



City of Palo Alto

Finance Committee Staff Report

(ID # 2991)

Report Type: Action Items Meeting Date: 7/3/2012

Summary Title: Cost of Services Study

Title: Discussion of Scope of Work and Methodology Utilized for the Cost of Services Study

From: City Manager

Lead Department: Administrative Services

Recommendation:

This report is provided for background purposes. In addition, Staff will be available to respond to questions at the July 3, 2012 meeting.

Background:

The City recently retained the services of MGT of America (“MGT”) to assist in the preparation of a full cost of fee related services study. It is important to note that the scope of MGT’s analysis is limited to fee-related services. The costs of services that are not fee-related, including the majority of public safety services, are not included in the scope of this particular study. However, some analyses have been conducted on these other services and additional studies will be conducted in the future. In addition, the City has hired a separate consultant to review and update the City’s development impact fees. The Fiscal Year 2013 Adopted Budget reflects \$133.4 million of General Fund revenue, of which \$20.3 million (approximately 15%) is generated from user fees.

The study of fee-related services is expected to be completed this summer and the findings and recommendations will be presented in Fall 2012. During the May 29, 2012 Finance Committee meeting, staff was asked to return to the Committee in advance of the Fall presentation to discuss the methodology that is being used to complete this analysis. This report will outline the scope of work for this analysis, methodologies utilized to develop costs and fees, and issues related to cost recovery levels.

Discussion:

User fees are charged to recover some or all costs incurred in providing a service from which one or more individuals obtain a benefit. In California, the ability to impose fees has been significantly curtailed by a series of voter approved initiatives as well as other statutory schemes and related court rulings. In general, public agencies can establish fees to recover up to 100% of the estimated reasonable cost of providing the service(s). Any amount of a particular fee that is more than 100% of the cost is considered a special tax and, by law, requires approval by two-thirds of the electorate. Please note that rental charges for rooms or facilities, fines, penalties and late charges are not technically user fees and are not required to be based on actual costs. Instead, these types of charges are more typically governed by market rates, reasonableness and other policy driven factors. Prior to the passage of Proposition 13 in 1978, local government agencies had the option of increasing property taxes to offset the cost of providing services. Proposition 13 and subsequent initiatives, including Propositions 4 and 218, significantly limited the extent to which California cities and counties could generate revenue to pay for critical public services. In addition, city and county tax revenues have been negatively impacted in recent years by a number of actions taken by the state to address its deteriorating financial status.

Given the financial challenges that most cities and counties face, many agencies are re-evaluating the costs of providing services, including fee-related services. The full cost of providing a particular service, less the revenue derived from the fee(s) charged for that service, is referred to as the subsidized portion of the cost. Historically many cities, including Palo Alto, have not passed on the full cost of service to the users. The extent to which services that primarily benefit the user are subsidized by general tax revenue is largely a policy matter. However, there are some common factors used by other agencies to evaluate “who benefits and who pays”. The latter part of this report provides a general overview of this issue in order to provide data to facilitate informed decision-making processes.

Scope of Work:

MGT was retained to provide the following deliverables for a not to exceed total cost of \$61,000:

- Estimated total cost (direct and indirect) for all fee related services- either at the activity or program level - and current cost recovery levels
- Comparable fees as available, charged in eight other Bay Area cities
- Recommendations for changes to the City's cost plan and user fees - including new or changed fees - based on best practices, industry standards and all applicable rules and regulations
- Alternative approaches and methodologies for future fee adjustments

- Models and templates that City staff can use to update cost of services calculations based on changes in costs, revenues, time and/or volume estimates

This study does not analyze the following:

- The cost of services that are not fee related (e.g. most public safety services, library services, advanced planning, etc.). Staff will review and report separately on these services.
- Development Impact Fees – the City has retained a separate consultant to review and update the City’s Planning related impact fees.
- The cost of utility services
- Potential cost savings, operational efficiencies, alternative service models or performance outcomes (although the cost of services study will provide useful information for City staff to use in these types of analyses)

MGT is utilizing data provided by City staff to quantify the total costs incurred in providing a particular service (or category of service) as well as the revenues derived in relation to those services through the imposition of user fees. For purposes of conducting this study, MGT was provided with Fiscal Year 2012 adopted expense and revenue information. The City will retain the model programs developed by MGT and staff will be able to update financial information as well as time and volume estimates in the future.

Methodology:

The standard approach for analyzing the cost of providing fee-related services is commonly referred to as a “bottom up” approach. With the exception of recreational fees, this is the approach that was utilized for all fees. Recreational fees will be discussed later in this report. A general description of the “bottom up” approach is as follows:

1. Identify all direct staff time spent on the fee related activity or service

MGT has had a series of meetings with staff from Public Works, PCE, Police, Fire, CSD and the Library to identify every employee, by classification, who performs work directly in support of a fee related service. Direct staff costs are incurred by employees who are “on the front line” and most visible to the customers (e.g. planners, park rangers, building inspectors, etc.). Once all direct staff are identified, the departments provided estimates of how much time each of those employees spends, on average, working on that particular service or program.

Developing time estimates for fee related services can be challenging and departments should be commended for the time and effort they put into this. Although MGT provided

departments with templates and other tools to assist them in developing average or “typical” time estimates, these calculations were necessarily developed by the subject matter experts in each operating department.

2. Calculate direct cost of the staff time for each fee using productive hourly rates

Productive hourly rates are used to support full cost recovery. A full-time employee typically has 2,080 paid hours per year. However, cost studies reduce that number to account for non-productive hours (sick leave, vacation, holidays, training, meetings, participation in non-core services, etc.). MGT calculated the productive hourly rate for each classification based on the salary and benefit information provided by the City and an industry standard of 1,600 productive hours.

3. Determine any other operational costs (i.e. other than personnel costs) that can readily be traced to a specific fee-related service as a direct cost

Professional services contracts are an example of an expense that can often be traced to a specific service or program.

4. Determine indirect or “overhead” costs

Indirect costs include department and citywide overhead. Department overhead costs include managers, supervisors and support staff as well as other operational costs that are incurred for a common purpose and not readily assigned to a particular service or program. Typically, these costs are allocated based on either the number of full time equivalent employees in the department or expenditures per division or cost center.

Citywide overhead costs include expenses incurred by departments that provide services to all City departments (Auditor, City Clerk, City Attorney, City Manager, Administrative Services, Human Resources and Public Works/Facilities Maintenance). These departments are also referred to as central services departments.

Citywide overhead costs are allocated to each operating department via cost plan charges. The State Controller’s Office guidelines stress the importance of allocating citywide overhead costs in a way that “equitably reflect the value of service” provided to the department receiving the service(s).

The bases for allocating citywide overhead costs can vary but must demonstrate a causal relationship between the allocation methodology and the costs allocated to the operating department. In most cases, industry standards utilize one of the following methodologies for allocating citywide overhead:

- Number of full-time equivalent staff in the operating department
- Total operating department expenditures, excluding fixed assets, pass through funds and large purchases (e.g. energy purchases)
- Actual or estimates of time spent in support of the operating department based on documented procedures

The scope of work with MGT includes an analysis of the City's current methodology for allocating citywide overhead (or cost plan charges). Cost plans must conform with Generally Accepted Accounting Principles (GAAP) as well as federal and state cost recovery guidelines. MGT's comments and recommendations in relation to the City's cost plan will be incorporated into the City's Fiscal Year 2014 cost plan. Once total costs are calculated, volume data is used to determine cost per service or activity. Finally, revenue data provided by the departments is used to determine current cost recovery levels.

Please note that recreational fees are typically calculated at the program levels (e.g. swimming programs, classroom programs, etc.) for several reasons, including:

- a. Programs and activities change in size and scope from one season or year to another, rendering a consistent fee schedule many times impractical;
- b. Many recreational or facility fees are set at comparable venue or service rates;
- c. The cost to calculate some fees at a more granular level could be outweighed by any realistic revenue offset, especially in light of the first two reasons above. So, for example, costs and revenues for classroom registrations are reported, but the scope of work for this study did not include itemization of costs and revenues by type of class (e.g. story acting class).

5. Crossover Support from other departments.

Where applicable, direct and indirect costs associated with external departmental assistance in the user fee process is an additional cost component of fee-for-service activities. For example, a set of building plans may be routed to PCE, Public Works and Fire staff for review and comment. If these departments do not charge their own plan review fees, their costs are appropriately considered as an additional cost component to the fee charged by the "home" department.

General Parameters for Setting Fees:

In setting fee levels, the primary guiding principle is that the charge cannot be greater than the cost incurred in providing the service. In addition, fees cannot be set higher than costs in one area in order to subsidize another program or service. Beyond that, fee setting is largely a policy matter typically focused on who benefits from - and who pays for - the service. Certain core municipal services clearly benefit the community as a whole (e.g. police patrol) and are typically funded 100% by General Fund revenues. Other services primarily benefit the individual (e.g. building and development, certain recreational services, etc.) and, as such, fees for these services can appropriately be set at full cost recovery. However, many services fall between 100% community benefit (no cost recovery) and 100% individual benefit (full cost recovery). For the latter, the level of cost recovery is driven by a number of factors including a particular jurisdiction's goals and priorities, fairness and equity, competing needs, and impact on demand. In the end, however, every dollar used to subsidize a service that primarily provides a private benefit is a dollar that is not available to fund other community public services.

The focus of the July 3rd Finance Committee meeting is the methodology used to complete the study. The report that will be provided in the Fall will assist in policy setting decisions such as cost recovery levels, level of services provided, method of service delivery and opportunities to develop public-private partnerships. Staff will provide a wider view of the process and timeline as well as examples of user fee policies used in other agencies as part of the Fall report.

Attachments:

- Attachment A-Scope of Work (DOCX)

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City Manager Approval:


James Keene, City Manager

ATTACHMENT A
SCOPE OF SERVICES - MGT OF AMERICA

Project #1: OMB A-87 and Full Cost Allocation Plans

1. Provide the City with a list of financial and operational data requirements for the study.
2. Review and comment on the City's current methodologies and processes for collecting, calculating and allocating direct and indirect costs.
3. Meet with staff from the Office of Management and Budget (OMB) to discuss critical issues surrounding development and implementation of the cost allocation plan.
4. Conduct a kick off meeting with departments heads and designated staff to discuss the purpose, scope, requirements and timeline for the project, followed by meetings with each central service department or division to identify the primary services or functions provided, the recipients of those services, and both gross and net cost for each service.
5. Recommend, based on applicable laws and regulations, industry guidelines and best practices, the bases for allocating these costs to their benefitting funds, departments, cost centers and/or activities.
6. Draft an OMB A-87 compliant and a full cost recovery plan consistent with Generally Accepted Accounting Principles (GAAP) using MS Windows 7 based software that the City can adapt and continuously update to reflect financial and organizational changes.
7. In addition to the draft plans, provide:
 - a) A narrative of changes and results
 - b) A schedule comparing total allocated costs between fiscal years, to receiving departments defined criteria (e.g. a variance greater than 5% or \$10,000)
 - c) A schedule documenting unit costs of identified support activities such as the cost of payroll per employee or the cost per purchase order
 - d) A schedule documenting unit costs of identified support activities such as the cost of payroll per employee or the cost per purchase order
 - e) A self-auditing schedule that reconciles the sum of all central service department expenditures to the sum of allocated costs
8. Meet with each central service department and OMB staff to present and discuss the draft plans and make modifications as directed by the Administrative Services Director/CFO.
9. Prepare supplemental schedules, management reports, compliance verbiage and certifications as necessary or requested.
10. At the request of the Administrative Services Director/CFO, participate in one presentation of the final plans to the City's Finance Committee.
11. Assist City staff in integrating the cost plans into the City's existing financial and operating systems and provide one training class for City staff.
12. Consult with City staff, should the need arise, to defend the cost allocation plans as a result of audits or other challenges.

Project #2: Comprehensive Review of the Municipal “User” Fee Schedule

1. Review the City’s municipal code and all existing fees.
2. Provide the City with a list of all financial and operating data requirements for the study.
3. Meet with designated OMB staff to solidify parameters and timeframe for the study and discuss issues that could impact the study.
4. Conduct a kick off meeting with department heads and designated staff to define the purpose, scope, requirements and timeline for the project, followed by meetings with individual departments to assess current methodologies for calculating costs and current recovery levels.
5. Ensure 100% of available staff hours are identified to fee or non-fee related services and calculate productive hourly rates for all employee classifications contributing to fee related services.
6. Conduct a full cost analysis using fully burdened rates.
7. Prepare a draft FY 2013 municipal fee schedule that reflects best practices and conforms to all applicable laws, statutes, rules and regulations governing the collection of fees, rates and charges by public agencies including, but not limited to, Proposition 218 and Proposition 26.
8. Identify any factors such as statutory limitations, market conditions or other potential policy and service level considerations which prevent, or could prevent, full cost recovery.
9. Prepare a narrative explanation of the basis for the recommended fees.
10. Prepare a financial analysis of projected revenue impacts and changes associated with the recommended fees.
11. Meet with City staff to discuss the draft fee schedule and make agreed upon revisions with final approval from the Administrative Services Director/CFO.
12. Prepare a Final FY 2013 municipal fee schedule, including estimated costs, revenues and cost recovery levels for each fee.
13. Prepare and deliver one presentation to the City’s Finance Committee or the City Council to facilitate their understanding of the fee study and its implications for the City. This presentation will be at the guidance and discretion of the Administrative Services Director/CFO.
14. Provide the municipal fee schedule and models written in MS Excel to the City so the City can adapt and continuously update these to reflect financial and organizational changes.
15. Consult with City staff, should the need arise, to defend the City’s fees as a result of any legal or other challenges.

Project #3: Survey of Comparable Agencies (Optional at City’s discretion)

1. Conduct a benchmark survey of comparable public agencies
2. Work with City staff to identify common fees charged in comparable agencies and develop a matrix to illustrate comparable fees.

