



# Agenda Item

## Orange City Council

Item #: 3.2.

3/24/2026

File #: 26-0116

TO: Honorable Mayor and Members of the City Council

THRU: Jarad Hildenbrand, City Manager

FROM: Trang Nguyen, Finance Director

### 1. SUBJECT

First Budget Study Session for the Proposed Fiscal Year 2026-27 Budget

### 2. SUMMARY

This is the first budget study session for the Fiscal Year 2026-27 Budget. This session presents revenue assumptions, the proposed expenditure budget, and budget-balancing measures for the General Fund.

### 3. RECOMMENDED ACTION

1. Provide direction to staff to prepare the Fiscal Year 2026-27 Preliminary Budget.
2. Review and discuss potential revenue measures.

### 4. FISCAL IMPACT

Fiscal Impact will be determined with final budget adoption.

### 5. STRATEGIC PLAN GOALS

Goal 2: Enhance Economic Development and Achieve Fiscal Sustainability

### 6. DISCUSSION AND BACKGROUND

#### Background

Fiscal Year 2026-27 (FY27) continues to present significant financial challenges for the General Fund, as the City faces an ongoing structural imbalance between revenues and expenditures. The City's largest revenue source, Property Tax, is expected to grow modestly within the constraints of Proposition 13, while Sales Tax revenues are projected to remain relatively flat. At the same time, costs across all major expenditure categories continue to increase.

Development of the FY27 Proposed Budget began with a zero-based budgeting approach, requiring departments to justify expenditures from the ground up rather than relying on prior-year spending as the baseline. This process resulted in proposed position reductions, continued vacancy controls, and the deferral of several lower-priority or non-core requests in order to align limited General Fund resources with the City's highest service priorities.

The FY27 Proposed Budget includes reductions totaling approximately 56 full-time equivalent (FTE) positions, reducing the City's workforce to 689.7 FTEs, or about 3% below FY26 and nearly 6%

below FY24.

Over the past three years, the City has exercised strong fiscal discipline, limiting operating expenditure growth to an average of 2.2%, compared to an average Consumer Price Index for All Urban Consumers (CPI-U) of 3.2%. For FY27, operating expenditures are projected to increase by 1.3%, which remains below the February CPI-U of 2.9%. Despite that restraint, the General Fund continues to face a structural imbalance driven primarily by annual debt service obligations totaling approximately \$17.9 million, including \$16.2 million for Pension Obligation Bonds and \$1.7 million for Lease Revenue Bonds.

This fiscal outlook underscores the need to evaluate potential revenue enhancements and long-term strategies to achieve structural balance and ensure the City's long-term financial sustainability.

### General Fund Revenues

Based on current trends and analysis, General Fund operating revenues, excluding transfers, are projected at approximately \$153.7 million for FY27, a decrease of about \$140,000 from the FY26 year-end estimate. Total revenues, including transfers, are projected at approximately \$170.7 million, an increase of about \$12.4 million or 7.8% over the FY26 year-end estimate. Excluding one-time transfers, the FY27 General Fund revenue outlook is essentially flat.

The table below summarizes the General Fund revenues by source type, comparing the changes from the FY26 year-end estimates and the FY27 proposed budget:

*Table 1: FY 27 Proposed General Fund Revenue*

|                                | FY26 Year End Estimate | FY27 Proposed        | Variance From FY26  | % Change     |
|--------------------------------|------------------------|----------------------|---------------------|--------------|
| Property Tax                   | \$59,355,220           | \$61,239,700         | \$1,884,480         | 3.2%         |
| Sales Tax                      | 50,567,208             | 50,676,800           | 109,592             | 0.2%         |
| Internal Service Charges       | 10,077,495             | 4,496,300            | -5,581,195          | -55.4%       |
| Fees for Services              | 6,599,526              | 6,944,100            | 344,574             | 5.2%         |
| Licenses & Permits             | 6,742,362              | 6,849,300            | 106,938             | 1.6%         |
| TOT                            | 6,339,957              | 6,412,400            | 72,443              | 1.1%         |
| Miscellaneous Revenue          | 3,612,876              | 4,982,900            | 1,370,024           | 37.9%        |
| Use of Property                | 3,922,905              | 4,169,800            | 246,895             | 6.3%         |
| Franchises                     | 3,235,228              | 3,424,400            | 189,172             | 5.8%         |
| Fines                          | 1,669,836              | 2,874,900            | 1,205,064           | 72.2%        |
| Revenue from Other Agencies    | 1,704,322              | 1,615,700            | -88,622             | -5.2%        |
| <b>Total Operating Revenue</b> | <b>\$153,826,935</b>   | <b>\$153,686,300</b> | <b>-\$140,635</b>   | <b>-0.1%</b> |
| Transfers In                   | 4,485,252              | 17,000,000           | 12,514,748          | 279.0%       |
| <b>TOTAL REVENUE</b>           | <b>\$158,312,187</b>   | <b>\$170,686,300</b> | <b>\$12,374,114</b> | <b>7.8%</b>  |

Provided below is a summary of the assumptions used for the FY27 General Fund revenues:

- **Property Tax:** The City's largest source of General Fund revenues, is proposed to be \$61.2 million in FY27, an increase of roughly \$1.9 million or 3.2% over FY26 year end estimates. While Proposition 13 generally limits annual assessed value increases to 2% on existing properties, additional growth occurs when properties change ownership and are reassessed at current market value. With the Federal Reserve lowering interest rates over the past year, housing market activity is expected to increase, leading to more home sales and modest additional growth in property tax revenues.
- **Sales Tax:** The FY27 revenue is projected to remain relatively flat at roughly \$50.7 million, reflecting a \$109,600 (0.2%) increase over the FY26 year-end estimate. According to statewide reports from the City's sales tax consultant, while inflation has moderated and interest rates have declined, statewide economic indicators suggest consumers remain cautious. As a result, taxable sales are expected to stabilize, with spending largely focused on essential goods and value-oriented purchases. While fuel prices have been trending upward due to external and foreign market factors, a significant increase in sales tax is not considered in the FY27 projections largely due to thresholds within the City's current sales tax agreements and the potential for volatility in this sector.
- **Internal Service Charges:** Internal Service Charges is projected to be almost \$4.5 million, a decrease of \$5.6 million (55.4%) from the FY26 year-end. The decrease in Internal Service Charges does not reflect a corresponding reduction in actual service levels or citywide costs. Rather, it reflects a change in budgeting and reporting methodology, as several formerly separate Internal Service Funds were consolidated into the General Fund. As a result, costs previously reflected in this category now appear directly in other operating expenditure categories.
- **Fees for Services:** The city is projecting a total of approximately \$6.9 million in FY27, an increase of \$345,000 (5.2%), compared to FY26 estimate. These fees are intended to offset the City's operating costs of providing services and have been revised following the user fee study to more appropriately align charges with the cost of service delivery. This estimate considers the updated fees adopted at the January 13th Council meeting and proposed for the April 28th Council meeting.
- **Transient Occupancy Tax (TOT):** The projected TOT revenue for FY27 is just over \$6.4 million, relatively flat with a slight increase of \$72,000 (1.1%) compared to the FY26 year-end estimate. Travel demand has remained relatively stable as consumers continue to prioritize spending on experiences, travel, and leisure, though at somewhat moderate levels compared to the post-pandemic surge. According to the U.S. Travel Association, hotel room demand declined approximately 1% from the prior year, while short-term rental demand grew slightly by about 1%, reflecting shifting travel preferences.
- **Miscellaneous Revenue:** Miscellaneous revenue is projected at just under \$5.0 million in FY27, an increase of approximately \$1.4 million over the FY26 year-end estimate. This category includes one-time reimbursements, donations, and other miscellaneous revenues, including approximately \$1.0 million in Cal OES reimbursements for fire deployments and \$150,000 to offset credit card fee surcharges. Because portions of this category are dependent on reimbursement timing and other one-time factors, actual

revenues will continue to be monitored and refined as needed during the budget process.

- Fine and Forfeitures:** Fine and forfeitures revenue is projected at approximately \$2.9 million in FY27, an increase of about \$1.2 million over the FY26 year-end estimate. This reflects anticipated revenues of approximately \$1.0 million from the City's paid parking program in Old Towne, as well as \$300,000 from increased collections associated with Transient Occupancy Tax and Business License audit activities. As these revenues are partially dependent on program performance and collection activity, staff will continue to monitor actual results and update projections as needed.
- Revenue from Other Agencies :** FY27 revenue in this category is projected at approximately \$1.6 million, a \$89,000 (5.2%) decrease from the FY26 year-end estimate. This category is primarily comprised of revenue received from other government agencies, as well as one-time grants from state funded programs. As is typical, revenue in this category may fluctuate throughout the year as additional grant programs are awarded and recognized.
- Transfers In:** Transfers into the General Fund are projected to total \$17.0 million in FY27, an increase of approximately \$12.5 million over the FY26 year-end estimate. This amount primarily reflects one-time transfers of available fund balances from the Emergency Medical Transport Fund, Equipment Replacement Fund, and Capital Improvement Program Fund to temporarily offset the projected General Fund operating deficit. These transfers are non-recurring in nature and provide temporary budget relief rather than a long-term structural solution.

Overall, the FY27 revenue outlook reflects continued stability in core tax revenues, but not sufficient growth to close the City's underlying structural gap. Staff will continue to monitor key economic indicators and actual revenues over the next few months. If warranted, staff will update the proposed FY27 revenue for the Preliminary Budget presentation.

### General Fund Expenditures

The proposed FY27 General Fund operating expenditures total approximately \$143.2 million, an increase of about \$1.8 million or 1.3% over the FY26 year-end estimate. Total expenditures, including debt service and transfers out, are projected at approximately \$170.7 million, reflecting an increase of about \$10.3 million or 6.4% year over year.

Table 2 summarizes the General Fund expenditure by category, comparing the changes from the FY25 actuals, the FY26 year-end estimates, and the FY27 proposed budget:

*Table 2: FY 26 Proposed General Fund Expenditure*

| Expenditure Category    | FY26 YE Estimates | FY27 Proposed | FY 27 Variance from YE Estimate | % Change |
|-------------------------|-------------------|---------------|---------------------------------|----------|
| Salaries and Benefits   | 105,296,845       | 109,683,500   | 4,386,655                       | 4.2%     |
| Repair/Maintenance      | 9,469,606         | 9,898,200     | 428,594                         | 4.5%     |
| Professional/Other Svcs | 7,002,544         | 7,987,000     | 984,456                         | 14.1%    |

|                                     |                    |                    |                   |             |
|-------------------------------------|--------------------|--------------------|-------------------|-------------|
| Internal Service Costs              | 8,866,258          | 3,743,700          | (5,122,558)       | -57.8%      |
| Materials and Supplies              | 4,474,858          | 5,193,600          | 718,742           | 16.1%       |
| Miscellaneous Expenses              | 2,782,239          | 3,065,000          | 282,761           | 10.2%       |
| Utility Charges                     | 3,448,883          | 3,605,500          | 156,617           | 4.5%        |
| Capital Outlay                      | 62,481             | 44,500             | (17,981)          | -28.8%      |
| <b>Total Operating Expenditures</b> | <b>141,403,714</b> | <b>143,221,000</b> | <b>1,817,286</b>  | <b>1.3%</b> |
| Debt Services                       | 17,515,954         | 17,905,400         | 389,446           | 2.2%        |
| Transfers Out                       | 1,455,252          | 9,554,500          | 8,099,248         | 556.6%      |
| <b>TOTAL EXPENDITURES</b>           | <b>160,374,920</b> | <b>170,680,900</b> | <b>10,305,980</b> | <b>6.4%</b> |

Provided below are the budget assumptions impacting the FY27 General Fund expenditures:

- **Salaries & Benefits:** The FY27 proposed budget for salaries and benefits is \$109.7 million, an increase of about \$4.4 million or 4.2% above the FY26 year-end estimate. The increase is attributed to the following factors:
  - **Salary Increases:** The proposed FY27 budget includes annual step increases and a 3% increase for all City employees.
  - **Position Changes:** The proposed budget includes the elimination of 45.7 FTEs while keeping 10 FTEs frozen for FY27. It also included reclassification of select existing positions to better align with current operational needs and organizational priorities.
  - **Fully Funded Overtime:** Historically, overtime budget has been funded at 40% and utilizing vacancies to fill the gap. For FY26, staff is projecting a shortfall of about \$5.4 million. Going forward, staff will fully budget projected overtime costs. Staff is projecting approximately \$7.5 million in overtime for FY27. This amount is in line with the average of the last four fiscal years.

Although the FY27 Proposed Budget includes significant position reductions, salaries and benefits still increase year over year due primarily to annual step increases, the proposed 3% salary adjustment, and the decision to fully fund projected overtime costs rather than relying on vacancy savings to absorb those expenses.

- **Professional/Other Services:** The proposed FY27 budget for contractual services is approximately \$8.0 million. This reflects a net increase of approximately \$980,000, or 14.1%, compared to FY26 year-end estimates. This expenditure category includes \$800,000 associated with North SPA services, \$125,000 to support enhancements within the City's Economic Development Division, \$250,000 for year-round aquatics services, \$498,000 for the Old Towne paid parking program, and \$100,000 for on-call building inspection services. These increases are partially offset by one-time expenditures included in FY26 for labor relations legal services and the IT Strategic Plan.

- **Materials and Supplies:** The proposed FY27 budget for materials and supplies is

almost \$5.2 million and reflects an increase of approximately \$719,000 (16.1%) compared to the FY26 year-end estimate. This increase is primarily driven by \$400,000 for the replacement of mandatory safety equipment for the Fire Department, \$100,000 in additional safety uniform costs, and general cost increases across various operating materials and supplies categories due to rising costs for materials and normal pricing adjustments.

- **Miscellaneous Expenditures:** The proposed FY27 budget for miscellaneous expenditures totaling just under \$3.1 million reflects an increase of approximately \$280,000 (10.2%) compared to the prior year. This increase is primarily attributable to anticipated election-related costs of \$220,000, as well as \$95,000 in additional Fire Department training expenses offset through the Santa Ana College training program.
- **Internal Service Costs/Allocations:** As part of the FY26 budget process, the City completed a comprehensive Cost Allocation Plan conducted by Matrix Consulting Group and consolidated internal service functions into the General Fund. As a result of these changes, internal service costs are projected to total approximately \$3.7 million, a decrease of approximately \$5.1 million (57.8%) in FY27. This reduction reflects updated cost allocation methodologies and the elimination of prior internal service fund structures. The decrease is partially offset by corresponding increases in other expenditure categories within the General Fund, as costs previously accounted for in Internal Service Funds are now directly reflected in departmental operating budgets.

### ***Transfers to Internal Service Funds***

The City's Internal Service Funds (ISFs) are used to account for goods and services provided internally to support services such as vehicle replacement, computer replacement, general liability, workers' compensation, and employee accrued liability.

Historically, contributions from the General Fund to certain Internal Service Funds were maintained at reduced levels in order to minimize near-term impacts on the General Fund, with the expectation that future year-end surpluses would be used to replenish those funds. As budgetary constraints have persisted, that strategy has resulted in continued underfunding of several Internal Service Funds, including the Workers' Compensation Fund, which currently has a negative fund balance. The FY27 Proposed Budget includes a transfer of approximately \$9.5 million to the Employee Accrued Liability Fund; however, due to ongoing General Fund constraints, negative balances in the Workers' Compensation, General Liability, and Employee Accrued Liability Funds totaling approximately \$17.3 million will continue to be deferred.

### ***Unfunded Requests and Future Considerations***

Due to limited ongoing revenues, several priority needs were not included in the FY27 Proposed Budget and remain subject to future Council consideration if additional recurring resources become available. The following items are identified:

1. Restore negative fund balance in the ISFs.
2. Restore public safety positions.

3. Address deferred maintenance.
4. Expansion of Fire Prevention staffing model to address increased inspection, plan review, and compliance workload.
5. Restore community programs and events.
6. Implementation of a body-worn camera program for the Code Enforcement Division to enhance transparency, accountability, and staff safety.
7. Restoration of the Historic Preservation Planner position to support planning, development review, and preservation efforts.
8. Additional administrative support within the City Manager's Office, City Clerk's Office, and Finance Department to address increasing operational demands and workload.

These unfunded items may be revisited as part of future budget cycles, with priority given to those that support public safety, regulatory compliance, and core service delivery.

### General Fund Balance

The proposed FY27 General Fund budget includes approximately \$153.7 million in operating revenues, excluding transfers, and approximately \$161.1 million in operating expenditures, including debt service, resulting in an operating deficit of approximately \$7.4 million. After accounting for transfers out of approximately \$9.6 million and one-time transfers in of \$17.0 million from the EMT, CIP, and Equipment Replacement Funds, the budget is projected to close with a nominal net surplus of approximately \$5,400. While this approach balances the FY27 budget on paper, it relies on one-time resources and does not fully resolve the City's underlying structural imbalance.

The Fiscal Management Policies adopted by the City Council on August 12, 2025 recommend maintaining a catastrophic reserve of 20% of General Fund operating expenditures for FY27. However, given the fiscal challenges outlined in this report, staff recommends maintaining the reserve at 18% for FY27, with the intent to revisit a phased return to 20% in future years as the City's financial condition improves. At the 18% level, the catastrophic reserve is projected to total approximately \$25.8 million, leaving an estimated undesignated General Fund balance of approximately \$717,000 as of June 30, 2027. Table 3 highlights the proposed fund balance for the General Fund.

*Table 3: Proposed Fund Balance for the General Fund*

|   | FY26 Year-End Estimate | FY27 Proposed      | Variance to YE Estimate | % Change     |
|---|------------------------|--------------------|-------------------------|--------------|
| Operating Revenues                      | 153,826,935            | 153,686,300        | -140,635                | -0.1%        |
| <b>Total Revenues</b>                   | <b>153,826,935</b>     | <b>153,686,300</b> | <b>-140,635</b>         | <b>-0.1%</b> |
| Operating Expenditures                  | 141,403,713            | 143,221,000        | 1,817,287               | 1.3%         |
| Debt Service                            | 17,515,954             | 17,905,400         | 389,446                 | 2.2%         |
| <b>Total Expenditures</b>               | <b>158,919,667</b>     | <b>161,126,400</b> | <b>2,206,733</b>        | <b>1.4%</b>  |
| <b>Operating Surplus/<br/>(Deficit)</b> | <b>-5,092,732</b>      | <b>-7,440,100</b>  | <b>-2,347,368</b>       |              |
| Transfers-In                            | 4,485,252              |                    | -4,485,252              | -100.0%      |

|  |                   |                |                  |               |
|--|-------------------|----------------|------------------|---------------|
| Transfer In - Fund 225<br>EMT                              | -                 | 3,700,000      | 3,700,000        |               |
| Transfer In - Fund 500 CIP                                 | -                 | 10,000,000     | 10,000,000       |               |
| Transfer In - Fund 790<br>Equipment Replacement            | -                 | 3,300,000      | 3,300,000        |               |
| Transfers Out  | -1,455,252        | -9,554,500     | -8,099,248       | 556.6%        |
| <b>Net Surplus/(Deficit)</b>                               | <b>-2,062,732</b> | <b>5,400</b>   | <b>2,068,132</b> |               |
| Estimated Beginning Fund<br>Balance - 7/1/2026             | 28,553,721        | 26,490,989     | -2,062,732       | -7.2%         |
| Estimated Ending Fund<br>Balance - 6/30/2027               | 26,490,989        | 26,496,389     | 5,400            | -0.0%         |
| Catastrophic Reserve                                       | 25,452,668        | 25,779,780     | 327,112          | 1.3%          |
| <b>Estimated Undesignated<br/>Fund Balance - 6/30/2027</b> | <b>1,038,321</b>  | <b>716,609</b> | <b>-321,712</b>  | <b>-31.0%</b> |

Overall, the FY27 Proposed Budget reflects a continued effort to reduce operating expenditures, align ongoing costs with available revenues, and preserve the City's core service priorities. However, recurring General Fund revenues remain insufficient to fully support recurring operating costs, debt service obligations, and long-term internal service fund needs. As proposed, the FY27 budget relies on one-time transfers from other available fund balances to close the remaining gap. Staff will continue to monitor revenue performance, expenditure trends, and policy options in order to improve long-term structural balance and fiscal sustainability.

Staff is seeking City Council direction on the proposed FY27 budget. Directions received tonight will be included in the Preliminary Budget.

The next study session is tentatively scheduled April 14<sup>th</sup> and will focus on the City's Capital Improvement Program. Staff will incorporate the City Council's directions and feedback received from both study sessions in the FY27 Preliminary Budget for review during a regular City Council meeting in May.

## 7. ATTACHMENTS

- None