



MEMORANDUM

DATE: December 3, 2010

TO: Mayor Kris Valstad and City Council Members
City Employees
Members of the public

FROM: Charlie Long, Interim City Manager

SUBJECT: City Manager's Weekly Report

Overview of Report: The following topics are included in this week's update:

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City/Agency financial condition: We have completed an initial assessment of the City's financial condition and have found significant financial challenges that will require significant effort by the Council, city workers and the community to address.

To explain the nature of our financial challenges, I first need to describe the relationship between our redevelopment revenues and city revenues.

The redevelopment agency receives property taxes from the increased value in the redevelopment project area called "tax increment revenue," because it is the property taxes on the incremental assessed value in the redevelopment project area since it was established. In 2007/08, the total tax increment revenue was about \$13.5 million. For this

year, the total tax increment revenue has dropped to \$10.5 million because property values have been dramatically reassessed lower as a result of the Great Recession. The \$3 million reduction in tax increment revenue that resulted from the Great Recession has dramatic impacts on the financial health of both the City and Redevelopment Agency.

Because the tax increment takes property taxes away from other overlying public agencies, state law requires that the agency give a portion of its tax increment revenues to other agencies, the county, special districts, etc. After these, “pass-throughs” are paid, the agency has a “net tax increment” to use for accomplishing its mission. For Hercules, the pass-throughs are about 15% of the total tax increment.

After the agency gets its net tax increment, state law requires that the agency divide into two parts, a 20% “housing set aside” and the remainder is “unrestricted.” The redevelopment agency can then legally use tax increment for only one purpose, to repay debt.

The agency incurs many kinds of debt: the highest priority is to pay principal and interest on its bonds. Since 2005, the Hercules Redevelopment Agency has issued about \$138 million in bonds (both for housing and for unrestricted purposes) and pays annual debt service of about \$10 million.

In 2007/08, the redevelopment agency had a \$2 million surplus compared to bond service and was able to pay that surplus to the city to reimburse administration cost and to reimburse advances that the city made in the past toward redevelopment projects. This reimbursement went to the city’s general fund to pay for municipal services such as police, public works, and other municipal services.

In addition to paying bond service, the Hercules Redevelopment Agency has incurred a debt to the Catellus development company to reimburse it for infrastructure that it installed associated with development at the old refinery site. The Agency had a dispute with Catellus on how much it owed on this debt and the lawsuit was settled this year, resulting in a legal agreement that the Agency must pay Catellus 75% of the tax increment from the old Project Area 2 (one of three sub-areas that are part of the redevelopment project area). This legal obligation results in an annual cost to the Agency of about \$1.8 million per year.

So after the \$10 million in annual bond payments and the \$1.8 million in payments to Catellus, we face two major problems:

- First, it appears that the Agency does not have enough tax increment to pay its obligations for bond payments and the Catellus payment; and,
- Second, there is no surplus to make the reimbursement payments to the city for administration costs and for prior advances that the city made to redevelopment.

The result of the second problem is that the city's general fund revenues are insufficient to pay its costs for municipal services.

There is more. While a major part of the financial problems that the city and agency face today result from the drop in property values and tax increment revenues in the redevelopment project areas, many problems also result from faulty budgeting and lack of appropriate internal controls. There are three major components to these faulty budget practices and lack of internal controls:

1. *The budget failed to alert policymakers to the fact that redevelopment revenues are insufficient to pay bond service and the Catellus payment costs:* The City and Redevelopment Agency Adopted Budget estimates the amount of tax increment revenues and does compare it to bond payments. It fails, however to highlight the fact that tax increment revenues are insufficient to pay bond payments. It also fails to show the Catellus payments as an obligation to pay out of tax increment, since it was assumed that it would be paid out of bond proceeds. ***In other word, policymakers were unaware that we had this problem.***
2. *City General Fund Revenues were misstated and are actually significantly less than shown in the 2010-11 budget:* The City's Adopted Budget estimates General Fund Revenues of \$25,642,190. This estimate includes about \$12 million of revenues that were not actual revenues. First, the estimate included about \$7.0 million of a bank loan to fund the Palm Center project. It also included \$2 million in "revenue" that was actually the use of reserves to fund an estimated deficit. And, third, it included \$3 million in revenues from the redevelopment agency to reimburse administration costs and previous city advances. As we noted above, the Redevelopment Agency has less revenue than it needs to pay its bonds and Catellus payment obligations, so it has no revenue available to reimburse the City the estimated \$3 million.
3. *The city has been making payments from the redevelopment agency in spite of it not having enough money, even though the fund balance in the redevelopment agency is negative:* Attached is a "fund balance report" for all the city's funds for September 2010 showing \$27.8 million in cash. Unfortunately, the city's practice has been to pool the cash from all its funds (there are approximately 60 funds)

into one pool and to continue to make payments from funds that are in deficit to be implicitly funded from the surpluses in other funds. I've attached a copy of [the cash fund balances as of September 30, 2010](#). Note that the four redevelopment agency funds have a cumulative deficit in excess of \$14 million. In other words, the redevelopment agency has been implicitly borrowing from the other funds as payments out are made *even though the redevelopment agency funds are in deficit*.

These three items are the major items we discovered in our financial review, but they are not the only ones. We uncovered several other items that need further investigation, which include:

1. The budget fails to show a 5 year projection of operating revenues and expenditures which would have highlighted the drop in redevelopment revenues and the deficit situation. We are correcting this deficiency by developing a budget model that will be used in the future for budget deliberations.
2. Comprehensive presentations of the revenue and expenses (including allocated debt service) of our two utilities (the Hercules Municipal Utility and Wastewater Utility) are not detailed anywhere and we have spent considerable effort constructing these. Until we do this, there is no information available to policymakers or the public on whether the Wastewater and HMU are running a deficit or surplus.
3. There is no clear allocation of the costs associated with approximately \$40 million of debt that the city has incurred through the Public Facilities Authority. This debt, while it was planned to be paid from the sewer enterprise, electric utility or private lease payments is actually an obligation of the city's general fund and to the extent that the other revenue sources are insufficient, the city's general fund must pay. This issue is not addressed in the budget.
4. The adopted budget for 2010-11 showed a negative beginning fund balance for redevelopment in June 2010 with a higher negative fund balance at the end of the year in June 2011. Why was this not flagged as an issue to be addressed?
5. Payments are shown in the budget from the 2009 Public Financing Authority bonds that appear to be illegitimate: one payment is \$1.4 million to the Red Barn developer for New Town Center and the other is a \$2 million appropriation to pay the Redevelopment Agency's obligation to the state for the Supplement Education Augmentation Fund (SERF) obligation to the State of approximately \$2 million. How can bond funds be used to pay these expenses?
6. Approximately \$5.6 million of redevelopment bond proceeds were transferred to the Hercules Municipal Utility to pay for the new substation. Why is the

redevelopment agency, which is searching for funds to finish the Sycamore North Project funding a major cost in a “self-supporting” utility?

Based on the concerns raised in our preliminary financial review, I am recommending hiring outside experts to verify exactly where we stand financially and to make preliminary recommendations for addressing the situation. This study, if initiated now, would be available in early January and would form the basis of informed decision-making about how to address our financial challenges.

The firm that I am recommending is Municipal Resources Group, LLC, (web site: <http://municipalresourcegroup.com/>). See also [the brochure](#), which is available for download. Mike Oliver is the president of the firm and is the former city manager of Oakley, Citrus Heights, and San Leandro. Tom Sinclair, the other principal that would be involved in our project, is the former city manager of Orinda and former finance director/assistant city manager of El Cerrito. Tom was the interim finance director of Vallejo two years ago and continues to serve as project manager for financial issues in Vallejo. I have attached a draft scope of work (page 13) for Municipal Resources Group. This study would be in preparation for the Council and community beginning the process in January of addressing the City and Agency’s significant financial issues.

Pending availability of the results of this study, we are moving ahead now on preliminary steps to address our significant financial challenges:

1. We recommend deferring the HMU Substation project until there is more information about it funding and justification.
2. We have instituted a hiring freeze. The recruitment for the Real Property Manager and the filling of two police officer vacancies have been placed on hold.
3. We are reviewing all consulting contracts to see which can be delayed or are unnecessary at this time.
4. Already, suggestions are coming forward from our people to change several current practices to see if cost savings can be achieved. Suggestions so far include:
 - a. Employee computer loans.
 - b. Possible outsourcing of all janitorial work.
 - c. Instituting a cell phone stipend instead of allowing use of city cell phones.

5. We are also looking at several additional areas that could result in savings. So far these include:
 - a. Community events – Cultural Festival, MLK Celebration, 4th of July, Farmer’s Market (breaks even or generates a little revenue), community clean up days, tree lighting.
 - b. Funding levels for day care program and other recreation program.
 - c. Sharing services with other cities.

We have briefed our employees on the challenges we face. Obviously, this is not great news to share just before the holidays, but its significance warrants alerting people to the issue. We have asked for patience in fully documenting the problems and have asked people to bring forward ideas for doing more with less.

Reduced Scope of Work for Affordable Housing Solutions Group Effective 12/1:

As you recall, the Council approved a reduced scope of work for Affordable Housing Solutions Group on November 9 which reduced payment for services to AHSG by \$600,000 per year. Remaining within AHSG’s scope were some \$518,000 per year (\$46,000 per month) of affordable housing management services, which we promised to address in a second stage to insure that the services provided by AHSG were competitively priced.

This second stage reduction is now complete. We have agreed on [a revised scope of work for AHSG](#) that will transition affordable housing management and accounting services in house to the Planning and Finance Departments over the next 6 months. Prior to the end of this time, we will likely issue a bid call for loan processing services, which will continue to be provided by an outside vendor.

Based on the November 9 reduction in AHSG’s scope, the remaining services AHSG provides are:

1. Affordable housing client services to respond to questions and issues.
2. Housing rehabilitation loan program--there are 2 remaining loans being processed.
3. Property management on the 8 remaining houses that the Agency owns as a result of the Loss Mitigation program.
4. Monitoring and customer services for the business development loans.
5. Processing applications for the HMU low tariff program.
6. Completing the Secure Mailbox program.
7. Completing the gas valve shutoff program.
8. Managing accounts receivable.

9. Annual compliance reporting for loan portfolio and the 25 inclusionary private units. All other affordable units are in affordable housing corporation projects that are self reporting.

Dennis Tagashira, Walter McKinney and I assessed that these services could be provided by one person located in the Planning Department with the Finance Department handling the receivables and accounting on the 100 or so loans we have outstanding.

Consequently, as of December 1, AHSB will focus on transitioning the management and accounting services in-house over the next six months in three ways:

1. AHSB will assign one employee, Jonathon Sakamoto, who will report to Dennis Tagashira, the Planning Director, and help in preparing the specifications for in-house management of affordable housing services.
2. Effective December 1, there will be a two month transition of all the accounting for the affordable housing program to the Finance Department which will be accomplished by AHSB staff transitioning that all records and receivables management to the Finance Department.
3. Walter McKinney, as principal for AHSB will actively participate throughout this 6 month transition period in assisting Mr. Tagashira with preparing the specifications for in-house management of affordable housing services and transition of records and receivables management to the Finance Department.

During this six month period, the Agency and City will suspend issuance of affordable housing loans, pending clarification of the financial situation and the transition of services in house. The two housing rehabilitation loans that are in the final stages of processing will be completed under the management of AHSB.

We are in the process of transitioning a current employee to the Planning Department who will report to the Planning Director and who will have primary responsibility for day-to-day management of affordable housing services. On May 31, 2011, AHSB's services for affordable housing management, receivables and accounting will terminate.

Also, toward the end of this transition period, the City/Agency will likely competitively bid loan processing services, and AHSB would be eligible to participate as a bidder in this process.

The fee for these transitional services will be:
-\$12,500 per month for the 6 month program transition services for a total of \$75,000
-\$12,500 per month for the 2 month accounting transition services for a total of \$25,000

-\$5,000 per month for 4 months for additional support during transition.

These services replace the remaining scope of work of \$518,000 per year, or \$46,000 per month, that was approved on November 9. The savings over the six month transition period will be \$150,000. This is in addition to the \$600,000 that was already eliminated in November. We anticipate that when the affordable housing program moves entirely in-house that we will be able to absorb the cost of affordable housing management and accounting with existing employees. When we resume loan processing we will incur the cost of loan processing, which will depend on the volume of transactions that are processed.

The Council will have on its December 7 agenda the ratification of these contract changes.

Sycamore North Funding and Affordable Housing Mix: I have asked Jim Donovan of Grubb and Ellis to prepare a broker's opinion of value for the Sycamore North project that I will present to the Council at the Special Meeting on December 7. I will also seek Council's support to issue a request for statements of qualification from brokers to assist with marketing the project for sale to both non-profit and private buyers. This RFQ will be posted on the City's website on Monday.

We have \$22 million in bond funds remaining to keep this project moving and we are asking for Council concurrence at the December 7 special meeting to advance this money to the project, pending resolution of the permanent financing program. Additionally, we are asking for authority to formally solicit expressions of interest to purchase the residential project component from the four affordable housing corporations in the Bay Area that have the capacity to do this, namely, Bridge Housing, Eden, Mid-Peninsula and EAH.

We are also exploring private financing options for a sale or construction loan. Unfortunately, until our overall financial situation is resolved, we will have a difficult time obtaining loans.

Sycamore Downtown RFQs: The two Request for Qualifications regarding Sycamore North retail broker and Sycamore Crossing site developer were posted to the [City's website this week](#). The responsible departments are also sending the RFQ to various agencies as requested. The deadline to respond is Friday, December 17, 2010.

Bayfront: I met on November 29 for a full day with Jim Anderson. We included the folks from Strategic Economics in the first part of our meeting and expect a full scope of

work from them soon. Jim and I, with our teams, discussed the evolving public private cooperation principles which I shared publicly two weeks ago. We will continue our discussion today and next week with the hope to be able to report to the Council and public the week of December 13 on an agreement.

The draft EIR has been printed and delivered to the City and we are ready to release to the public for review and comment.

Intermodal Transit Center: This week, the following items were completed related to the ITC project:

- Completed site visit and prepared revised site access and laydown plan for Bay Trail and retaining wall construction work at Bio-Rad
- Revised detailed construction staging plans for track and railroad bridge review with Union Pacific Railroad (UPRR)
- Met with Senator DeSaulnier’s staff. There were several purposes of the meeting. First, to provide information on the Intermodal Transit Center and Hercules Bayfront projects. Second, to discuss future assistance with funding, specifically related to the Hercules ferry service.
- Prepared revised ventilation plan per Title 24 for the station structure including passenger waiting area
- Reviewed hydraulic and hydrologic analysis for Refugio Creek in relation to sea level rise at the Intermodal Transit Center site
- Incorporated staff and developer comments into draft Biological Assessments for U.S. Fish and Wildlife Service and National Marine Fisheries Service.

Private Investors Show Interest in Former Walmart Parcel: The City is considering changing the 17.27 acre parcel located along John Muir Parkway, west of Alfred Nobel Drive, from its existing designation of Planned Commercial-Residential (PC-R) to “Planned Commercial-Industrial (PC-I) Mixed Use District.” This parcel has been known as the Walmart parcel and Parcel C. There has been increasing interest shown by private investors and developers to build a continuation of business park type uses currently in the North Shore Business Park and retail-related businesses along John Muir Parkway. No residential land uses have been presented during the discussions.

In order to develop the parcel with North Shore Business Park-type buildings, the current PC-R General Plan and zoning designations have to be changed. In anticipation of developing this site with research and development type buildings and retail commercial uses, I’ve asked the Planning Department to begun looking at its adopted Zoning Ordinance, mainly Chapter 14, Section 14.400, page 52: “the specific purposes of the “Planned Commercial Industrial (PC-I) Mixed Use District purposes are to:

1. Accommodate commercial or industrial uses on properties adjacent to and visible from I-80 and State Route 4 in a manner that preserves visibility from these highways.
2. Provide site planning and architectural guidelines for development within these highly visible areas of the City.
3. Allow warehouse, distribution and wholesale uses within this district if they directly serve or are essential to businesses in Hercules.
4. Allow for new light industrial uses related to R&D, manufacturing, and business industrial services.

The former Walmart parcel is highly visible from Interstate 80 and is the “main entrance” to the Waterfront. The development of this site with its buildings, density, land uses, and exterior treatments will give drivers and pedestrians an image of Hercules from Interstate 80, and State Route 4. Currently, drivers along I-80 and SR-4 get an impression of Hercules looking down at the Creekside Shopping Center and Home Depot. The 17-acre former Walmart site is sloping upwards from John Muir Parkway, has no tall obstructions, and is more visible than the Creekside Shopping Center (which is 60 feet lower than I-80). The successful development of the former Walmart’s 17 acres will attract customers not only to that site, but to the Waterfront and other parts of Hercules.

Subcommittee Replacement Meeting: Due to several pressing issues that have arise in the last month, including Sycamore North funding and the five year financial projections, I am requesting that the community meeting regarding the subcommittees be postponed until the first quarter of 2011. This will give the current Council time to handle the most urgent matters and bring the new Council members on board. The budget situation will most likely result in several strategic issue study sessions in January and February.

Corporation Yard Pond Closure: This week, City contractor, Lloyd Corone began work on removing three ponds at the corporation yard that were left from the closure of the wastewater treatment plant on that site. Work this week included removal of vegetative materials, minor clearing, and grubbing of debris surrounding the ponds. Work is expected to be completed in approximately 30 days. The ponds will be filled with rocks and dirt, creating more useable space at the Corp yard and eliminating the stagnant water. When the ponds are filled, there may be minor disturbance to the neighborhood due to noise and additional trucks in the area.

East Bay Regional Communications System Update: Hercules signed the Program Operating Agreement discussed at the November 23, 2010 city council meeting. The police department will now work with our partner agencies in West Contra Costa County to obtain the most competitive pricing for purchasing new radios. There is also a high

probability that a “lease to buy” option will be available which will significantly reduce initial purchase costs to the City. Purchase information will likely come before the council in the first quarter of 2011.

Organizational Changes: The application period for the Real Property Manager position closed last week. More than 90 applications were submitted. The process of screening applications and preparing for interviews began earlier this week. However, we’ve decided that the recruitment for the Real Property Manager position will be temporarily suspended pending further review and analysis of the City’s financial status. All applicants will be notified directly. I’ve also asked the Administrative Services Department which includes IT, the City Clerk and general administrative staff, to oversee all administrative support for the City Manager’s office and the City Council.

The application period for the Senior Project Manager position closed on Monday, November 29. The recruitment was an internal recruitment only and selection of the appropriate candidate will be forthcoming.

Noteworthy Police Calls: On Sunday evening, November 28th at about 9:45 pm, officers responded to a report of two men smoking marijuana in a vehicle parked in front of the 44 Sports Bar, located in the Willow shopping center. When the officers arrived, they identified the occupants of the suspected vehicle as convicted felons, one from Hercules and the other from San Pablo. Both subjects were arrested, for being felons in possession of a weapon, after a loaded handgun was found in the vehicle. During the search and arrest, a crowd of patrons associated with the 44 Sports Bar surrounded and yelled at the officers. County Sheriffs Deputies were called to the scene to assist in controlling the crowd.

On Wednesday evening, December 1st at about 9:00 pm, officers responded to White Birch Lane, where a resident reported finding a briefcase on the walkway to his residence. The resident had no idea who the case belonged to or why anyone would leave it there. As a precaution, the Walnut Creek Bomb Squad was contacted and responded to the scene. They examined the briefcase and determined it contained promotional literature and posed no danger.

Police Department Training: Two police sergeants attended a one day legislative update training in Walnut Creek. The training familiarized those attending with changes in the law beginning January 1, 2011. The two sergeants are responsible for ensuring everyone on the department is made aware of these changes.

Christmas Coalition: The Rodeo/Hercules Fire Department is encouraging members of the public to participate in the Christmas Coalition, an annual toy drive that provides gifts

to children in need. Toys can be dropped off at several locations throughout Hercules and Rodeo between now and Friday, December 10. Locations include: both Rodeo and Hercules fire stations, Hercules City Hall, Rodeo Hills, Lupine Hills, Hanna Ranch and S. Patrick's Elementary Schools and True Value Hardware in Rodeo. Toys should be new and unwrapped.

Tree Lighting: Tonight is the City's annual tree lighting event at Market Hall from 6-9pm. For more information on the event, please visit [our event calendar](#) on the City's website.

**Draft Scope of work to Conduct Fiscal Analyses, Peer Review,
Best Practices on budgeting and internal control
Regarding the City of Hercules Fiscal Condition**

Phase I

Meetings with City Staff to review:

- City Budget
- City Audit Report
- Redevelopment Agency Financial Status
- Bond Issue Status
- Interfund Transfer Status
- Municipal Utilities Fiscal Condition
- Draft Revenue & Expenditure Model
- Best Practices applications

6 Meetings- 48.5 hours

Review City Financial Records:

- Budget
- CAFR
- Audit Reports
- Redevelopment Agency Documents
- Financial Reports

15.0 hours

Report & Public Presentation Preparation

- Develop Municipal Resource Group Findings
- Prepare Public Presentation

15.0 hours

Make 2 Public Presentations

20.5 hours

Total Hours: 99.0 @\$200.00=\$19,800.00

Mileage Reimbursement, Printing, Misc. 500.00

Total Phase I Cost Estimate \$20,300.00

Phase II

Finance Best Practices

- Training, operations training assistance, best practices

24.0 Hours @ \$200.00=\$4,800.00

1. All work performed on Time and Material basis, not to exceed \$20,300.00 for Phase I. Phase II is optional for 24.0 hours as needed.
2. Principals only will conduct this Project—Mike Oliver and Tom Sinclair.
3. Full Insurance coverage will be provided.
4. Travel costs included.