

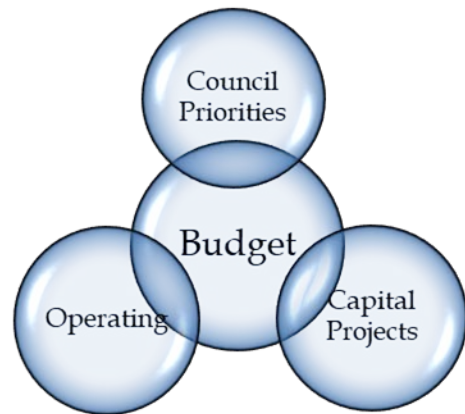


*Fiscal Year 2021-2022 Manager's Budget Transmittal Letter
Executive Summary*

Mayor, Vice-Mayor and Council:

I am pleased to present the City of Flagstaff Fiscal Year 2021-2022 budget totaling \$388.8 million for your consideration. While we are required to prepare a budget annually per our City Charter, the annual budget is much greater than an articulation of the City's financial resources. It is a comprehensive snapshot of the current City organization, informed by past trends and influences, while at the same time looking to emerging priorities and visions for the future. The budget formulation is an integration of policy and administration, bringing Council and staff together over numerous meetings and retreats that span several months.

In a very simplified and conventional description, the budget is comprised of three significant components – Council priorities, operating services and programs, and capital projects, as depicted in the model:



Priority Based Budgeting

In 2019, the City embarked upon a new budgeting concept that will be based upon priorities to guide resource allocation. Priority Based Budgeting (PBB) is a multi-year process and its implementation over time will significantly change conventional budgeting methodology. The City Council and staff members collaboratively created a map of the City's priorities, staff created an inventory of programs, assigned costs, and scored them against the City's priorities.

In early 2020, the Budget Team worked with organizational divisions to incorporate PBB data into the City's increased funding request process by asking divisions to link their requests to specific City priorities. This process allowed for a new lens that Council and the Budget Team used to analyze budgetary requests and served as a first step in incorporating PBB into the City's budgeting process. As the budget process for the future fiscal years ensues, more emphasis will be placed upon costing and scoring the entirety of City programs to align with the stated priorities as the multi-year implementation continues.





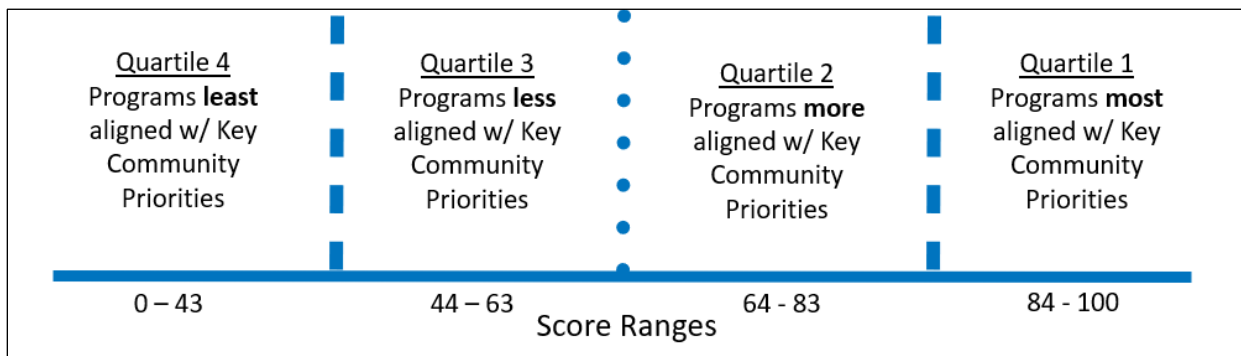
The Key Community Priorities are provided below. Public vetting of these and other emerging priorities will continue to occur in the early stages of the budget process, likely on a bi-annual basis.



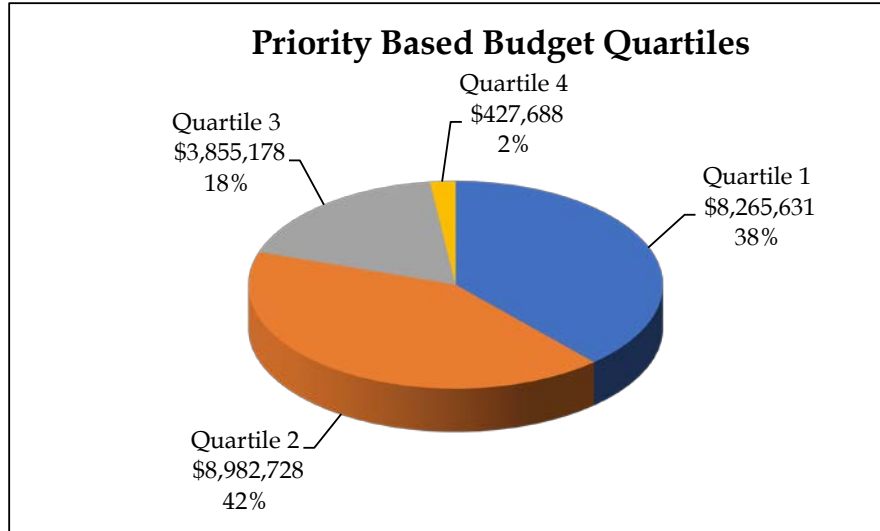
Scoring

After the creation of an overview of services offered by the City (“program inventory”), line-item costs are allocated to relevant programs and each program is scored based on how well it aligns with and supports the City’s seven Key Community Priorities as depicted above.

After weighting program scores and normalizing them out of 100, four quartiles are created based on average scores. Programs in Quartile 1 are therefore the highest scoring and most strongly align with and support Flagstaff’s Key Community Priorities. Programs in Quartile 4, conversely, have scored relatively low and are least aligned with the Priorities. Viewing programs in this way allows for data-based resource allocation decisions and opens the door to discovering partnerships, efficiencies, and trade-offs to use funds in the most effective way possible.



The FY 2021-2022 budget includes the following proposed expenditures by Priority Based Budgeting quadrants, totaling over \$21.5 million. It is notable, and certainly expected, that the highest two quartiles as ranked align with the highest percentages of proposed expenditures:



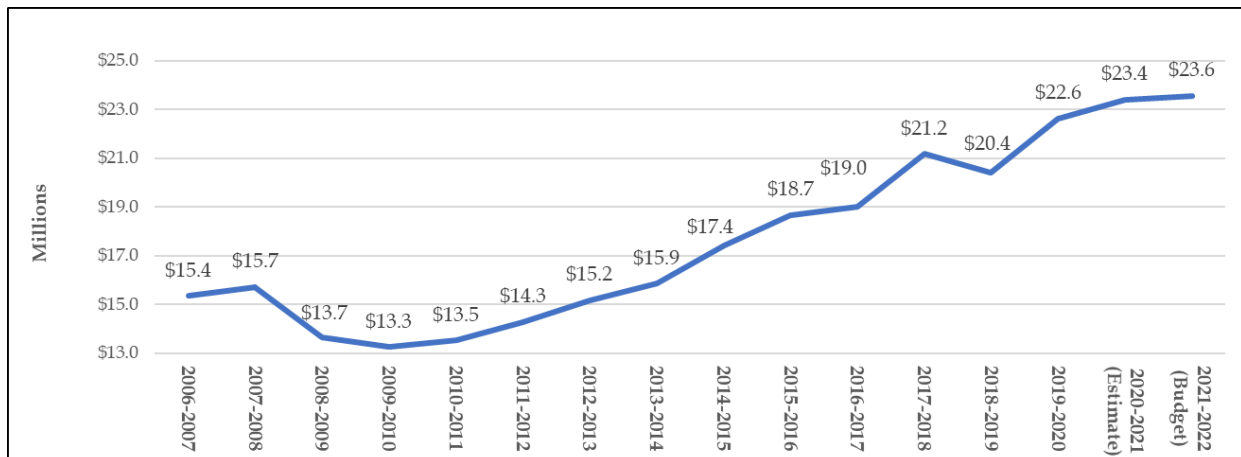
Economic Condition

The Flagstaff economy can perhaps best be measured by four indicators - sales tax, Bed, Board and Beverage (BBB) tax, state shared income tax and the construction industry. There are three types of sales taxes in Flagstaff. The first is a 1% tax on all general sales except food. Revenues from these sales support General Fund operations.

As a general comment, local economic conditions, based upon these indicators, have shown several years of steady improvement since the “Great Recession”, but as evidenced in the below graph, the City started to see a decline of sales tax revenues in FY 2018-2019. This may be attributable to different factors, including more online auto sales, a fluctuating construction industry and the preemptive collection of sales taxes by the State, replacing that of local collection in 2017. In 2019, the Arizona Auditor General determined that the Department of Revenue was auditing significantly fewer businesses and not consistently monitoring required business licenses. The City has recently budgeted for increased staffing to help backfill these reduced services, in hope to bring about better compliance.¹

The forecasted sales tax revenues for FY 2021-2022 are conservative as the economy recovers from the COVID-19 pandemic. The recovery is indeed underway, as the City has implemented strident measures throughout the economic downturn through its Recession Plan, addressed below.

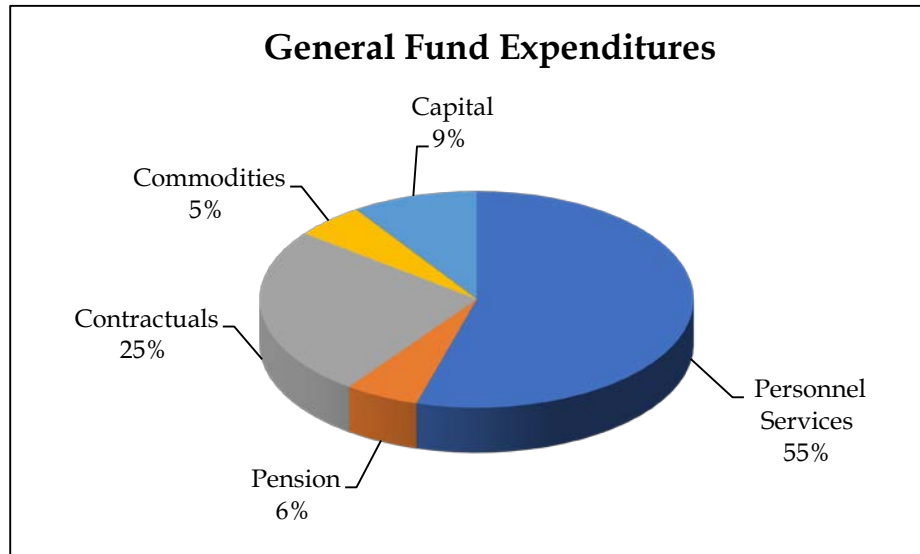
General Fund Sales Tax



¹ In 2019, the Arizona Auditor General determined that the Department of Revenue was auditing significantly fewer businesses and not consistently monitoring required business licenses.



In terms of General Fund expenditures, the below pie chart illustrates the various components, with labor and pension costs constituting the larger expenditures.



Economic Downturn

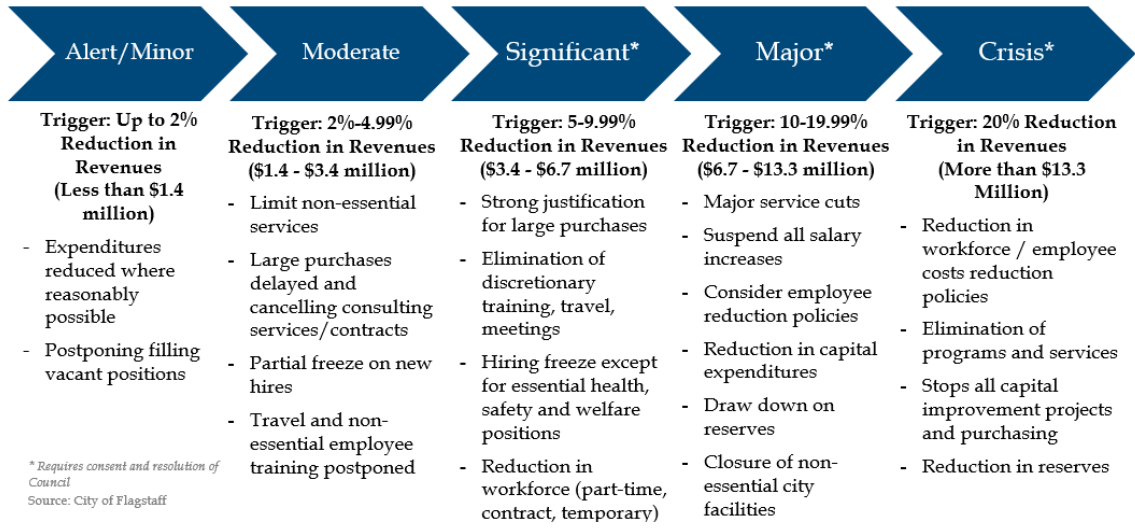
Largely attributable to the COVID-19 pandemic, an economic downturn commenced in March of 2020. The resulting stay-at-home directives that were implemented by Emergency Declarations at both the local and state level remained in place for remainder of 2020 and lingered into 2021. As of the time of this transmittal letter, COVID-19 restrictions are still in place but have been greatly lessened as vaccinations increase and transmission is reduced. The City remains under Phase III of its Re-Entry Plan, which translates into some restricted hours of operation at City facilities, capacity limitations and the emphasis to employees to work remotely when possible.

Revenues for FY 2019-2020 were approximately 1% below the original budget. FY 2020-2021 was estimated to continue to see declines in many of the City's major revenue categories. In forecasting revenue declines for FY 2020-2021, a methodology was employed that averaged three different economic recovery scenarios, which yielded a projected decline for the fiscal year.

Recession Plan

As noted in last year's transmittal letter, the City staff formulated a Recession Plan to help guide the City through economic downturns. This endeavor commenced in the Fall of 2019, and the resulting Recession Plan was adopted and implemented in April 2020. Fortuitously, the plan was in effect at the time of the economic downturn resulting from the COVID-19 pandemic.

The Plan is based upon five stages. Each stage represents an incremental severity in declining revenues – the first stage is relatively minor and is triggered by a decrease of up to 2%, while the fifth stage is quite severe and triggered by a decrease of greater than 20%. During the Great Recession, as one basis of measurement, the City of Flagstaff experienced a revenue decline of approximately 13%. Had the Recession Plan been in place, the fourth stage (major) would have been triggered. As summarized in the table, each stage within the plan has a series of increasingly stringent action measures to be pursued by the City to offset the revenue declines.



In April 2020, the City was in the second stage (moderate). This correlated with such measures as a recruitment freeze, cessation of unnecessary travel and training, and some delay of large purchases. In June 2020, the City Council agreed to the recommendation to advance to the third stage (significant). This was premised upon expected revenue declines in FY 2020-2021 between 5-10%, as noted in the Economic Condition section above.

The Recession Plan is nimble and can be implemented with quick action, proving to be a preferable approach than conventional budget adjustments and revised revenue projections. Scaling back the budget to meet anticipated revenue declines would necessarily equate to greatly reduced expenditures and quite possibly the implementation of drastic actions such as labor reductions. This in turn could not be reversed should the economic landscape improve mid-fiscal year. Utilizing the Recession Plan allowed for quick implementation of expenditure curtailment as needed. Conversely, should the economic landscape improve during the fiscal year, the Plan would allow for increased expenditures as budgeted. Such was the case in April 2021, when implementation of the Plan was scaled back to the Moderate Phase, allowing for some easing of the austere measures then in place. By June 2021, the City ascended to the Minor Phase.

PSPRS Unfunded Liability

The transmittal letter of July 2020 provided a detailed narrative of the City's endeavor to finance, entirely, the unfunded liability of the public safety retirement pension. The Public Safety Personnel Retirement System (PSPRS) provides a statewide retirement system for public safety personnel, overseen by a board of trustees that oversee the system's policies, operations, and investments. Funding for PSPRS comes from employee contributions, employer contributions and net investment income. In 2019, the debt was approximately \$112 million.

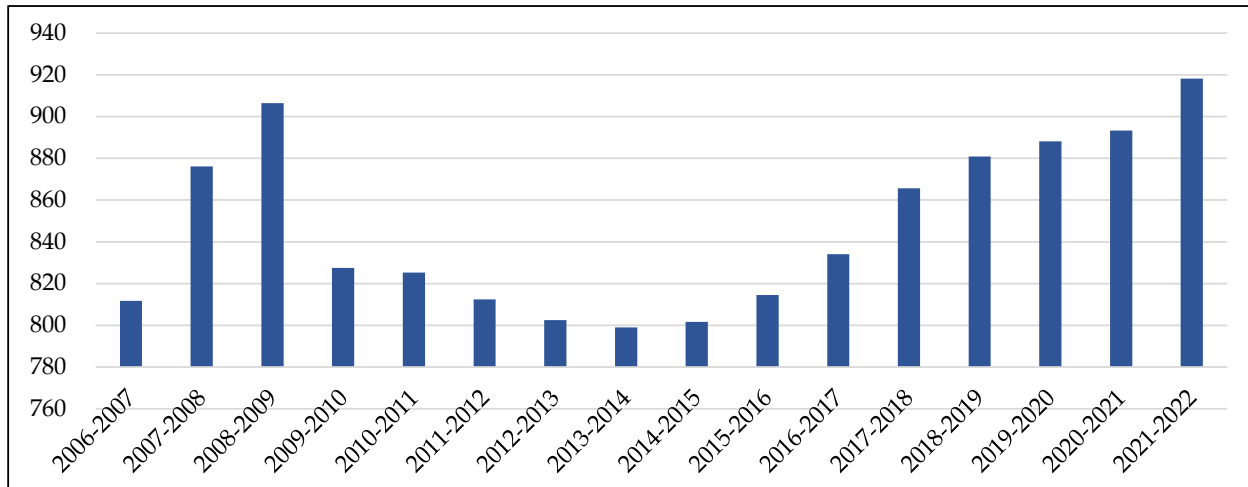
Some jurisdictions have successfully accomplished this to reach a higher funding ratio, enabling the realization of more investment earnings. The City safety pension plan accrues at an assumed rate of 7.30%, well above what the City might pay on refinancing the debt. In July 2020, the City did in fact close on the refinance, consisting of issuance of Certificates of Participation, at an aggregate interest rate of 2.68%. The difference between the interest earnings and the new debt service (7.30% - 2.68%) equates to substantial earnings for the City over time. Additionally, the fixed debt service now constitutes a manageable component of the City's General Fund expenditures. The amortization schedule for this refinanced debt was reduced by eight years (payoff in 2040 rather than 2048).

With annual fixed debt service payments significantly reduced, the shortened amortization schedule, and the increased earnings on the investment now paid in full, the City realized a present net value savings of approximately \$76 million.



Organization

The following depicts the size of the City organization in full-time equivalents (FTE), prior to and after the Great Recession. As shown, the organization has remained relatively flat in terms of employee growth in recent years. With the City's emergence from the recent economic downturn of FY 2020-2021, the City is now able to address staffing needs. As budgeted, the City will now see its FTE count increase to a level above what existed prior to the Great Recession.



In terms of the reporting structure of the organization, the City Council has three direct appointments - City Attorney, Presiding Magistrate, and the City Manager. The City Manager, pursuant to the City Charter, is responsible for the administration and oversight of the organization.

Consistent with management strategies to see the organization better reflect community needs through broadened leadership and enhanced collaboration, several restructuring measures have been implemented over the past two years.²

Employee Retention and Recruitment

Employee retention remains a growing concern for the organization, as compensation continues to be a concern with our employees. Merit-based increases have been sporadic through the years, and as a general comment, our employee compensation packages may be lagging market rates.

Achieving market-based pay is a continued Council goal and is supported by our Employee Advisory Committee (EAC). A comprehensive compensation study including pay structure, benchmark market wage analysis and compensation policies was commissioned at the end of calendar year 2019. The work began in the Spring of 2020 with an analysis of the City's current information. Over the course of the next year, revised pay structures were recommended and developed. Benchmark market data was collected by the consultant for 134 City positions and City pay ranges modified as identified to improve our competitive position for recruitment and retention. This work resulted in the elimination of both the broadband and multi-skilled worker pay systems and adoption of one regular pay plan for all positions except public safety personnel and multi-skilled workers within Water Services³. Compression adjustment methodologies were also identified, budgeted, and implemented to address salary compaction whereby longer-tenured employees were compacted into the lowest quadrants of the pay ranges.

² The restructures include the creation of the new Public Affairs program under the City Manager; the elevation and placement of the Sustainability section under the City Manager; the placement of the City Clerks program under the City Manager; the placement of the Economic Vitality division under the City Manager; the placement of the Water Services division under the City Manager; the elevation of the Information Technology section to division status; and the elevation of the City Engineering and Capital Improvements section to division status.

³ Competitive step pay plans were established for public safety personnel and multi-skilled employees.



Consistent with this simplified and updated pay structure, a 3% annual merit structure was reinstated in FY 2021-2022 and within the five-year plans for future budgets. Those employees under competitive step plans will have merit increases established for each step, allowing for faster ascension through their respective pay ranges.

These modified compensation strategies will improve our employee retention and overall morale. The 2019 Employee Survey, which saw participation by 461 employees, revealed that compensation is now the lowest ranking factor for the employees. This represented a drop by four percentage points from the previous survey in 2017.

With compensation being properly addressed, the City will enable better retention of its staff. An emerging issue for the City organization, however, is that of recruitment of new employees. As of the time of this transmittal letter, there are approximately 129 recruitments in some level of process. The vacancy rate throughout the City organization has become high, as competition in the recruitment market has greatly increased for employers as a general comment.

Creative solutions are being implemented to address the staffing shortages, including enhanced recruitment efforts through videos and marketing, increased cross-training, organizational restructuring as noted above and increased compensation for staffing for exigent services such as 911 emergency dispatch.

Miscellaneous Updates

COVID-19

The City of Flagstaff was the first local government in Arizona to issue a state of emergency (March 17, 2020) and impose restrictions, limiting dining at restaurants and closing most gathering places to fight the spread of the new coronavirus. The action was followed by many other local governments in Arizona. City facilities largely remain closed at the beginning of FY 2020-2021, with many operations being performed remotely.

The City organization has generated a detailed Re-Entry Plan that is predicated upon four phases. With some success through the vaccination program in early 2021, the City was able to reach Phase 3 of the Re-Entry Plan which allows for limited operation of City facilities with some capacity restrictions. The City is currently in Phase 3 and will likely remain in this status for some time, with the current surge of the Delta variant in our region and throughout the U.S.

Under Phase 3, the City Council has returned to in person meetings in the Council Chambers, but subject to a newly enhanced hybrid meeting platform that enables virtual attendance. Many organizational meetings and functions are still occurring remotely currently.

Pulliam Airport

The Flagstaff Pulliam Airport experienced some decline in activity during the COVID-19 pandemic but is now experiencing rapid increases in enplanements and overall Airport activity. Efforts continue to see the Airport function as an enterprise fund with self-sustained revenues over time. This effort was greatly advanced through CARES funding as approved during both the previous and current fiscal years in the aggregate of approximately \$23 million. These funds will be used to upgrade hangars, provide improvements to the terminal and related facilities, and address needed infrastructure.

The new parking lot facility (350 surface spaces) is now being constructed with completion anticipated by December 2021 at a project cost of approximately \$4 million. This will enable the utilization of two parking lots, premium and economy, both of which will be subject to a paid parking program to be implemented in January 2022. Revenues from this program will help in the pursuit of Airport enterprise status.



The City Council has also approved the initial planning steps to see the development and leasing of the vacant 31.45-acre parcel that adjoins the Airport facility as a long-term revenue generator.

Flagstaff Watershed Protection

The watershed protection and wildfire risk reduction programs were established in 1997 by City Council. The program is currently funded through a sustainable, ongoing funding source as approved in the June 2020 utility fee structure. That fee structure now includes two significant components.

First, the Environment Management Fee has been revised to a use-based allocation whereby increased revenues are collected upon increased water consumption. The second component is the institution of a Water Resource and Infrastructure Protection fee. The revenues from this fee structure will sustain the continued function and staffing of the program, although future funding for project-based capital will still be needed.

Rio de Flag Project

The Rio de Flag Flood Control Project team is currently working through final design coordination to complete the utility relocation plans, stormwater side drains and the upper reach composite channel. Real estate documents are also being revised to allow for property appraisals and acquisitions. Approved design plans and full real estate acquisitions are due to be complete by April 2023.

One important component of the project approval process is the execution of a construction and maintenance agreement between the City and the Burlington, Northern and Santa Fee (BNSF) railway, which includes plan approval, real estate acquisition and mitigation measures. Although the construction funding is in place from the Army Corps (\$52 million appropriation in FY 2019-2020) and the City (capital stormwater fees), the cost of the mitigation measures that BNSF is requiring is outside of the Corps' current project authorization and too costly for the City to bear on its own. To fund these measures, the group has united to back the City in seeking federal grant funding. A 2021 Rebuilding American Infrastructure with Sustainability and Equity (RAISE) planning grant application was submitted July 2021 to fund project coordination, design, and National Environmental Policy Act (NEPA) clearances of the Flagstaff local projects (including the Rio de Flag) and the required BNSF mitigation in order to prepare for a full construction grant application in 2023. BNSF has committed to contributing \$100 thousand for the local match.

Our path forward for design completion, real estate acquisition and funding procurement is supported by our partner agencies. Future award of a full construction grant in 2023 would provide the resources to satisfy the BNSF mitigation measures and get the project construction underway.

An aerial photo that shows the portion of the Rio de Flag project (shown in blue) that integrates with the BNSF railway, with related projects that concern the railway, is shown below.



Transportation

The FY 2021-2022 budget includes several important transportation projects. Design work will continue on the Lone Tree Overpass (also shown in the above aerial), a City capital project that will provide a grade-separated bridge crossing of the BNSF railway corridor and the Rio de Flag. This new segment of Lone Tree Road will begin at Butler Avenue and end at Route 66 to the north. Project funding in the amount of \$73 million is provided by a 2018 approved transportation bond. Design and construction completion are anticipated by 2026.

In partnership with the Arizona Department of Transportation (ADOT), design work will begin on a new round-a-about intersection at Fourth Street and Cedar Avenue/Lockett Road. The project is funded with a \$1.9 million Federal Highway Safety Improvement Program (HSIP) grant and approximately \$60,000 in City transportation funds.

The bridge widening project on Fourth Street over I-40 was completed during 2020. The multimillion-dollar project was the result of a successful partnership between the City and ADOT. Beyond the bridge work over I-40, improvements will continue on Fourth Street to Butler Avenue with the eventual reconstruction of the Fourth Street and Butler intersection.

Courthouse

The City of Flagstaff Municipal Court Facility was substantially completed in October 2020. The three-story, 40,000 square-foot facility provides four court rooms, one hearing room, a jury assembly/training room, customer service area and offices for the City Court and City Prosecutor's operations. Total project cost is \$19.9 million, which was provided by user fees and a voter-approved bond proposition in 2016.



There are many other important projects and programs to note, and those reference above are by no means an exhaustive list, but rather indicative of some of the more significant endeavors in terms of budgetary impact.

On September 30, 2021, the City Council will be considering additional capital improvement needs related to stormwater infrastructure, wastewater plant upgrades and bike lane infrastructure. Infrastructure needs and capital projects comprise a significant component of the budget process, as noted in the diagram that is depicted on the opening page of this transmittal letter. Thank you.

Respectfully Submitted,

Greg Clifton
City Manager