. Therefore, the impact of annexation has to be viewed from the perspective of whether the addition of the

PAA will improve the impact of those decisions as they occur. To test this dynamic, a number of different policy scenarios have been generated to assess the impact of different actions.

Not surprisingly, the near-term gap grows from annexation, although much of this increase is mitigated by the State sales tax credit during the first ten years. However, in the latter years, nearly any action the City Council takes to close the City's projected financial gap will close the annexation gap and result in a more positive overall outcome. This occurs because the City benefits from having a larger population, employment, and tax base, which should provide some economies when applying the measures required to address the current City's projected gap. In addition, the level of new development activity in the PAA is expected to increase during the latter years of the forecast period, recognizing that the City's current land supply will begin to reach build-out during the projection period. As described in Attachment A, the impact of the policy choices improves after annexation in the long-term.

*Why is this different from the results of the prior evaluations?*

This study approached evaluating the impacts in a manner that differed from prior studies:

- It is important to recognize that the projected annexation figures will continue to change over time based on refinements in estimates. For example, the \$4.8 million funding gap in the PAA estimated in the 2005 evaluation was reassessed in early 2006 and had closed somewhat due to Council action related to public safety staffing at year-end 2005 and improvements in economic conditions.
- The analysis looked at the needs of the City as a whole over time, rather than isolating only the impacts of annexation at a point in time.
- By looking at the whole City, the estimated resource needs for public safety purposes could be reduced by recognizing that there could be some economies realized by looking at patrol districts across the current City boundaries. One of the underlying assumptions in the 2005 analysis was that the needs of the PAA should be addressed as a stand alone service area. As a result of these changes, the fiscal gap was reduced by approximately \$1.8 million.<sup>1</sup>
- Current planning for facilities needs indicates that, if annexation does not occur, a new Public Safety building would not be necessary, with the total needs for expansion of City Hall and the Maintenance Center projected at \$30 million. If annexation occurs, the current estimate for a new Public Safety facility is \$44 million (reflecting a 75 bed jail), resulting in total facilities expansion costs of \$80 million (which also reflects the additional City Hall/Maintenance Center space needs for additional annexation staffing). The impact of the increased needs is allocated to the PAA in a manner that reflects the proportional share of the incremental needs (this issue is discussed in more detail in Attachment A).

*What are the policy choices to consider related to closing the gap?*

Attachment A contains a detailed discussion of the policy choices available to address the fiscal gap, which involve the application of some or all of the following tools:

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<sup>1</sup> Note that the possible need to add fire personnel in the Kingsgate area, should the decision be made to relocate Fire Station #34, is not reflected in the current annexation cost projections since discussions are on-going related to options for ensuring coverage for this area. This issue is discussed further at the end of this document.

1. Development-related revenue
  - new construction property tax
  - sales tax
  
2. Tax policy revenue
  - property tax
  - utility tax
  - business tax
  
3. Expenditure management
  - level of service – staffing levels
  - efficiency/productivity
  - compensation

In the scenarios reflecting a variety of policy choices tested to date, potential actions taken to address the current City's gap are improved with the addition of the PAA. It is important to note that this evaluation has been undertaken to evaluate the financial impact that annexation will have on the City over time, not to decide on a course of action to close the City's fiscal gap over the next 20 years. Those decisions will be made over time as each budget is balanced, recognizing the economic conditions, service needs, and policy choices of this and future City Councils.

*What are some of the major financial issues to be evaluated in Phase II, if the decision is made to proceed?*

- The analysis assumes that Kirkland will receive the maximum state sales tax credit for the ten-year period and that the funding will remain intact for the whole timeframe (meaning there will be no reductions in the funding level contemplated in the legislation). In addition, the method for demonstrating eligibility for the full credit is still under development and negotiation with the state.
- The infrastructure needs of the PAA will be evaluated as part of Phase II. The fiscal study addressed facilities needs and projected revenues that would be available to fund infrastructure improvements, but the actual infrastructure requirements will need to be identified based on a technical assessment of the deficiencies in each area.
- The availability of funds from King County to assist with the annexation transition would be negotiated as part of Phase II.
- The impacts of adding fire staffing to meet the needs of the area currently served by the Kingsgate station in the event that the station is relocated are not reflected in the draft analysis. The magnitude of the requirement is dependent on when and where a new station would be located and the City's ability to negotiate for coverage with neighboring agencies.
- The ultimate sizing and configuration of the new Public Safety/Jail facilities required with annexation is currently under study as a separate effort expected to be completed in the next few months. The facilities financing and impacts of annexation would be impacted by alternate public safety facility scenarios.
- The Northshore Utility District provides water and sewer services in most of the PAA. The City and the District currently have a franchise agreement which includes a time limited non-assumption clause. At this juncture, the analysis assumes that the District will continue to provide these utility services, but also assumes that the franchise fee charged to the District will keep pace with the utility tax rate applied by the City to its own utilities.

December 4, 2006

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*Conclusion*

The presentation on December 12 will include an overview of the preliminary findings and discussion of the policy framework established for evaluating fiscal scenarios.

**CITY OF KIRKLAND  
LONG-TERM FISCAL IMPACTS OF ANNEXATIONS**

**Preliminary Draft Summary of Findings**

**December 2006**

# DISCUSSION DRAFT

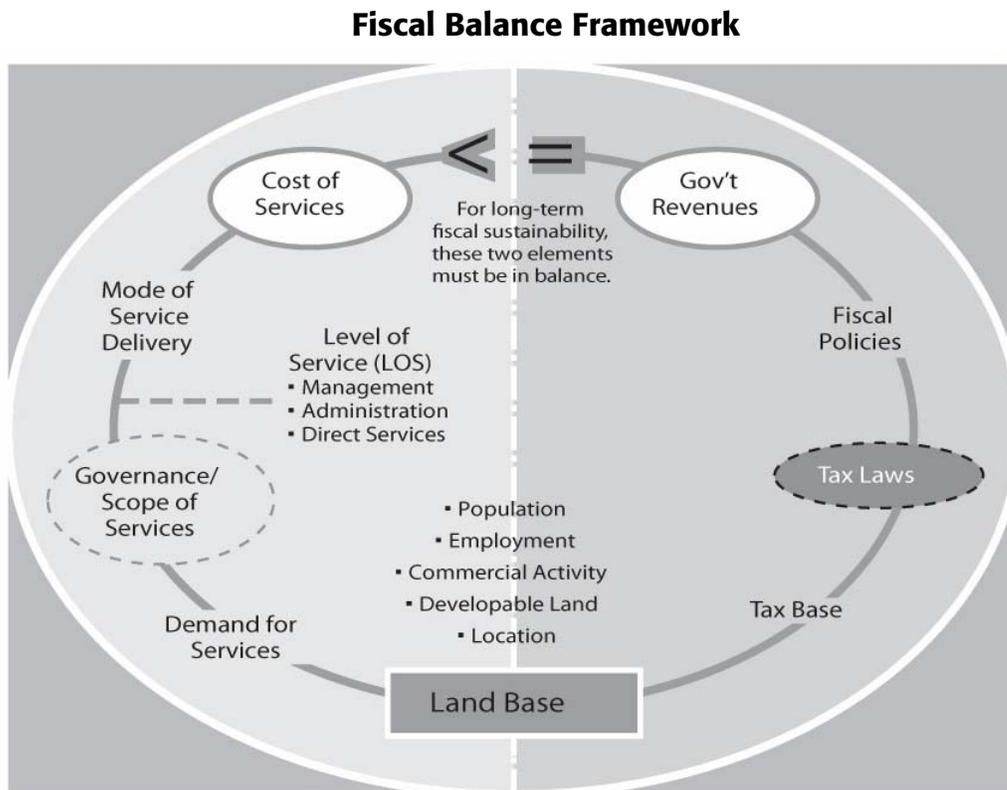
## PURPOSE AND OBJECTIVES OF MODEL

- 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.
- While infrastructure costs are excluded, the model does estimate future capital-restricted revenues (such as gas tax distributions from the State and real estate excise tax) for the current City and the PAA's.
- 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 estimates the maximum sales tax credit and the eligible annexation deficit to determine the amount of potential revenue from this source.
- 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.

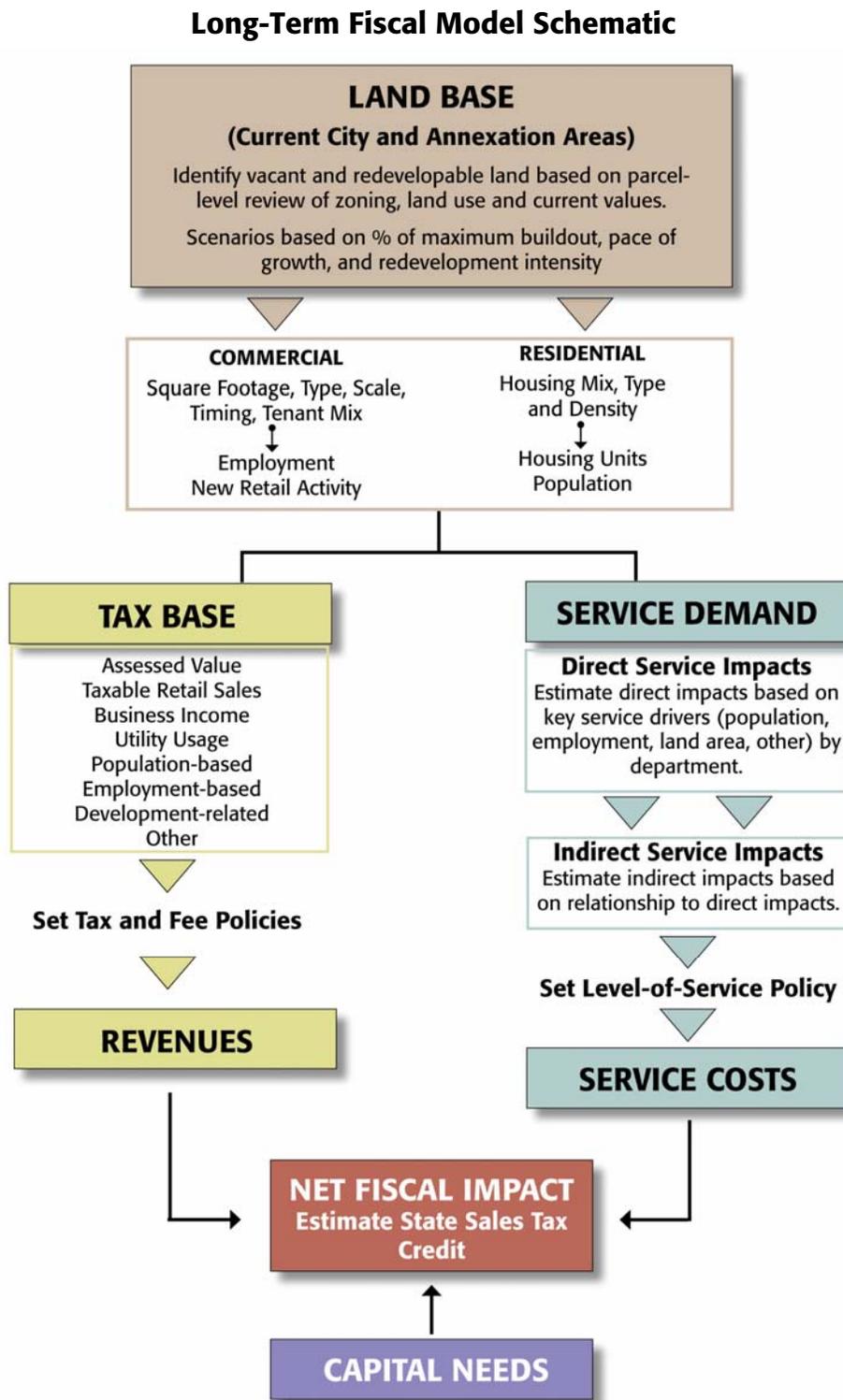


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- A particular challenge for this project is the need to project land base changes over a 20-year window.

# DISCUSSION DRAFT

## MODEL SCHEMATIC



## 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 specific decisions or plans to balance future budgets, but rather to identify how annexation might affect the City's ability to meet these fiscal challenges in the future.

# DISCUSSION DRAFT

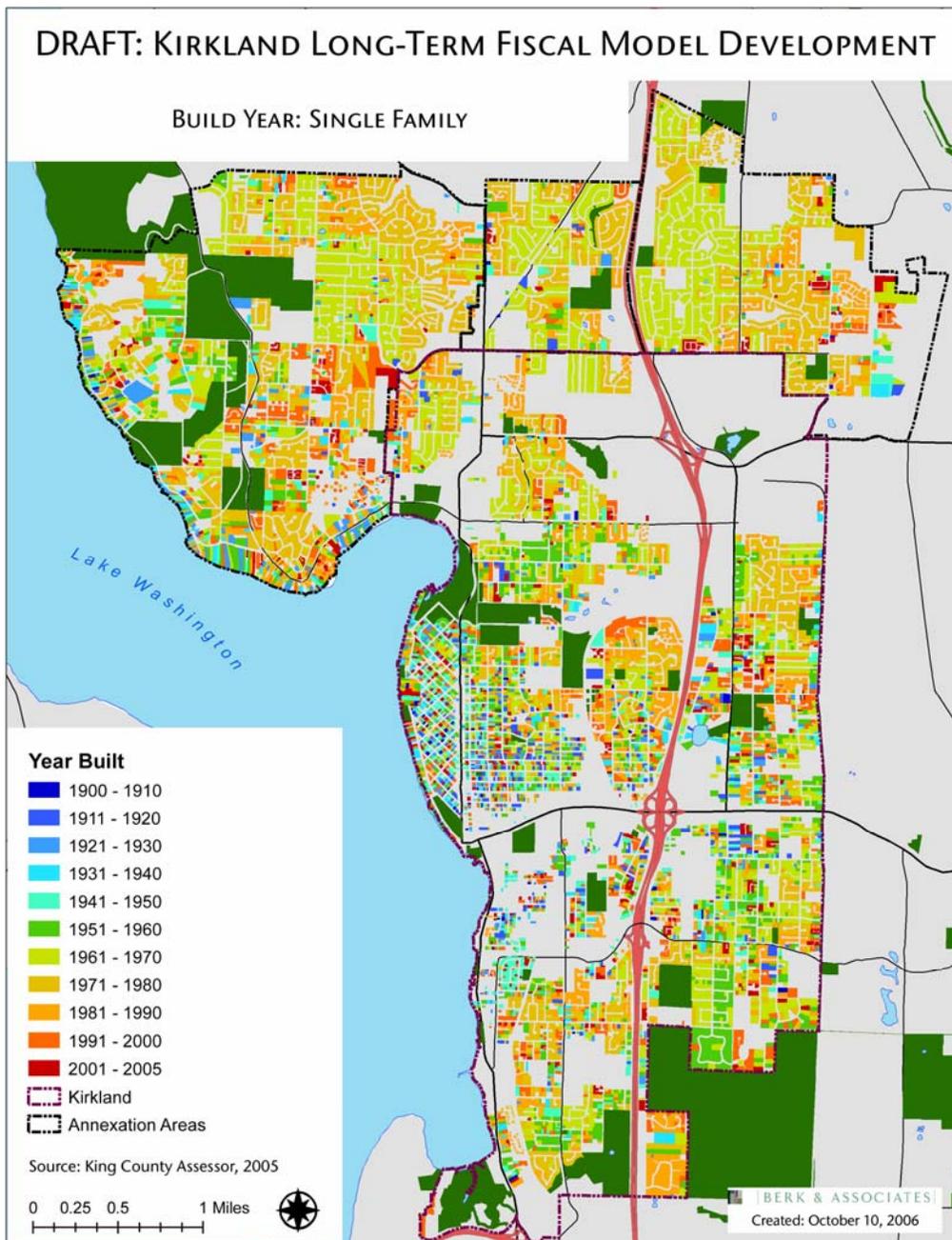
## DEVELOPMENT SCENARIOS

- 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. The parcel module is where assumptions can be varied to create alternative "maximum development" scenarios.
- Within the fiscal model one chooses from the list of "maximum development" scenarios and then select 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

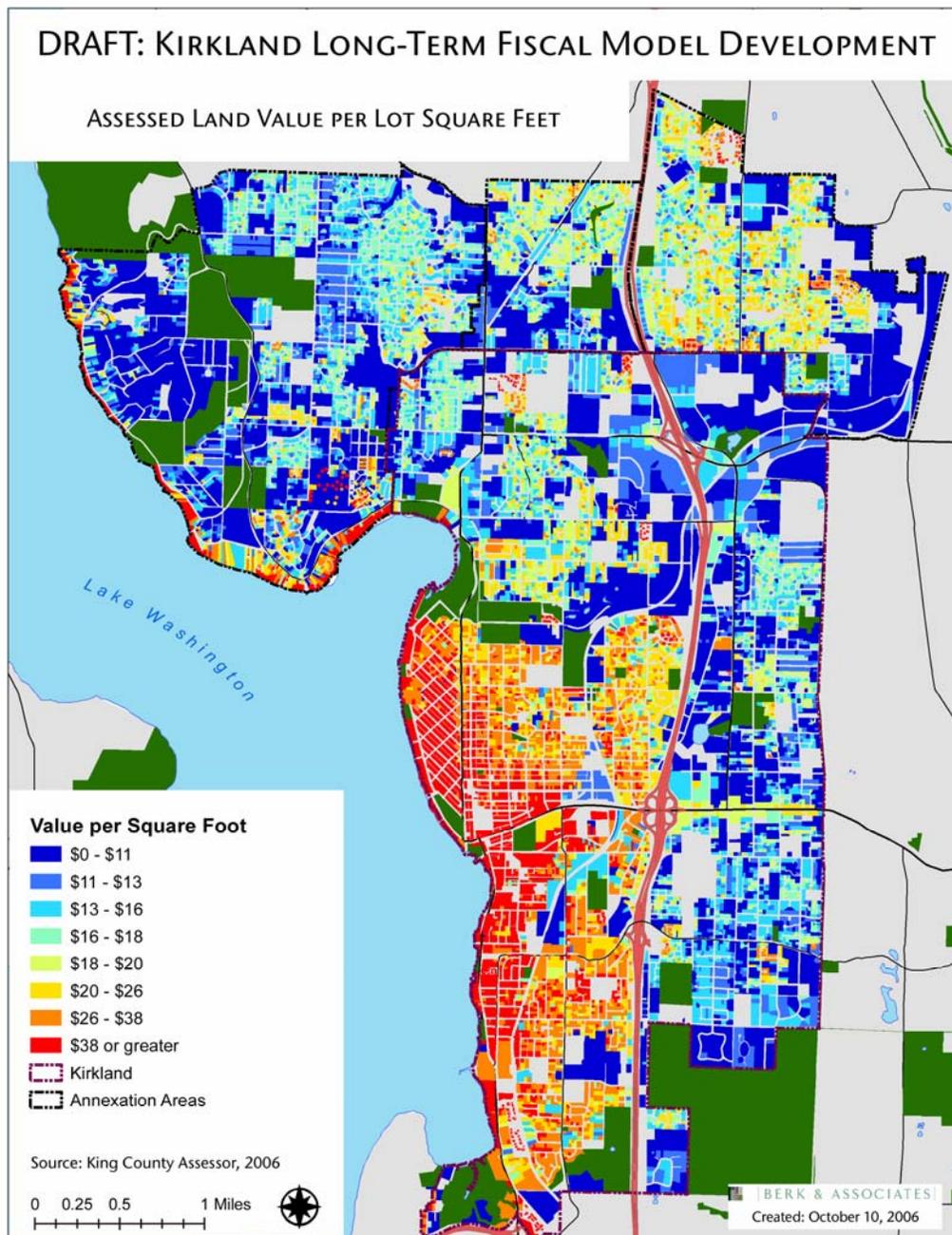
- Older single family homes are scattered throughout the City and to a less degree the PAA's, but are clearly focused in the area immediately north of downtown Kirkland.



# DISCUSSION DRAFT

## LAND VALUE

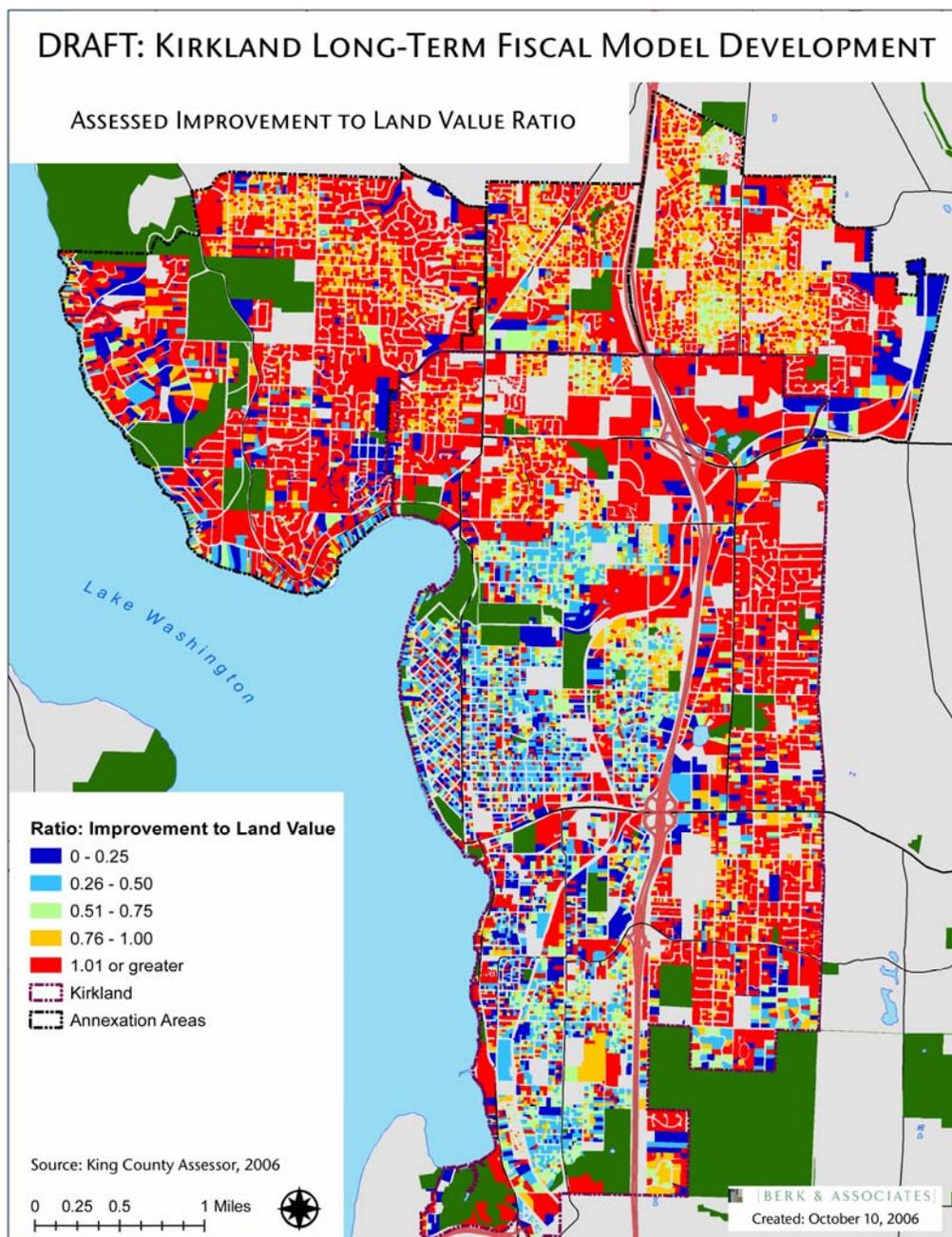
- There are clear patterns in land values on a per square foot basis, with the highest values along the water, downtown and concentrated in some of the older neighborhoods.
- There are significant differences in land values between the PAA's, areas east of I-405 and the higher value areas of the City.



# DISCUSSION DRAFT

## IMPROVEMENT TO LAND RATIO

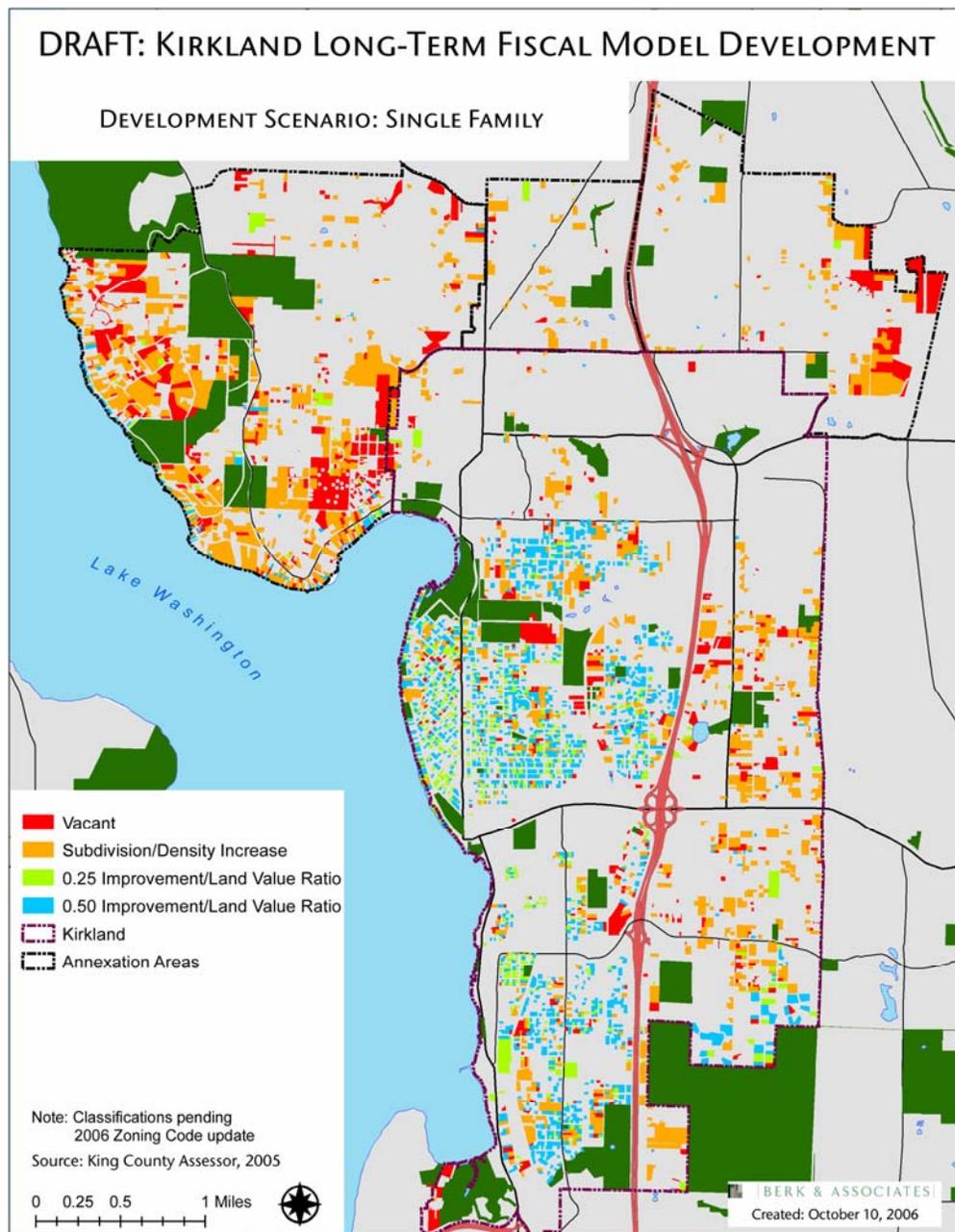
- Not surprisingly many of the areas with low improvement to land ratios are located in the high land value areas and where there are older buildings. These are the areas that are likely to experience redevelopment pressures and higher rates of reinvestment in existing buildings.



# DISCUSSION DRAFT

## SF (VACANT, SUBDIVIDABLE, REDEVELOPABLE)

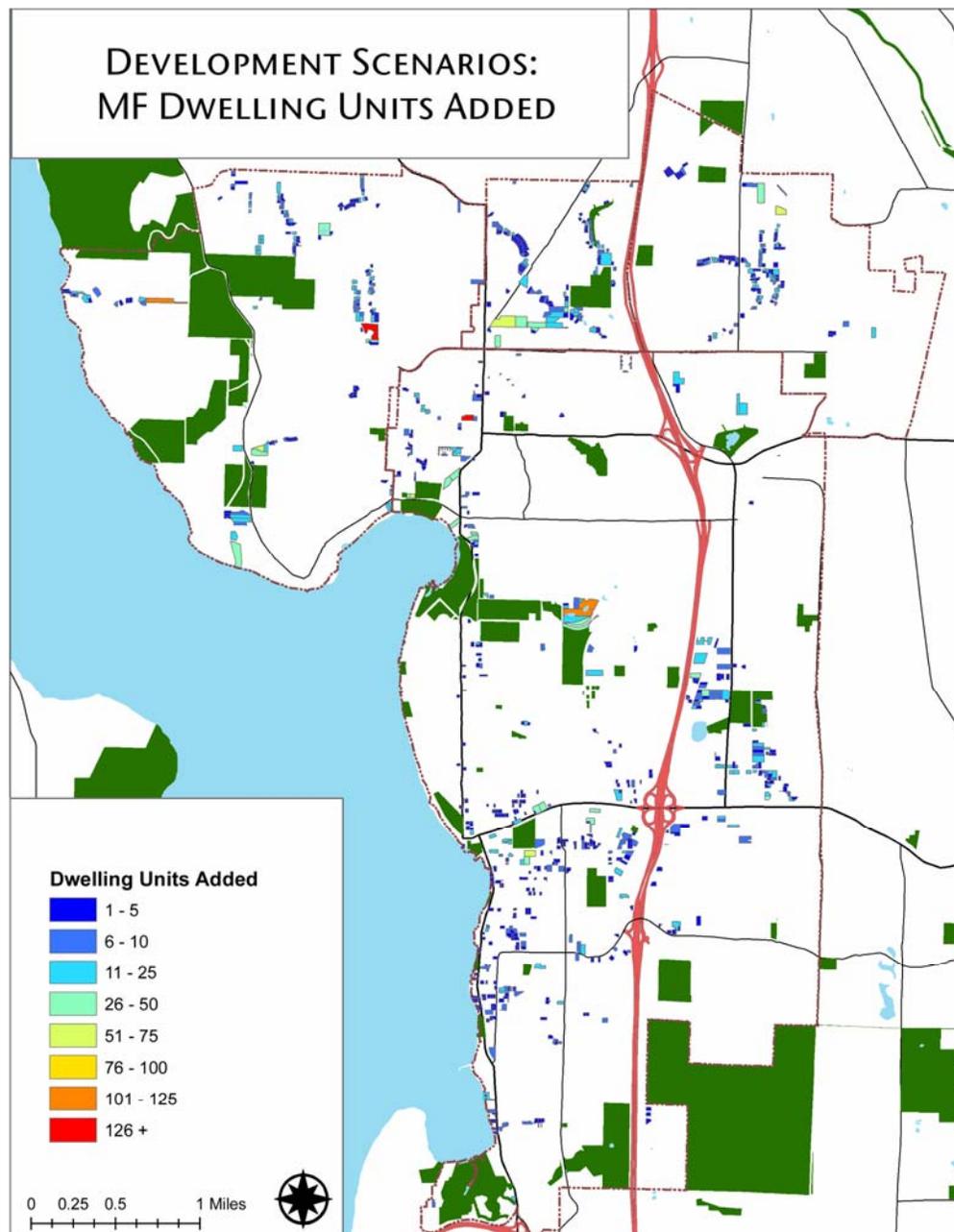
- The potential for new single-family development includes a significant number of subdividable properties in the Finn Hill and Rose Hill areas as well as redevelopment/reinvestment in the older Kirkland neighborhoods.
- A considerable number of the subdividable properties in Finn Hill are within steep 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

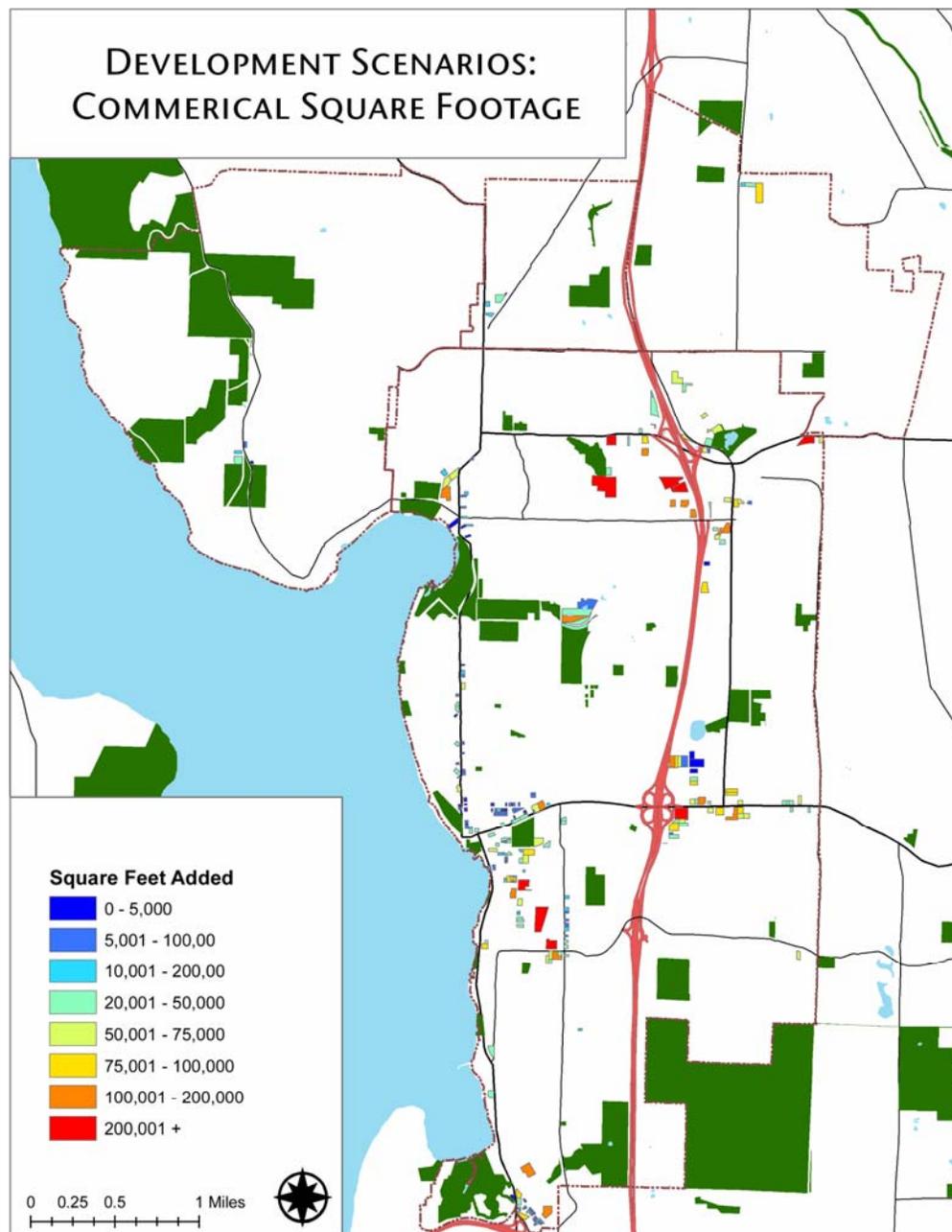
- Applying the same approach described above, results in the following distribution of potential new multifamily housing.
- The model allows for different assumptions about the mix of uses in the mixed use zones, such as higher residential or commercial mixes.



## 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 hiring rates. The model uses the current relationships between direct services and the demand drivers or between the direct staff positions and the indirect positions to determine when new positions are needed in response to growth. It is possible to adjust the hiring rate 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 REVENUES**

- 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.

# DISCUSSION DRAFT

## COMPARISON WITH 2005 STUDY RESULTS

- The exhibit below demonstrates how the current model's annexation impacts on FTEs compare to those identified through annexation service packages in the 2005 annexation study.

### Annexation Impact Comparison, 2005 Study to Current Model

Department	Annexation FTEs		
	2005 Study	Current Model	Change
Nondepartmental	0.00	0.00	0.00
City Council	0.00	0.00	0.00
City Manager	1.50	1.50	0.00
Human Resources	2.00	2.00	0.00
City Attorney	1.50	1.50	0.00
Parks Community Services	6.93	6.93	0.00
Public Works	17.24	17.24	0.00
Finance Administration	5.05	5.05	0.00
Planning Community Development	9.50	9.50	0.00
Police	77.50	64.50	-13.00
Fire Building	10.00	10.00	0.00
Municipal Court	8.24	6.92	-1.32
<b>Total</b>	<b>139.46</b>	<b>125.14</b>	<b>-14.32</b>

- The biggest change in the base operating and maintenance impact came from the Police Department, which reduced its annexation FTE request by 15 FTEs (currently, the model only includes a reduction of 13 FTEs, as 2 are contingent on Police having its 2007-08 Budget Service Package fully funded).
- The Municipal Court, where many employees are driven directly by Police staffing levels, also sees a decrease in annexation-related FTEs.
- The net effect of these FTE changes is to reduce ongoing costs by \$1.8 M, or 12%, and to reduce one-time costs by \$450,000, or 7%.
- Due to the current availability of more precise data from the Department of Revenue, sales tax revenues are higher than assumed in the 2005 study.

## OTHER KEY ASSUMPTIONS

- The initial baseline analysis does **not** include the need for additional firefighting personnel related to the Kingsgate station. The model does have the ability to add these contingent positions for fire protection.
- Two other key assumptions are the pre-FTE inflation rates of salaries and benefits, which have both been reduced in the 2011-2025 timeframe from levels predicted in the Base Kirkland Forecast. This reflects the fact that the model is a long-term fiscal model where the compounding effects of inflation rates can be quite large, and the shorter-term assumptions used in budgeting are not likely to be sustainable over time.

# DISCUSSION DRAFT

## PRELIMINARY FINDINGS

- Based on the current assumptions about baseline conditions, the following are the key findings to date (see more detailed findings in **Attachment A**):
  - The City has a long-term fiscal challenge regardless of whether the City chooses to pursue annexation of the PAA's or not.
  - The base fiscal challenge facing the City will not be made worse as a result of annexation and in most cases annexation makes enhances the City's ability to address the base challenge.
  - Even without the state sales tax credit, the impact of annexation on an *operating basis* (including equipment capital but excluding facilities and infrastructure) is equal to or less than the existing City operating fiscal imbalance. This is the result of several factors:
    - Costs of PAA services are lower than the 2005 analysis because of fewer FTE's
    - Revenues are higher primarily due to higher sales tax on construction
    - Growth in incremental revenues from the PAA's is able to keep up with cost inflation due to higher development activity, especially in the outer years.
  - The incremental cost of new facilities (City Hall, police and maintenance) that are necessary to support the larger post-annexation city are a substantial challenge, as they are significantly higher than those for a no annexation scenario.
    - The almost \$50 million incremental cost associated with annexation would likely require a "subsidy" from existing city to fund these improvements.
    - In cases where policies to address the base fiscal challenge result in a net positive benefit from annexation, funds would be available to offset some of the facility cost impacts.
  - The state sales tax credit is something of a "wild card" in this analysis, since the rules for which costs will be eligible have not been fully developed. If Kirkland is unable to qualify for all of the potential sales tax credit, it is unlikely the City would pursue annexation, since the PAAs simply do not have the ability to generate enough revenues to cover the total incremental costs, including the facilities to house the new staff required by annexation. If Kirkland is able to qualify for the maximum allowable credit, then annexation would appear to be fiscally viable on both an O&M basis, including the need to address related facilities.
  - Since the City cannot operate at a deficit, the Council will need to make appropriate policy adjustment to close the fiscal gap in the future ***with or without annexation***. Depending on which measures are selected, the economics of annexation will vary.
    - To assess the sensitivity of the basic PAA fiscal findings a series of alternative policy scenarios were developed using the framework shown in **Attachment B**.
    - In most cases, annexation lessens the severity of policies needed to address the baseline fiscal challenges. By increasing its size, Kirkland would effectively lengthen the

## DISCUSSION DRAFT

various policy levers it has to balance its budget, allowing the City to use a lighter touch with those levers. **Attachment C** provides a summary of several alternative “balanced budget” scenarios and the relative impact on the economics of annexation.

- There are likely to be more needs for infrastructure capital than there will be capital resources coming from the PAA’s. This situation is comparable to the base City situation and unless there are significant immediate capital infrastructure needs in the PAAs, then the long-term funding situation is unlikely to be dramatically different than the status quo. When capital infrastructure needs are more fully assessed as part of Phase II of the annexation analysis, it will be possible to more fully assess infrastructure capital portion of the impact of annexation.
  - While the model provides estimates of the revenues from the Real Estate Excise Tax and the capital portion of the Gas Tax, they are not included in operating revenues. Nor are they used to cover any of the equipment or facility related capital needs. Instead, they are held aside as available infrastructure capital funding pending the Phase II analysis of capital infrastructure needs in the PAAs.

### Facility Needs

- The City of Kirkland has facility needs regardless of the decision on annexation, though the annexation decision would dramatically increase those needs. An annexation scenario increases total facility needs by approximately \$50 million:
  - **Base City Facility Needs -- \$29.6 million**
    - City Hall expansion and public safety: \$25 million
    - Maintenance facility expansion: \$4.6 million
  - **City Needs with Annexation -- \$80.7 million**
    - City Hall expansion: \$28.9 million
    - New public safety and jail facilities: \$44.0 million
    - Maintenance facility expansion: \$7.8 million
- The 2005 annexation analysis included a \$1.6 million per year charge for facility impacts resulting from annexation based on the debt service for a 30-year bond to pay for specific improvements. The cost was determined based on a “fair share” of new facilities using the number of FTE’s to allocate costs. The analysis assumed a PAA facility cost allocation of \$ 25.6 million, comprised of the following shares for specific improvements:
  - City Hall expansion: \$6.6 million
  - Maintenance center expansion: \$3.2 million
  - New public safety building: \$15.8 million
- The \$50 million estimate likely overstates the “true incremental cost” for two reasons:
  - The property owners in the PAA’s will, upon annexation, contribute to existing voted-G.O. debt. This will reduce existing City taxpayer burden. From an equity perspective this can be

## DISCUSSION DRAFT

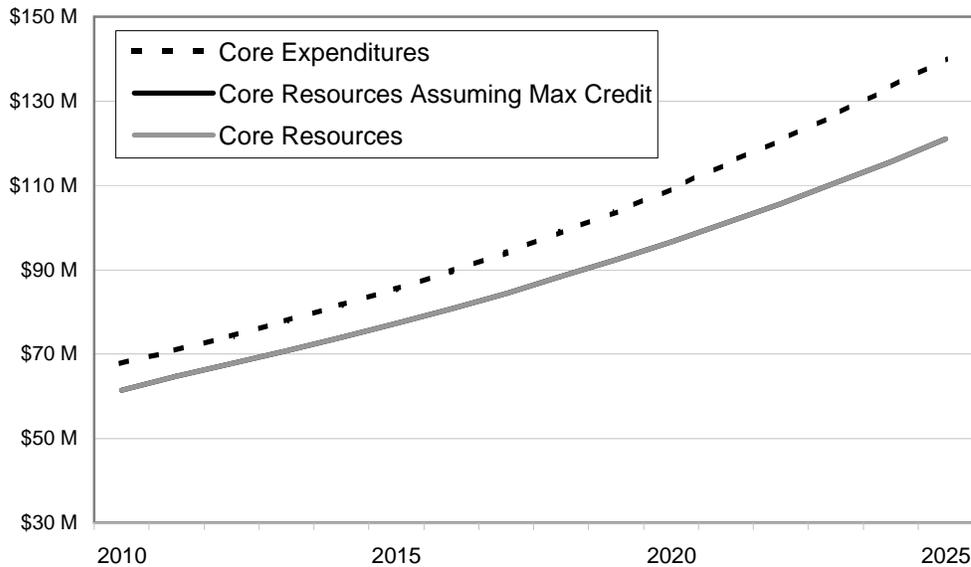
considered an offset against the incremental cost of facilities due to annexation. The present value of these taxpayer savings is approximately \$2.2 million.

- Regardless of the annexation decision, the City will need to address the base City facility needs. For the purposes of analysis, one could assume that this base need would be funded through a new voted G.O. bond. If this were done, the millage rate to repay these bonds could be applied to the PAA annexation areas to develop a credit that would reflect a balanced base City situation. This credit would be worth approximately \$10.5 million.
- Adjusting the incremental estimate to account for these credits results in a PAA facility cost impact of \$38 million. As a result, the annual facility cost impacts could range from a low of \$1.6 million per year for a “fair share” approach to a high of \$2.7 million per year for an incremental approach.
- There are a number of issues that will influence how facility impacts might be viewed, in particular the eligibility of these costs for sales tax credit and how one interprets potential changes in annexation economics resulting from policy changes to address base fiscal challenges.

**DISCUSSION DRAFT**

**ATTACHMENT A: BASELINE SCENARIOS**

**Scenario: Baseline No Annexation**

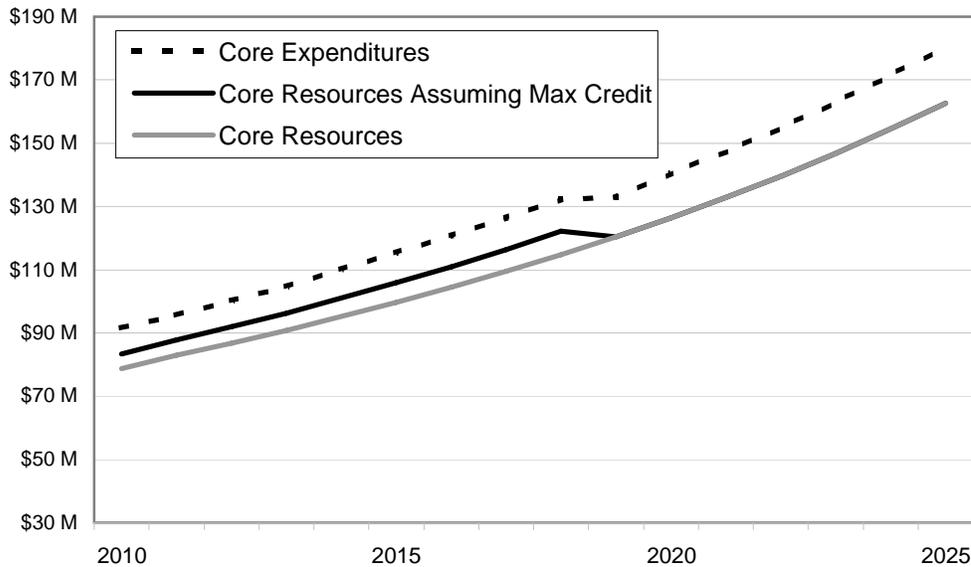


<b>Current Kirkland</b>	<b>2010</b>	<b>2015</b>	<b>2020</b>	<b>2025</b>
Core Expenditures (000's)	65,376	83,153	106,792	137,791
Facility Debt Service (000's)	2,295	2,295	2,295	2,295
<b>Subtotal Expenditures</b>	<b>67,671</b>	<b>85,448</b>	<b>109,087</b>	<b>140,085</b>
Core Resources (000's)	61,446	77,250	96,545	121,009
State Sales Tax Credit ('000's)	0	0	0	0
<b>Subtotal Revenues</b>	<b>61,446</b>	<b>77,250</b>	<b>96,545</b>	<b>121,009</b>
<b>Net Resources (000's)</b>	<b>(6,225)</b>	<b>(8,198)</b>	<b>(12,543)</b>	<b>(19,076)</b>
<b>Deficit as % of Expenditures</b>	<b>-10%</b>	<b>-10%</b>	<b>-12%</b>	<b>-14%</b>

<b>Increment from PAAs</b>	<b>2010</b>	<b>2015</b>	<b>2020</b>	<b>2025</b>
Core Expenditures (000's)	0	0	0	0
Facility Debt Service (000's)	0	0	0	0
<b>Subtotal Expenditures</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
Core Resources (000's)	0	0	0	0
State Sales Tax Credit ('000's)	0	0	0	0
<b>Subtotal Revenues</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Net Resources (000's)</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Deficit as % of Expenditures</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>

<b>Entire City</b>	<b>2010</b>	<b>2015</b>	<b>2020</b>	<b>2025</b>
Core Expenditures (000's)	65,376	83,153	106,792	137,791
Facility Debt Service (000's)	2,295	2,295	2,295	2,295
<b>Subtotal Expenditures</b>	<b>67,671</b>	<b>85,448</b>	<b>109,087</b>	<b>140,085</b>
Core Resources (000's)	61,446	77,250	96,545	121,009
State Sales Tax Credit ('000's)	0	0	0	0
<b>Subtotal Revenues</b>	<b>61,446</b>	<b>77,250</b>	<b>96,545</b>	<b>121,009</b>
<b>Net Resources (000's)</b>	<b>(6,225)</b>	<b>(8,198)</b>	<b>(12,543)</b>	<b>(19,076)</b>
<b>Deficit as % of Core Expenditures</b>	<b>-10%</b>	<b>-10%</b>	<b>-12%</b>	<b>-14%</b>

**Scenario: Baseline With Annexation**



<b>Current Kirkland</b>	<b>2010</b>	<b>2015</b>	<b>2020</b>	<b>2025</b>
Core Expenditures (000's)	65,368	83,387	106,972	137,783
Facility Debt Service (000's)	2,297	2,297	2,278	2,236
<b>Subtotal Expenditures</b>	<b>67,664</b>	<b>85,685</b>	<b>109,249</b>	<b>140,019</b>
Core Resources (000's)	61,802	77,619	96,990	121,565
State Sales Tax Credit ('000's)	0	0	0	0
<b>Subtotal Revenues</b>	<b>61,802</b>	<b>77,619</b>	<b>96,990</b>	<b>121,565</b>
<b>Net Resources (000's)</b>	<b>(5,863)</b>	<b>(8,065)</b>	<b>(12,259)</b>	<b>(18,454)</b>
<b>Deficit as % of Expenditures</b>	<b>-9%</b>	<b>-10%</b>	<b>-11%</b>	<b>-13%</b>

<b>Increment from PAAs</b>	<b>2010</b>	<b>2015</b>	<b>2020</b>	<b>2025</b>
Core Expenditures (000's)	17,107	22,716	30,182	39,235
Facility Debt Service (000's)	6,887	6,887	1,034	1,076
<b>Subtotal Expenditures</b>	<b>23,994</b>	<b>29,603</b>	<b>31,216</b>	<b>40,311</b>
Core Resources (000's)	16,983	22,060	29,487	41,023
State Sales Tax Credit ('000's)	4,468	6,166	0	0
<b>Subtotal Revenues</b>	<b>21,450</b>	<b>28,226</b>	<b>29,487</b>	<b>41,023</b>
<b>Net Resources (000's)</b>	<b>(2,544)</b>	<b>(1,377)</b>	<b>(1,729)</b>	<b>712</b>
<b>Deficit as % of Expenditures</b>	<b>-15%</b>	<b>-6%</b>	<b>-6%</b>	<b>2%</b>

<b>Entire City</b>	<b>2010</b>	<b>2015</b>	<b>2020</b>	<b>2025</b>
Core Expenditures (000's)	82,475	106,104	137,154	177,018
Facility Debt Service (000's)	9,184	9,184	3,312	3,312
<b>Subtotal Expenditures</b>	<b>91,658</b>	<b>115,287</b>	<b>140,466</b>	<b>180,330</b>
Core Resources (000's)	78,784	99,679	126,477	162,588
State Sales Tax Credit ('000's)	4,468	6,166	0	0
<b>Subtotal Revenues</b>	<b>83,252</b>	<b>105,845</b>	<b>126,477</b>	<b>162,588</b>
<b>Net Resources (000's)</b>	<b>(8,406)</b>	<b>(9,443)</b>	<b>(13,989)</b>	<b>(17,741)</b>
<b>Deficit as % of Core Expenditures</b>	<b>-10%</b>	<b>-9%</b>	<b>-10%</b>	<b>-10%</b>

**DISCUSSION DRAFT**

**ATTACHMENT B:**  
**FRAMEWORK FOR EVALUATING ALTERNATIVE POLICY  
SCENARIOS**

# DISCUSSION DRAFT

## ANNEXATION FISCAL POLICY

### Tools and Scenarios

#### Tools

1. Development-related revenue
  - new construction property tax
  - sales tax
2. Tax policy revenue
  - property tax
  - utility tax
  - business tax
3. Expenditure management
  - level of service – staffing levels
  - efficiency/productivity
  - compensation

#### Scenario Options

Varying emphasis on specific tools

High (H)

Medium (M)

Low (L)

Options (as examples)

Tools	Development	Tax	Expenditure
Option 1	M	L	H
2	L	H	M
3	M	M	M
4	H	L	L

Fill in numbers for the above options – show math and results

**DISCUSSION DRAFT**

**ATTACHMENT C:**  
**SENSITIVITY ANALYSIS OF ALTERNATIVE  
FISCAL POLICY OPTIONS ON THE  
ECONOMICS OF ANNEXATION**

	Tools			Long-Term Fiscal Outlook		
	Tax Policies	Expenditure Management Policies	Development	Fiscal Analysis Findings		Net Impact of Annexation
<b>Baseline No Annexation</b>	No change in tax policy 1% property tax limit	Hiring rate reflects current policies	Baseline	<b>O&amp;M Impacts</b>  Deficits in all years Deficit grows to \$15.5M by 2025 Def. as % of exp.: 3% to 14% Cost growth: 5.2%/yr Revenue growth: 4.5%/yr	<b>Facilities</b>  \$30 M unfunded need Annual D/S: \$2.3 M	<b>Surplus/Deficit in 2025</b>  Current Kirkland: (\$17.9M) PAA: 0.0M Total City: (17.9M)
<b>Annexation Scenarios</b>						
<b>Baseline With Annexation</b>	Same as above	Same as above	City: Baseline PAA: Baseline	<b>O&amp;M Impacts</b>  Citywide deficit marginally reduced PAA deficit starts at 1% and ends balanced Cost growth: 5.7%/yr Revenue growth: 6.0%/yr	<b>Facilities</b>  \$80 M need citywide \$38 M impact from annexation 30-year bond -- \$3.3M/yr (all city) 10-year bond -- \$5.9M/yr (PAA impact)	<b>Surplus/Deficit in 2025</b>  Current Kirkland: (\$17.3M) PAA: 0.6M Total City: (16.7M)
<b>Balanced Scenarios (closes fiscal gap to within 1% of Expenditures in 2020)</b>						
<b>Property-Tax Focused (75% of deficit)</b>	<b>High</b>  Same as baseline plus annual levy increases greater than 1%	<b>Medium</b>  Hire 13% fewer FTEs than baseline	<b>Medium</b>  City: Baseline PAA: Baseline	Balancing with primarily property tax results in net gains from the annexation areas which help offset base City structural deficit issues. Without annexation, tax rates would need to be higher to achieve the same ends.		If the City qualifies for maximum state sales tax credit, overall annexation impact is neutral to small positive.
<b>Business-Tax Focused (75% of deficit)</b>	<b>High</b>  Same as baseline plus a new business tax	<b>Medium</b>  Hire 13% fewer FTEs than baseline	<b>Medium</b>  City: Baseline PAA: Baseline	This scenario is similar to the property tax based scenario except the net contribution from annexation is smaller, since the tax is based on businesses only.		If the City qualifies for maximum state sales tax credit, overall annexation impact is neutral to small positive.
<b>No growth-related hiring, balance with property tax</b>	<b>Medium</b>  Same as baseline plus annual levy increases greater than 1% but less than High scenario	<b>High</b>  Hire 25% fewer FTEs than baseline	<b>Medium</b>  City: Baseline PAA: Baseline	The impact of much lower hiring reduces the need for new taxes, though at a likely cost in terms of level-of-service. The impact of annexation is even more positive as the rate of growth in the annexation areas is somewhat higher than current Kirkland.		If the City qualifies for maximum state sales tax credit, overall annexation impact is neutral to small positive.
<b>Low Development PAAs, Balance With Property-Tax</b>	<b>High</b>  Same as baseline plus annual levy increases greater than 1%	<b>Medium</b>  Hire 13% fewer FTEs than baseline	<b>Low</b>  City: Baseline PAA: Low	The impact of lower PAA development is higher tax rates and a lower FTE's demand overall, though the PAA fiscal impact remains positive and the taxes lower than a no annexation scenario.		If the City qualifies for maximum state sales tax credit, overall annexation impact is neutral to small positive.
<b>High Development Current City, Balance With Property-Tax</b>	<b>Low</b>  Same as baseline plus annual levy increases greater than 1% for first six years only	<b>Low</b>  Hire 3% fewer FTEs than baseline	<b>High</b>  City: High PAA: Baseline	The impact of high development in current Kirkland is a much lower tax need and the ability to fund closer to the full FTE demand. The impact of annexation remains positive, but to a much lower degree, since most of the funding gap is solved by development in current Kirkland.		If the City qualifies for maximum state sales tax credit, overall annexation impact likely to be neutral.