City of Scottsdale

Monthly Financial Update

October 2008

We appreciate your patience regarding FY 2007/08 year-end financial information. Financial Services staff spends the first part of the new fiscal year closing the books and preparing for the external auditors. The year-end process to be in conformance with Governmental Accounting Standards, makes an earlier report release not possible.

Economic/Financial Summary…Fear, Uncertainty & Doubt (FUD)

Recession? Our nation is seeing a shake-up with financial markets that is causing serious economic impacts that have not been seen since the last depression. Economists recognize 'recessions' based upon *two consecutive negative quarters of GNP*. In recent weeks/month we have seen further deterioration of financial markets, national retail sales posted the largest decline (-11%) in seventeen years and fuel prices increased again. The majority of economists now predict a recessionary economy for the coming year.

Last fall I stated that in Scottsdale terms we were already experiencing a local recession – even if on a national scale it wasn't (yet) being characterized as one. My measurement is based upon measurements of our major 'elastic' revenues sources (revenues that vary directly with economic fluctuation) and that fund our operating budget and pay-as-you-go capital program: sales tax, gas tax, bed tax, building permit fees and State shared sales and income taxes. Let me put this 'recession' into perspective by comparing to Scottsdale's past…Scottsdale has historically seen only slower growth during past recessions, with our only negative growth (a modest 1% decline) being in 2001/02 after the terrorist attacks. Last fiscal year we realized a 4% decline in sales tax and recent months revenues have dropped 13% in the major sales tax categories over the prior anemic year (see page 3 for discussion). These impacts are unprecedented and news from surrounding cities is just as glum – we are not unique in this. The local economic forecast is dismal for the next year or more, which will result in the deepest and longest recession Scottsdale has ever experienced.

Current Budget Forecast: We are experiencing a general recessionary impact across all our business activities and the most significant factors are outlined below: construction and car dealerships. These impacts are unfortunately very severe and we are currently estimating that Scottsdale is facing a General and Transportation Fund deficit of $25 to $35 million over the next 12-24 months. And if revenue returns do not improve in coming months, the estimated deficit could grow even larger. Management and staff are working on a variety of budget balancing strategies and will be updating and involving City Council as we proceed through this fiscal year. Our goal is to make necessary adjustments to re-balance this fiscal year while simultaneously making decisions necessary to manage the tight economy and balance the budget for FY09/10.

Construction Activity: The real estate market ("bust") is causing a drop in construction-related sales tax and building permit revenues – two of our largest 'elastic' General Fund revenues. Overbuilding of residential and commercial property in recent years combined with financial market turmoil has made it more difficult for businesses and developers to secure financing and pursue new growth projects. And absorption of the current vacancies in Arizona, Scottsdale and the metro area has slowed significantly as people in other parts of the country struggle to sell their homes or business property in the depressed real estate market (in order to make the move to Arizona). Our current forecast takes into consideration the two plus years of double digit decreases in development activity as measured by permits issued and property valuations and predicts $3.5 million decrease in construction sales tax and $6.0 million decrease in building permits for this fiscal year and contributing further to our pessimistic budget prognosis for the next several years.

Car Dealerships: The abrupt closure of Bill Heard car dealership only added to the growing loss of another key 'elastic' and significant General Fund revenue. The car dealers that have left, closed and planning to leave: Scottsdale Audi, Scottsdale Lincoln Mercury, Scottsdale Suzuki, Scott Toyota, Nissan of Scottsdale, Bill Heard, Pitre Pontiac/Buick and Chapman BMW represent $3-4 million in annual revenue for the City and a major portion of our operating budget and will be difficult to replace even if the economy does improve.

Lots of FUD (Fear, Uncertainty & Doubt), but there is some positive financial news:

- Although AIG has been one of the largest insurers and we have purchased excess insurance coverage from them in the past, our current year's excess insurance coverage is being satisfied with other companies.

- Scottsdale discontinued investment activity with the State Investment Pool and was not party to recent Lehamn losses. Scottsdale's investment portfolio remains strong and stable in the face of financial market events as our conservative investment management approach puts safety and liquidity first.
- The Association of Public Treasurers of the US & Canada certified Scottsdale's Debt Management Policies as meeting their recommended criteria – including consistency with the government entity's legal authority, and appropriateness for the policy's capital funding objectives.

GENERAL FUND YEAR END BALANCES

FY 2007/08 *Actual* Fiscal Year End General Fund Balance

The Actual June 30, 2008 Ending Fund Balance was $44.2 M., $3.6 M. greater than Budget Forecast and reflected in the audited financial report. Actual revenues were greater than Forecast for two main reasons: 1) franchise fees and state shared revenues were greater than expected and 2) several operating activities performed better than expected such as WestWorld, court fines, and property rentals. Operating Expenses were slightly greater than forecast due to expenditures for police overtime, jail services, maintenance services / contracts, and utilities. Additional funds were also transferred to the Highway User Revenue Fund (HURF) from the General Fund necessary to eliminate that fund deficit in order to close yearend and finalize our Annual Financial Report (no funds can be closed with a negative balance). The HURF fund was in a deficit position due to less than expected gas and sales taxes.

FY 2008/09 *Estimated* Fiscal Year End General Fund Balance

The following table compares the FY 2008/09 budget plan to the current General Fund balance forecast, incorporating the latest economic estimates and impacts of economic contingency plans.

Estimated Fiscal Year End 2009 General Fund Balance (In Millions)	FY 2008/09 Approved Budget	FY 2008/09 Current Forecast	Variance Favorable/ (Unfavorable)
Actual Beginning Balance July 1, 2008	$ 40.6	$ 44.2	$ 3.6
Sources of Funds	286.8	266.6	(20.2)
Uses of Funds (Operating Expenses)	259.1	259.1	-
Transfers Out	22.9	22.9	-
Debt Service	6.0	6.0	-
***Estimated* Ending Balance June 30, 2009:**			
Operating Contingency	4.8	4.8	-
Photo Enforcement Loop 101	0.6	-	(0.6)
General Fund Reserve	29.9	29.9	-
Unreserved Fund Balance	4.1	(11.9)	(16.0)
***Estimated* Ending Fund Balance June 30, 2009**	**$ 39.4**	**$ 22.8**	**$ (16.6)**

Table may display minor rounding variances in the aggregate due to reflecting amounts in millions.

Estimated Ending Fund Balance

As discussed on page 1, Scottsdale is experiencing an unprecedented recessionary impact across revenue categories, with the most significant factors including retail sales, construction, and auto dealers. The current revenue forecast for FY 2008/09 is included in the GF Summary table above but the Estimated Ending Balance does not (yet) take into consideration budget balancing strategies currently being discussed / evaluated by City management and staff. Based upon the prognosis that the economy will not achieve any significant recovery or growth in the near term our current overall deficit projection is in the $25M - $35M range for the next 12-24 months. Budget balancing strategies will be aimed at providing current benefit/relief from lower revenues, as well as structural changes to help address our deficit prognosis and balance the budget in FY 2009/10 and beyond. As these strategies are evaluated and implemented, their estimated results will be reflected in future financial reports as the budget is balanced (see Budget Update section).

GENERAL FUND REVENUE – FY2008/09 FORECAST

The following table summarizes key revenues that affect the City's General Fund. The table compares year end revenue forecast to the budget plan. The latest adjustments to forecast are reflected in the table. The current net impact of these adjustments to the revenue bottom line is $(20.2) million under the FY 2008/09 budget plan, reflecting ongoing recessionary forces at the national and local level, factors related to the financial market turmoil, a depressed housing market, and dropping retail, automotive, and construction activity. We will continue to closely monitor revenues and make further adjustments to forecast as necessary.

FY 2008/09 General Fund Revenues (In Millions)	FY 08/09 Adopted Budget	FY 08/09 Current Forecast	Variance Favorable/ (Unfavorable)
Transaction Privilege (Sales) Tax (1)	$ 116.6	$ 103.4	$ (13.2)
Transient Occupancy (Bed) Tax (1)	2.0	1.8	(0.2)
Property Tax	22.4	21.4	(1.0)
State Shared Sales Tax	22.0	20.0	(2.0)
State Shared Income Tax	34.0	35.1	1.1
Auto Lieu Tax	9.7	9.7	-
Business & Liquor License	1.8	1.8	-
Development Permits & Fees	14.5	8.5	(6.0)
Interest Earnings	4.5	3.6	(0.9)
Other	47.6	49.6	2.0
Total Revenue	**$ 275.1**	**$ 254.9**	**$ (20.2)**
Transfers In	11.7	11.7	-
Total Sources of Funds(2)	$ 286.8	$ 266.6	$ (20.2)

Table may display minor rounding variances in the aggregate due to reflecting amounts in millions.

(1) Privilege & Use Tax and Transient Occupancy Tax collections lag by one month (August activity reported in September results).

(2) Reconciles to Sources of Funds line item in "General Fund Balance" table, page 2.

The following highlights the activity presented in the schedule above.

Sales Tax

As the single greatest revenue source for the General Fund, fiscal year-to-date revenues are down 13% or $3.4 M. compared to prior fiscal year. Category fiscal year-to-date changes over prior year: automotive -27%, construction -15.9%, food stores -1.8%, hotels and motel -11.5%, major department stores -10.2%, miscellaneous retail -18.3%, other taxable activity -7.2%, rental -0.7%, restaurants -11.8%, utilities +5.3%. A volatile Wall Street, skittish consumers, housing market bust, and tight credit markets continue to have a severe impact on the City's largest revenue source for the General Fund. Drops in construction activity, auto sales, and related dealership closings and relocations have resulted in Financial Services staff revising the current Sales Tax forecast down $13.2 M. from the adopted budget plan. We will continue to closely monitor sales tax activity and make additional revisions as necessary, especially as the critical holiday shopping season approaches.

Bed Tax

Fiscal year-to-date revenues are down 11% or $0.1 M. compared to prior fiscal year. Staff has reduced the current forecast by $0.2 M. One of the fallouts from the economic recession is tough times in the tourism industry. As consumers tighten their wallets, businesses cut back on business travel and conferences, and airlines cut flights and raise fares, hotels are experiencing lower demand and growing room vacancies. The outlook for hoteliers and the travel industry as a whole remains dim until the economy starts showing signs of a significant turnaround.

Property Tax

Variance reflects recent utility settlement, and City's portion of $29M legislative proposed rebate ($730K Scottsdale share) to the State's General Fund.

State Shared Revenues
Adjustments reflect latest state shared estimates provided by the Arizona Department of Revenue.

Development Permits & Fees
Fiscal year-to-date revenues are down 40% or $1.4 M. compared to prior year. Coinciding with a decline in the City's construction sales tax revenues, the real estate market bust is causing a drop in building permit revenues. Our current forecast takes into consideration two plus years of double-digit decreases in development activity as measured by permits issued and property valuations and predicts a $6 M decrease in building permits for this fiscal year.

Interest Earnings
$(0.9) M. unfavorable variance reflects revised forecast based on latest financial market forces.

Other Revenue
Adjustments to forecast for Other Revenue category include projected minor increases to parking and court fines, light and power franchise fees, and intergovernmental revenue.

BUDGET UPDATE

Budget Process Update:

The Financial Services staff has spent the summer reevaluating the FY 08/09 revenue and expense forecasts based on FY 07/08 actual results and the ever changing economic environment. We are currently estimating a revenue decline of 10% over the prior fiscal year actuals, with a deficit impact range of $25M - $35M for the combined General and Transportation Funds for this year and into FY09/10.

All departments will be involved in finding budget balancing solutions to mitigate these revenue reductions. A portion of our problem is due to recessionary impacts and can be partially addressed with one-time or temporal solutions, i.e., use of unreserved fund balance and/or adjustments to CIP funding. However, we must also seek structural budget changes to help Scottsdale adjust to the long-term loss of vacated car dealerships and extended downturn in construction activity and related revenues. To this point, departments have been asked to identify budget reductions equal to 10% ($30 M) of their operating budgets to address these longer term revenue base changes. Managers have been asked to re-examine current budgets and look for savings in supplies, equipment and manage every contract with a focus on efficiency and cost reduction or savings opportunities. The evaluation process will focus on City priorities and level of service impacts. Budget reduction proposals will be reviewed to determine what can be scaled back while minimizing service impacts to our citizens.

Other specific steps are also underway. Staff from the City Manager's Office, Human Resources, and Financial Services meet every other week to review vacant positions. The objective is to ensure filling a vacant position is consistent with only our highest service needs and priorities. The strategic management of vacant positions is a key component of mitigating the impact of the revenue reduction while considering service delivery impacts to our citizens.

Additionally, staff is reviewing the "pay as you go" existing Capital Improvement Plan (CIP) and identifying areas of possible changes, such as reducing short-term funding for maintenance projects. Examples of other solutions being looked at include use of reserves, reducing fuel consumption, and overhead cost allocations to CIP projects.

As these solutions materialize, staff will provide timely updates to the City Council, citizens, employees, other stakeholders, and the media. Finally, because these modifications will be necessary to balance this year's budget as well as deal with longer–term economic downturn, our objective is to simultaneously achieve a balanced FY 09/10 Budget proposal.

Contingency Budget Update:

- General Fund Operating Budget Contingency. During the fiscal year, Financial Services staff monitors the $5,000,000 General Fund Operating Budget Contingency. As of September 30, the City Council has approved the following uses of cash from the General Fund Operating Budget Contingency:
    - July 8, 2008: $208,000 WestWorld – to bring feed and bedding program in-house.

  The total FY2008/09 General Fund Operating Budget Contingency approved by City Council to date is $208,000, leaving a cash balance of $4,792,000.

- Capital Budget Contingency. During the fiscal year, Financial Services staff monitors the use of the $4,500,000 million Capital Budget Contingency. As of September 30, the City Council approved the following uses of cash from the Capital Budget Contingency:
    - September 9, 2008: $236,000 Camelback Park – funds required to cover additional costs.

  The total FY 2008/09 total Capital Budget Contingency approved by City Council to date is $226,000. leaving a cash balance of $4,264,000. FYI - The October 7th Council Agenda also includes a proposal to use $241,873 to close tow prior year street light signal projects (the current year street light signal budget has been reduced accordingly).

NATIONAL, STATE, AND LOCAL ECONOMIC TRENDS

The following table summarizes some key national and state economic indicators, compares the results to previous actual or forecast, and provides a positive, negative, or neutral trend. Unless otherwise indicated, previous and current values represent a month-to-month comparison in the same year.

Economic Indicators	Month or Quarter	Current Value	Overall Trend***	2008 Estimate
National **– Leading Economic Index**	August	100.8	Negative	-
Consumer Confidence	September	59.8	Negative	-
Consumer Price Index	August	219.086	Negative	-
Unemployment Rate	September	6.1%	Negative	-
State **– Business Leader Confidence Index**	Q3 2008	38.5	Negative	-
Retail Sales Growth	Forecast*	0.3	Negative	2.9
Personal Income Growth	Forecast*	4.5	Negative	4.9
Wage and Salary Employment Growth	Forecast*	0.2	Negative	1.4
Manufacturing Employment Growth	Forecast*	-0.8	Negative	0.2
Unemployment Rate	Forecast*	4.7	Neutral	4.6
Population Growth	Forecast*	2.3	Negative	2.4
Hotel/Motel Room Rate (Scottsdale)	August**	$99.46	Neutral	-
Hotel/Motel Occupancy Rate (Scottsdale)	August**	49.7%	Negative	-

*Reflects Arizona Blue Chip Consensus Economic Forecast annual percent change 2008 from 2007 and projected 2009 from 2008, as of August 2008.

**Reflects over-the-year comparison.

***Overall Trend considers performance of indicators over a three-to-six-month period, not necessarily a month-to-month comparison.

National:

- The U.S. leading index decreased again in August, the third decline in the index in the last four months, and it is 2.7 percent below its level one year ago. Building permits, supplier deliveries, and initial claims for unemployment insurance made large negative contributions to the August index. The six-month change in the leading index stands at -1.1 percent (a -2.1 percent annual rate), up slightly from -1.6 percent (about a -3.3 percent annual rate) for the previous six months. The leading index has been generally falling for a year now and real Gross Domestic Product growth slowed to a 2.1 percent average annual rate for the first half of the year (including a 3.3 percent annual rate in the second quarter), from an average annual rate of 2.3 percent in the second half of 2007. The prolonged and widespread deterioration in the index suggests further weakening in economic conditions going forward.

- Consumer Confidence Edges Up Slightly. The Consumer Confidence Index, which had improved moderately in August, posted a slight gain in September. The Index now stands at 59.8 (1985=100), up from 58.5 in August. The Consumer Confidence Survey is based on a representative sample of 5,000 U.S. households. The cutoff date for September's preliminary results was September 23rd and did not capture the tumultuous events in the financial sector near the end of the month. Shocks, such as the 1987 crash, generally have a temporary adverse effect on confidence, lasting on average two to four months, unless they result in significant job losses. Consumers' assessment of current conditions continues to indicate that the current economic environment remains quite weak.

- The Consumer Price Index for All Urban Consumers (CPI-U) decreased 0.4 percent in August, before seasonal adjustment. The August level of 219.086 (1982-84=100) was 5.4 percent higher than in August 2007.

- The unemployment rate was unchanged at 6.1 percent, following an increase of 0.4 percentage point in August. Nonfarm payroll employment declined by 159,000 in September. By comparison, from January through August, payroll employment decreased by 75,000 a month on average. In September, job losses continued in manufacturing, construction, and retail trade.

  Manufacturing job losses continued in September. Over the past 12 months, employment in this industry has fallen by 140,000. Construction employment was down by 35,000 over the month. Since its peak in September 2006, employment in this industry has fallen by 607,000. Eighty-five percent of the job losses over this 2-year period have occurred in residential building and residential specialty trades. In the service-providing sector, retail employment fell by 40,000 over the month, with the largest job losses occurring among department stores and motor vehicle and parts dealers. Health care employment continued to trend up over the month.

- The unemployment rate rose from 5.7 to 6.1 percent in August, and nonfarm payroll employment continued to trend down (-84,000). In August, employment fell in manufacturing and employment services, while mining and health care continued to add jobs. Average hourly earnings rose by 7 cents, or 0.4 percent, over the month. Over the past 12 months, the number of unemployed persons has increased by 2.2 million and the unemployment rate has risen by 1.4 percentage points, with most of the increase occurring over the past 4 months.

Arizona:

- Arizona Economy: "Still Looking for the Bottom". "Recession continues to grip Arizona and several more months are likely to pass before the economy bottoms and then begins to recover. By the middle of 2009, housing markets should bottom, credit will once again be expanding, and consumers will begin to release some pent-up demand. The business cycle will turn up and by mid-2010, robust growth will return once again." *"Arizona's Economy", October 2008 – Fall Edition, University of Arizona, Eller College of Management.*

- Forecast: Arizona to lose 47,500 jobs. The latest forecast from the Arizona Department of Commerce says the state could lose nearly two percent of its nonfarm jobs before the economy begins recovering late next year. The forecast predicts 34,000 job losses this year and another 13,500 next year, a total of 47,500 lost jobs. The state had about 2.6 million nonfarm jobs in August and the unemployment rate jumped to 5.6 percent. The Commerce Department report makes major revisions to the last forecast issued in May. That report estimated just 9,200 nonfarm jobs would be lost in 2008 and 2009. The new report says lower consumer spending is expected to create a domino effect in industries such as trade, transportation, leisure and hospitality.

- 2009 not much better. The *Arizona Blue Chip* forecasters project the 2009 outlook to be only slightly better than 2008. The job growth consensus is 1.4 percent for 2009. Retail sales will be up 2.9 percent. And single-family housing permits will barely move, up 1.1 percent.

- Hotel forecast puts skids on area's tourism. The weakening economy, troubles on Wall Street, and cuts to airline flights are darkening an outlook for hotels and resorts that is already gloomy. Skittish businesses and consumers are traveling less, pushing down demand for rooms at a time when new hotels are opening at a good clip. This trend is expected to continue through the end of 2009, hurting hotel occupancy and room rates and forcing hotels to cut staffing and other costs, according to a recent revised forecast from PKF Hospitality Research released in Phoenix. Demand for rooms is projected to fall this year and next, the first back-to-back declines since 1988. Occupancy will be down each year, too, on top of a slight decline in 2007. The supply of rooms is expected to jump 6.2 percent over two years. PKF still expects room rates to grow, but at an anemic 1.3 percent in 2009, compared with the recent boom years. Room rate growth isn't expected to exceed inflation until 2012.

This latest news does not bode well for Arizona, where hotels and resorts and the tourism businesses they support account for more than 5 percent of the state's economic output and are large employers. Statewide, visitors spend $19 billion annually. Greater Phoenix has seen the biggest declines in room occupancy among the 25 markets tracked by Smith Travel Research, down 9.4 percent through August. It also has had among the biggest declines in revenue per available room, a key industry indicator. The disproportionate drop is likely to continue given the make up of visitors who come to the Phoenix area. They are largely vacationers and convention and meeting attendees whose trips are more discretionary instead of business travelers who generally still have to make their sales calls and client visits in a down economy.

SCOTTSDALE BUSINESS ACTIVITY (PROVIDED BY ECONOMIC VITALITY)

- **INNEXUS Biotechnology**, based in Scottsdale, announced the results of an extensive mouse tumor study demonstrating superiority of InNexus' DXL625 (CD20) versus Rituxan® in the xenograft model. InNexus plans to submit the data for publication along with additional data from animal studies recently completed and presented at the American Association for Cancer Research 2008 Annual Conference. The company has also launched a large-scale study of DXL625 with primates, designed to evaluate toxicity and pharmokinetics, enabling the company to move the product to the Food & Drug Administration toward human testing.

- Two Scottsdale companies made the **Inc. 500** list of fastest growing private companies in America. **iCrossing,** ranked 125 on the list, saw revenues of $110 million equating to a growth of 1,661.5%. **American Solar Electric**, ranked 475 on the list, saw revenues of $8.6 million, equating to a growth of 662.0%. An additional 22 companies in Scottsdale made the expanded Inc. 5,000 list including GoDaddy, Massage Envy, LAI International, and The Little Gym International.

- The first **W Hotel** in Arizona opened in Scottsdale on September 5th. Located on Camelback Road, just east of Scottsdale Road, the hotel features three upscale bars, the Los Angeles-based, style-conscious restaurant Sushi Roku and 224 rooms.

- A new **Element by Westin** hotel is planned for the Rose Garden project site located along the southern edge of the canal, west of Goldwater Boulevard. This new extended stay hotel concept opened its first hotel in Massachusetts and plans to open several in the U.S. and Canada over the next few years. The new chain bills itself as Eco-conscious and will incorporate recycled materials into the construction, energy star appliances in the kitchens, and recycle bins in all guest rooms.

- A new Ovarian cancer drug is being tested by TGen Clinical Research Services at **Scottsdale Healthcare**. This experimental medication increases a tumor's sensitivity to the most commonly prescribed ovarian cancer chemotherapy.

- **Allviant,** a new software development company and spin off from Salt Lake City based Medicity, has chosen **SkySong** for its new corporate location. The new venture has begun developing a new product called CarePass. The product is being designed to help consumers interact with health care providers through a variety of methods to eliminate time spent in waiting rooms, on the telephone and filling out forms.

- **General Dynamics C4 Systems** of Scottsdale has been awarded a five-year, $4 million contract for work on the ground-based command and control system for the Landsat Data Continuity Mission satellite. General Dynamics is also building the actual satellite.

- Well known seafood restaurant **McCormick & Schmick's** will open its second Valley location in Scottsdale on October 13th. The new restaurant is located in the Shops at Gainey village and occupies the space vacated by the Thaiphoon restaurant.

- **Sparkplug, Inc.**, a leading provider of fixed wireless business broadband services, relocated its headquarters from Chicago to Scottsdale. Representative from the company cited the close proximity to their primary markets and the City's reputation as a location for technology leaders as their primary reasons for the relocation.