



LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

City of Palo Alto
December 2004



Long Range Financial Plan

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CHAPTER ONE

STATE OF THE ECONOMY

GENERAL ECONOMIC OUTLOOK

The national economy continues to trend slowly upwards. In the three months ending September 30, gross domestic product grew at a 3.7 percent annual rate.¹ A recent report by UCLA Anderson Forecast predicted that the current pace of the national economic recovery will continue, with 3 percent national annual growth through 2005. The forecast also said that a recession is possible in the next couple of years if one or more sectors, such as manufacturing or retail, slump.²

The reasons for the cautious growth predictions include: the price of oil, the geopolitical situation, rising healthcare costs, weak job creation, and the fear that consumers may reduce their spending, as the rising cost of necessities crowds out discretionary spending.

Record-high oil prices – in particular the cost of gasoline – are driving up the cost of consumer necessities. The impact is likely to be felt in other areas of spending, such as vacations, entertainment, electronics, and eating out. Some economists estimate that for every one-cent increase in the price of gas, spending in other areas will decline by one billion dollars. Retail experts estimate that the current higher gasoline prices take away \$7.00 per week from an average family budget.³

Similarly, healthcare costs comprise an increasing portion of household spending. According to a specialist with the Pennsylvania consulting firm Economy.com, “Consumers are now spending more on healthcare than ever before. It's difficult to isolate the impact of healthcare costs, but what's unmistakable is that it's taking away from (discretionary) spending. The only question is how much.”⁴

Since consumer spending has fueled the economic recovery to date, prospects of decreased discretionary spending bode ill for continued recovery.

Finally, although unemployment has declined, job growth continues to lag behind population growth, and workers' incomes have declined. According to economists, businesses have the cash and demand to add workers, but business confidence is fragile. According to the Economic Policy Institute, the nation is still about a million payroll jobs shy of peak employment. As a result, wages have suffered. Inflation-adjusted median family income fell from \$54,191 in 2000 to \$52,864 in 2002, a two-year drop of \$1,327.⁵

The national unemployment rate has hovered near 5.5 percent from July to October. Consistently, the number of payroll jobs gained has been insufficient to keep pace with the entry of new workers into the U.S. labor market. An aver-

¹ Tom Abate: “U.S. growth steady in quarter,” San Francisco Chronicle, Oct. 30, 2004

² Dawn C. Chmielewski: “Economic recovery to inch along,” San Jose Mercury News, Sept. 8, 2004.

³ Lars Perner, Ph.D., “Gasoline Prices, Consumers, and the Economy,” www.consumerpsychologist.com

⁴ Tom Abate: “Workers cut back to pay medical tab,” San Francisco Chronicle, Sept. 10, 2004

⁵ Monica Rivituso: “More Labor Pains,” SmartMoney.com, Oct. 8, 2004

⁶ Michael Martinez: “Stocks tumble below 10,000,” San Francisco Chronicle, Oct. 15, 2004

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

age of 104,000 payroll slots were added during the June through August period, but this was short of the 150,000 needed.⁶

In September, a total of 96,000 jobs were added, again less than the growth in worker population.⁷ In October, a greater-than-expected 337,000 jobs were created,⁸ possibly signaling a more positive trend.

However, the unemployment figures do not include those who have abandoned the job search and/or the work force. According to the federal Bureau of Labor Statistics, there were 1.6 million “marginally attached” persons in October of this year. These persons were out of work and looked for a job sometime in the last 12 months, but were not counted since they did not actively search for work in the 4 weeks preceding the survey. Of the 1.6 million, about one-quarter were considered “discouraged,” believing there were no jobs out there, and the remaining three quarters had not searched for reasons such as school or family responsibilities.⁹

In a sign of a strengthening economic foundation, company-announced layoffs have declined. Job-cut announcements by U.S. companies fell 5.6 percent in October to 101,840, according to outplacement firm Challenger Gray and Christmas. Furthermore, job reduction announcements are down 40.7 percent from October 2003, while year-to-date job cuts are down 21 percent from 2003's pace. However, layoffs remained above 100,000 for the second straight month, for the first time since January and February 2003.¹⁰

LOCAL ECONOMY VERY SLOWLY INCHING UPWARDS

The California economy started to turn around in 2003, with modest growth in 2004, yet growth in the Bay Area has been muted. Although there is greater optimism in the Bay Area than a year ago, it is qualified by concerns regarding slow job growth, the state budget shortfall, outsourcing, and the high cost of gasoline.

According to a recent poll, Californians' negative feelings about the state's economy have improved significantly since last year, and many voters expect further improvement in the next 12 months. Twenty-four percent of Californians surveyed in August said the economy is strong, up from 11 percent in August of 2003. In addition, more respondents say their own financial situation has improved since last year (41 percent) than say things have worsened (27 percent).¹¹

However, Bay Area residents surveyed had a more negative outlook on their economic situation. Fifty-nine percent of voters polled here say the state is in bad economic times (versus 53 percent statewide), while 14 percent consider these to be good economic times (versus 24 percent statewide). In April 2003, the corresponding numbers in the Bay Area were 89 percent and 4 percent.¹²

Many forecasters expect slight employment growth in California to continue this year and next. The July/August issue of the Western Blue Chip Consensus forecast (an average of eight economic forecasts) calls for California nonagricultural employment to increase 1.1 percent in 2004 and 2.0 percent in 2005.¹³ The Anderson Forecast predicts steady if unspectacular job growth for the rest of the year followed by faster – if not exactly brisk – employment gains of 2 percent annually in 2005 and 2006.¹⁴

UNEMPLOYMENT RATE (%)						
(Not seasonally adjusted)						
	2000 Average	2001 Average	2002 Average	2003 Average	Sept. 2003	Sept. 2004
U.S.	4.00	4.70	5.80	6.00	5.80	5.10
California	5.00	5.30	6.70	6.70	6.40	5.70
San Francisco	2.80	5.20	5.60	6.80	5.50	4.20
Santa Clara County	2.00	4.50	8.40	8.20	7.90	5.50
Palo Alto	1.00	2.30	4.40	4.30	4.10	2.80

Source: US Dept. of Labor and California Economic Dev. Dept, LMI

⁷ Monica Rivituso: “More Labor Pains,” SmartMoney.com, Oct. 8, 2004

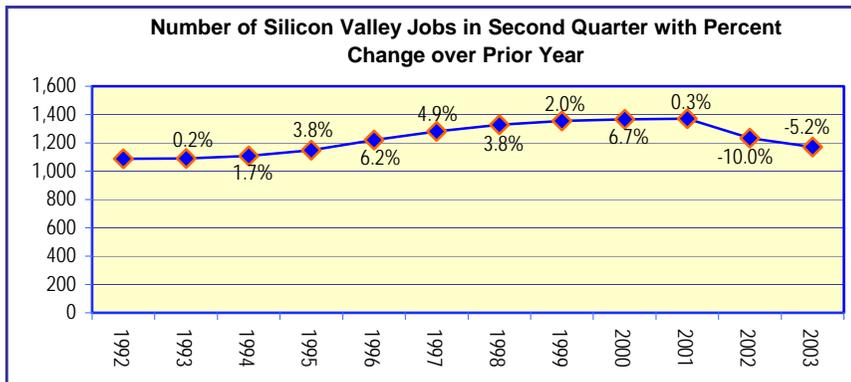
⁸ Tom Abate, “State, local figures improve,” San Francisco Chronicle, November 16, 2004

⁹ “Employment Situation Summary,” U.S. Department of Labor Bureau of Labor Statistics, November 5, 2004

¹⁰ “US layoffs down 5.6 percent to 101,840: survey,” News Designerz.com, November 10, 2004

¹¹ George Raine: “Cloud of economic pessimism begins to lift from California,” San Francisco Chronicle, Aug. 26, 2004

¹² George Raine:



Source: California Employment Development Department, as published by Joint Venture's 2004 index of Silicon Valley. Data do not include individuals who are self-employed.

The California unemployment rate has continued declining in the first half of 2004, from an average of 6.8 percent in the third quarter of 2003 to 6.2 percent in the second quarter of 2004.¹⁵ In October, the statewide unemployment rate dipped to 5.7 percent, causing one economist to comment, "These are the best numbers we've seen for a long time...It's a good solid sign that the economy is slowly picking up."¹⁶

The Bay Area continues to trail California and the nation as a whole in job creation. The region has continued to lose jobs over the last 12 months, albeit much more slowly than it had previously. October numbers were more positive, so if the trend continues the losses may be made up. Between July 2003 and July 2004, San Jose reported modest job losses of 1.1 percent while San Francisco showed a gain of 0.3 percent. In Santa Clara County, October unemployment was 5.3%, down from 5.5% in August, and 8.1% in August of 2003. Since October 2003, Marin, San Mateo, and Santa Clara Counties have added about 6,300 jobs (0.7 percent). In the heart of Silicon Valley, total payroll is still down about 7,000 jobs (0.8 percent) since October 2003, but the rate of job loss in the county is slowing. Stephen Levy of the Center for Continuing Study of the California Economy commented: "The Bay area has about pulled back

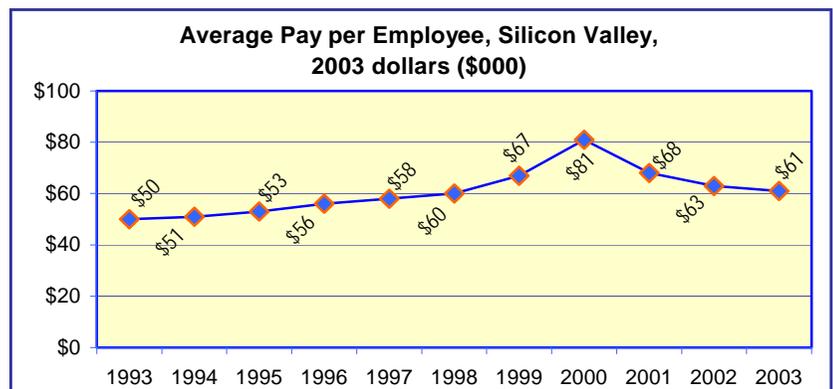
to even where it was last year, which is an improvement...[but] we need several months like this."¹⁹

As mentioned earlier, unemployment figures do not tell the whole story, because the long-term unemployed are dropping off the rolls. Twenty-four percent of the state's unemployed persons had been out of work for more than 27 weeks. In March 2001, the start of the last recession, the comparable rate of long-term unemployment was 13.2 percent.²⁰ Many long-term unemployed remove themselves from the official unemployment rolls, either by giving up the job-hunt, remaining under-employed, or becoming self-employed.

OTHER LOCAL CONCERNS AND OBSTACLES

The state budget situation continues to have implications for state and local economic prospects as well as for City coffers. According to UCLA Anderson Forecast:

...The economic implications of what [UCLA] dubs the "budget mess" will result in the loss of 45,000 state and local jobs in 2004 and 2005. Unless the problem is fixed, the study predicts



Source: California Employment Development Department, as published by Joint Venture's 2004 index of Silicon Valley

¹³ Department of Finance Bulletin, September 2004

¹⁴ Dawn C. Chmielewski: "Economic recovery to inch along," San Jose Mercury News, Sept. 8, 2004.

¹⁵ State Board of Equalization: Economic Perspective, August 2004

¹⁶ Joe Hurd with UCLA Anderson Forecast, as quoted by Tom Abate, "State, local job figures improve," San Francisco Chronicle, November 16, 2004

¹⁷ Dawn C. Chmielewski

¹⁸ Employment Development Department, Labor Market Information Division

¹⁹ Tom Abate: "State, local job figures improve," San Francisco Chronicle, November 16, 2004

²⁰ Tom Abate: "State's jobless rate still too high," San Francisco Chronicle, July 10, 2004

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

that state funding of road and bridge improvements and other long-term projects will be deferred. With a deteriorating infrastructure, the state will be unable to attract new residents or foster new businesses.²¹

In fact, many businesses currently in California have considered moving away. Nearly one in every six (14 percent) Bay Area companies has “seriously considered” moving their entire operations out of the nine-county region within the past two years, according to the Bay Area Council's quarterly Business Confidence Survey. Additionally, 31 percent of business leaders say that their company has considered moving business functions outside the region, and nearly one-fifth (18 percent) considered off-shoring jobs held by Bay Area workers. Off-shoring was considered by more than half of the largest employers – those with more than 10,000 Bay Area employees.²²

Outsourcing continues to be a concern. The table adjacent shows India-outsourcing plans for companies with a presence in the Bay Area. Any local jobs moved to India mean less income in the Valley, and less sales tax and other revenues for the City.

Lastly, rising gas prices are having a tangible impact on at least one Palo Alto business: Palo Alto's CNF Inc, a \$5.1 billion firm, runs two huge transportation companies, Conway Transportation Services and Menlo Worldwide. It is passing the higher costs to customers as a fuel surcharge of 8.5 percent on top of the standard invoice. According to spokeswoman Nancy Colvert, “We are very dependent on the manufacturing economy...If gas prices rise to the extent that people stop buying because they're buying fuel, that would have an impact.”²³

Outsourcing versus Headcount Reductions: The Case of India				
Company	Latest Manpower	India Manpower	Plans for India Office	Job Cuts Announced/Carried out in the last 12 months
Accenture	65,000	3,500	8,000 employees by Aug 2004	1,000
Adobe Systems	3,250	185	250 people in 6 months	260
Cadence	5,000	315	Doubling team in 4 years	500
Cap Gemini	56,500	800	2,000 people by December 2003	1,000
Cisco	34,466	2,300	n/a	Have frozen hiring engineers globally but have continued to increase India outsourcing
Covansys	4,556	2,000	2,800 people in 1 year	200
CSC	92,000	1,200	4,800 people by 2004	607
EDS	138,000	300	2,400 people by 2005	8,200
i2	2,800	1,000	Recruiting actively	Nearly 1,800 people
IBM Global Services	150,000	3,100	10,000 people in 3 years	Nearly 2,000 people
Intel	79,200	950	3,000 people by 2005	4,700
Keane	5,819	623	2,000 people by end 2003	607
Logica-CMG	24,000	350	1,000 people by end 2004	2,650
Lucent	35,000	570	n/a	13,800
Microsoft	55,000	200	500 people in 3 years	Increasing workforce
Oracle	40,000	3,159	6,000 people in the next 12 months	200
Sapient	1,500	600	Growing the India Center and Global Delivery	863
SunMicro	36,000	700	Growing the India Center	5,480
Syntel	2,700	2,000	650	n/a
Texas Instruments	34,400	900	1,500 people by Mar 2006	800 personnel
Xansa	5,583	1,200	6,000 people in a few years	502

Source: Morgan Stanley India
ABAG Focus 2004-2005 Regional Economic Outlook, January 29, 2004

²¹ Dawn C. Chmielewski: “Economic recovery to inch along,” San Jose Mercury News, Sept. 8, 2004.

²² Bay Area Council: “Companies Consider Moving Jobs Out of Bay Area, Survey of Region's Executives Shows,” August 6, 2004

²³ Carolyn Said: “Burning Up Over Gas Prices,” San Francisco Chronicle, June 9, 2004.

 **CHAPTER TWO****ADDRESSING THE ECONOMIC DOWNTURN**

Since the 2000-01 peak in the economic cycle, the City of Palo Alto's General Fund has been presented with the dual challenges of a \$10 million (16 percent) tax revenue decline and an \$8.1 million (34 percent) growth in employee benefit expense—primarily in the pension and healthcare expense categories. This represents a net \$18.1 million financial imbalance that has been the focus of City staff efforts for the past four years.

MAINTAINED COMMITMENTS

Significant accomplishments have been made to accommodate the fiscal imbalance while essentially maintaining pre-recession service levels. In addressing the recent annual budget deficits, the City Council identified its desire to maintain the following commitments:

- Preserving "essential" services
- Maintaining funding of the "CityWorks" infrastructure program
- Maintaining the City's investment of \$6 million per year in local education
- Keeping healthy General Fund reserves
- Preserving organizational vitality

TREADING WATER

For the past four years, the City has faced annual operating deficits of \$8 - \$12 million as revenues continued to decline and expenses increased. Tax revenue growth has been consistently below conservative estimates, as the post-recession recovery proves to be slower and less robust than those of the past. Specifically, employee pension costs have doubled and healthcare expenses have grown by 50 percent over the four-year period. As a result, each year's budget-balancing effort is primarily "treading water," as both cost containment and recovery efforts are offset by reduced revenues and increased expense.

STRENGTHENING THE BOTTOM LINE (SBL) 2001-2003

Begun in fiscal 2001-02, SBL was a bottom-up approach to organizational downsizing. Department action teams were charged with making and implementing both cost recovery and cost containment strategies with an overall goal of balancing the budget. With hundreds of suggestions, the following were a few of those implemented:

- Instituting a hiring freeze
- Implementing an unpaid employee furlough
- Adjusting fees to attain full cost-recovery
- Streamlining administrative processes such as procurement and contracting
- Using technology to enhance productivity
- Auditing tax revenues
- Aggregating utility bills for a large-account discount
- Refinancing debt to lower debt service expense
- Making strategic investments such as retrofitting traffic signals and City facility light fixtures to save on utility costs
- Delaying the replacement of vehicles and equipment
- Auditing the use of all fleet vehicles

The League of California Cities and the National League of Cities recognized the SBL approach to operational downsizing. The City was awarded the Helen Putnam Award for Excellence - Grand Prize at the League's 2003 national conference. Avoiding across-the-board cuts and layoffs while maintaining reserves and quality service delivery were the key factors acknowledged with the award.

COUNCIL-MANDATED 5 PERCENT BASE EXPENSE REDUCTION 2003-2005

As the City entered the 2003-05 budget cycle, it was clear economic conditions were continuing to worsen, albeit at a slower rate. The November 2002 Long Range Financial Plan (LRFP) confirmed the continuing "structural" deficit, and illustrated the impact of a 5 percent (\$5 million) reduction in base expense as mandated by City Council in March 2002. This reduction was implemented over the two-year period, primarily by the elimination of nearly 40 General Fund positions that were made vacant in the hiring freeze started two years earlier, along with a restructuring around those vacancies.

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

BUDGET BALANCING ACHIEVEMENTS

There are a number of successful efforts that have been incorporated into the City's financial planning processes. These include:

- Base budget cuts resulting in \$5 million annual savings
- Institution of a longer vesting period for most new employees for retiree medical benefits
- Capping of medical benefits to the PERS Choice Basic level for a majority of employees
- Implementation of an unpaid employee furlough with nearly \$1 million in annual savings for the past two years
- Elimination of several vehicles from the City's fleet
- Consolidation and renegotiation of the City's cell phone contracts
- Just-in-time capital project budgeting by clearly identifying the annual funding requirements of multi-year projects

EFFORTS TO ENHANCE THE LOCAL ECONOMY AND CITY REVENUES

Two mayoral committees were formed to reach out to businesses and address their concerns. The Mayor's Ad-Hoc Committee on the City of Palo Alto's Economic Base resulted in Council member and staff visits to a wide variety of businesses to identify issues and attempt to solve them. One by-product of these visits was to audit and re-evaluate the City's planning and permitting process in order to accelerate process times. For one auto dealer, staff formed teams to resolve specific site development issues. A second outcome was the collaborative effort of the City and downtown businesses to form a Business Improvement District to promote and enhance the area for shoppers. A third outcome was the Shop Palo Alto campaign. The other mayoral committee, the Retail Committee, concentrated on smaller businesses and ways the City could aid them. Key issues such as support for local business associations, signage, parking, a business registry, a needs assessment, and promotions were explored along with actions to support them.

The City has acted on a number of other initiatives to promote business. These include zoning changes to accommodate better and more visible signage for automobile dealerships, utility audits of lighting and power usage by businesses to help them save on costs, and exploration of Redevelopment Districts.

OTHER MUNICIPALITIES' FISCAL CONDITIONS

The City of Palo Alto is not alone in facing structural deficits. An informal survey of nearby cities revealed that many are facing deficits for the current fiscal year and beyond. They have adopted a variety of approaches, including layoffs (San Mateo), reducing services (Fremont, Richmond), use of reserves (Sunnyvale), freezing vacant positions (Palo Alto, Mountain View), raising new revenue sources, delaying capital projects, stretching out pension payments, and modifying benefit plans. Additional strategies include: reliance on one-time solutions (e.g., selling City owned property) in the hopes of an eventual rebound in revenue, refinancing current debt, and utilizing existing entities, such as Redevelopment Agencies (RDAs), to cover expenses that may otherwise be borne by the General Fund (assuming such expenses can be covered legally by the RDAs). Each local jurisdiction responds to budget crises in different ways depending on its available resources, political climate, expense patterns, union agreements, and other factors.

For example, the City of Cupertino's 5-year plan includes deficit spending each year, which will virtually eliminate its reserves by the end of the 5-year period. It is trying to identify new revenue sources and service reductions, having already reduced its CIP budget to close to zero.

The City of Sunnyvale is better positioned for the current fiscal year, since it drew down more on its reserves last year than it actually needed. It is planning \$2 million in reductions for 2005-06. However, that plan assumes the implementation of a 911 fee bringing in \$1.8 million. Since the fee has not been approved by Council or sent to the voters, the city may have to make closer to \$4 million in reductions.

The City of Redwood City projected in January of this year a 2004-05 deficit of \$7 million (or 9.9% of expenses), and a \$5.8 million deficit for 2005-06. For 2004-05, it plans to use \$3.5 million from reserves along with \$3.5 million in expenditure cuts. For fiscal 2006, it plans to use \$1.9 million in reserves, and make \$3.9 million in cuts.

After three years of substantial cuts, the City of Mountain View projects a \$1 million surplus for 2004-05, and expects revenues to meet expenditures in 2005-06. Staff attributed this in part to having established a PERS liability reserve last year, which has a \$1 million balance. The increased PERS rates will be paid from that reserve. Mountain View's 2004-05 budget cut 6.75 positions (FTEs), bringing the total headcount reduction to 50.1 over the three years. Twenty of those positions were

eliminated in 2002-03, the first year of the cuts. Mountain View has a Redevelopment District and a Shoreline Regional Park Community, both of which rely on incremental property taxes. It is possible these played a role in solving Mountain View's budget problems.

CHALLENGES AHEAD

As the City prepares for a fifth year of budget balancing challenges, in many respects this next effort may prove to be the most difficult yet for several reasons. First, much of the discretionary spending has been removed from the City's budget over the past four years, while most service levels remain nearly unchanged. Second, labor negotiations will be complex as the City operates in a heavily unionized environment and participates in a regional salary marketplace. Third, the budget-balancing effort will require that hard decisions be made to determine "essential" service levels.

COMPARISON OF CURRENT FORECAST WITH FORECAST IN 2004-05 BUDGET DOCUMENT

The combination of a prolonged sluggish economy, PERS rate increases for health and retirement, state takeaways, and compensation agreement negotiations has created a fluid fiscal environment. A comparison of the current forecast with that in the 2004-05 budget shows significant differences in the bottom line Net Operating Surplus (Deficit) for 2004-05 and 2005-06:

	2004-05	2005-06
Budget Document Forecast	\$777,000	\$612,000
Current Forecast	(\$1,517,000)	(\$5,176,000)
Change	(\$2,294,000)	(\$5,788,000)

Item/Year	Budget Impact
2004-05	
Lower than anticipated Fire Basic Life Support and Planning permit fees in 2003-04 affecting 2004-05 and 2005-06 revenues	\$1,179,000
Additional State takeaways in revenues affecting 2004-05 and 2005-06 revenues	\$540,000
Budget Amendment Ordinances resulting in additional expense	\$308,000
2004-05 Total	\$2,027,000
2005-06	
One-time draw upon Technology Reserve Fund of \$3.5 million in 2004-05 to solve budget shortfall that is now being added back over three years (2005-06 through 2007-08) to replenish reserve	\$1,000,000
Newly received PERS retirement rates for 2005-06	\$1,300,000
Lower Fire BLS and Planning permit fees	\$1,179,000
Lower sales and transient occupancy taxes	\$600,000
Negotiated and potential compensation agreements higher than previous model	\$1,000,000
Additional state takeaways in revenues	\$540,000
2005-06 Total	\$5,619,000

These changes result from the following:

Please note that the above totals do not equal the deficits in the LRF forecast and are solely meant to show the difference between this year's and last year's LRF forecast for 2005-06 as well as the causes of the deficits in 2004-05 and 2005-06.

While cities in the Bay Area are facing similar fiscal challenges, each will address them in its own way. Although staff has frequently stated in letters and reports (such as CMR:256:03) that simplistic comparisons between the City's budget and those of other cities are misleading, the comparisons persist. Despite the City Auditor's recent Span of Control report, the perception remains that the City's overall administrative function or staffing levels are rich. Tables 1 and 2 are provided to shed additional light on this issue, by showing changes in staffing levels by fund from 2003-04 to 2004-05. The General Fund

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

reduced staffing by 6.1 FTE during this period. This is in addition to the 33 FTE cut between 2002-03 and 2003-04.

Table 1 shows the change in FTEs by fund and department. Table 2 (next page) shows that the number of administrative FTE (CAOs, Administrative Services, and Human Resources) represents 9.3 percent of the City's entire staff. This statistic shows a relatively low ratio of administrative to operational staffing and will withstand benchmarking comparisons. Palo Alto is unique as a "full-service" city providing all utility services (352.6 FTE) that few local cities provide. The administrative function within the City provides support to all of the City's departments and enterprise operations.

Table 3 (next page) shows that a comparison of total General Fund expenses in Palo Alto to those in other cities can be deceptive. Although each city has a unique budget, the City of Palo Alto's budget includes significant expenses and services that are not included in those of other cities. These include fire services to Stanford University (\$6.1 million reimbursement), PAUSD covenant payments for Cubberley Community Center (\$6.0 million), administrative services to the Enterprise Funds (\$10.7 million GF reimbursement), and other expenses. To draw fair and insightful conclusions, these costs must be incorporated into a comparison with other cities' budgets.

**TABLE 1: City of Palo Alto Staffing by Fund by Department
Fiscal Year 2003-04 and 2004-05 Comparison**

	2003-04 Staffing	2004-05 Staffing	Difference	% of Total
<u>General Fund</u>				
City Attorney	11.75	11.75	-	1.76%
City Auditor	3.75	4.00	0.25	0.60%
City Clerk	6.00	6.00	-	0.90%
City Manager	10.50	10.50	-	1.57%
Administrative Services	55.00	55.50	0.50	8.29%
Human Resources	14.10	14.10	-	2.11%
Community Services	143.75	99.75	(44.00)	14.91%
Fire	128.50	128.00	(0.50)	19.13%
Library	-	43.00	43.00	6.43%
Planning & Community Environment	54.80	54.80	-	8.19%
Police	171.00	167.75	(3.25)	25.07%
Public Works	76.20	74.06	(2.14)	11.07%
Total General Fund	675.35	669.21	(6.14)	100.0%
<u>Enterprise Funds</u>				
Electric Fund	120.50	120.58	0.08	34.20%
Gas Fund	46.17	46.20	0.03	13.10%
CPA External Services	5.70	5.70	-	1.62%
Wastewater Collection Fund	27.32	27.33	0.01	7.75%
Water Fund	39.76	39.79	0.03	11.28%
Refuse Fund	33.60	35.07	1.47	9.95%
Storm Drainage Fund	9.75	9.90	0.15	2.81%
Wastewater Treatment Fund	68.00	68.05	0.05	19.30%
Total Enterprise Fund	350.80	352.62	1.82	100.0%
<u>Internal Service Funds</u>				
Printing and Mailing	4.15	4.15	-	7.74%
Technology	33.15	33.50	0.35	62.44%
Vehicle Replacement & Maintenance	16.00	16.00	-	29.82%
Total Internal Service Fund	53.30	53.65	0.35	100.0%
<u>Other Funds</u>				
Special Revenue	1.20	1.20	-	7.68%
Capital Projects	12.70	14.42	1.72	92.32%
Total Other Fund Positions	13.90	15.62	1.72	100.0%
TOTAL POSITIONS	1,093.35	1,091.10	(2.25)	

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

**TABLE 2: City of Palo Alto Staffing by Fund
Fiscal Year 2003-04 and 2004-05 Comparison**

<u>Summary</u>	2003-04 Staffing	2004-05 Staffing	Differ- ence	% of Total
Total General Fund	675.4	669.2	(6.1)	61.3%
Total Enterprise Fund	350.8	352.6	1.8	32.3%
Total Internal Service Fund	53.3	53.7	0.4	4.9%
Total Other Fund Positions	13.9	15.6	1.7	1.4%
TOTAL POSITIONS	1093.4	1091.1	(2.3)	100.0%
Total CSD, Fire, Library, Planning, Police and Public works	574.3	567.4	(6.9)	52.0%
Total Enterprise Fund	350.8	352.6	1.8	32.3%
Total Internal Service Fund	53.3	53.7	0.4	4.9%
Total Other Fund Positions	13.9	15.6	1.7	1.4%
Total CAOs, Administrative Services and Human Resources	101.1	101.9	0.8	9.3%
TOTAL POSITIONS	1093.4	1091.1	(2.2)	100.0%

**TABLE 3: Total General Fund Expenditures
for Year Ending June 30, 2003 (\$ millions)**

	General Fund
Expenditures	
Actual Expenditures	108,523
FY 2003 Reappropriations	4,279
Subtotal	\$112,802
Less	
Stanford Fire Agreement	(6,111)
Reimbursements from Utilities	(10,677)
Payments to PAUSD	(5,559)
External IT Services	(58)
Health & Human Service Agreements	(1,350)
Utilities Tree Line Clearing	(844)
Animal Control Services	(386)
Subtotal	(\$24,985)
Actual General Fund Expense	\$87,817
Population	60,500
Per Capita Spending	\$1,452

CHAPTER THREE

PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

In the City's forecast, as in all forecasts, there is a mixture of methodology, factual information, anticipated events, judgment, and informed guesswork. As discussed in Chapter 5, staff has discussed its methodology with a prominent local economist and finance personnel in a nearby city who do forecasting, and compared its forecast results with those of other quantitative methodologies. These conversations and comparisons have added value to the City's projections and also confirmed that forecasting is part science and part art.

FORECASTING METHODOLOGY: REVENUES

As in past Long Range Financial Plans, staff has assumed that the compound annual rate of growth (CAGR) for economically sensitive revenue sources between 2004-05 and 2014-15 will be roughly similar to that between the years 1993-94 and 2003-04. For example, the CAGR for sales taxes between 1993-94 (\$14.6 million) and 2003-04 (\$18.2 million) was 2.2 percent. This 2.2 percent growth rate was then applied to the sales tax forecast for years 2004-15, implying that future growth will mimic that of the past decade.

Using the CAGR methodology produces a somewhat conservative growth rate. Specifically, this methodology does not recognize the extraordinary one-time revenue gains experienced in 1999-00 and 2000-01. Likewise, had a recession occurred in the intervening years, it would not have affected the average rate of growth. In staff's view and given the prognostications of economists for the Bay Area, using this methodology ensures a more realistic approach to revenue and expenditure growth in the future.

Implicit in the forecast is the assumption that the City would channel any revenue windfalls, such as those in the "dot-com" era, into reserves or one-time capital improvements. This would avoid the dilemma of committing resources to new, ongoing operating programs or labor commitments in flush times, only to see them cut or under-funded when revenues retreat to more normal lev-

els. One drawback in the CAGR methodology is that it does not account for significant positive or negative structural changes in revenue generation (e.g., departure of automobile dealership or addition of a new electronics business). In such instances, the City would have to revise its forecast.

Staff has included the impact of a projected economic downturn in the forecast. Assuming that the economy continues to show signs of mild recovery throughout 2004, staff's best estimate is that another downturn will occur in approximately 7 years, around 2011.

BACKGROUND FOR FORECAST OF REVENUES

State Budget Actions and Revenue Changes

In 2004, the State of California instituted a number of revenue source changes and takeaways that impact the revenue streams shown in the forecast. The two most important changes are the "triple-flip" affecting sales tax and another takeaway of funds (called "ERAF III") involving vehicle license fees and property taxes.

The "triple-flip" is a swapping of revenue sources to allow the state to issue and pay for bonds to solve its budget dilemmas without having to ask voters to approve those bonds. The state will directly pay local jurisdictions three-quarters of the 1 percent of sales tax due to them. The remaining quarter percent will be paid to localities via property tax remittances from the county. While it is anticipated the City will eventually receive the full 1 percent of sales taxes, the timing of the quarter percent payments affects cash flow and interest income earned. Staff estimates the City's General Fund will lose \$60,000 annually from this change. Once the "triple-flip" bonds are repaid (estimate is 10 to 20 years), direct payment of the full one percent is anticipated.

As part of the state budget compromise, the City of Palo Alto will lose \$1.543 million in annual vehicle license fee (VLF) revenue in 2004-05 and in 2005-06. This revenue loss will not be repaid in the future and was "offered" in exchange for legislative and gubernatorial support for Proposition 1A. This proposition, overwhelmingly approved by voters in November 2004, is designed to protect against state revenue takeaways in the future.

In the future, most of the VLF revenue will be paid via property tax remittances. This is known as the "in-lieu VLF payment." The table below shows how the payment and state takeaway will work in 2004-05.

In-Lieu VLF paid via property tax	\$3,251,000
Less State takeaway in 2004-05	(\$1,543,000)
Net In-Lieu VLF paid via property tax in 2004-05	\$1,708,000
Direct VLF payment in 2004-05	\$295,000
Total Payments in 2004-05	\$2,003,000

The results of these changes are included in the Long Range Financial Plan forecast. In year 2004-05 there is an increase in property taxes due to the in-lieu payment and normal assessed value (AV) growth; and in 2006-07 there is a significant increase due to AV growth and cessation of the state takeaway. In 2004-05, there is a drop in "Other Taxes, Fines and Penalties" because of the exchange of the VLF for property taxes and the takeaway.

IMPACT OF RECENT ECONOMIC TRENDS ON REVENUE

As Chapter One indicates, there are signs of economic stabilization at the local, state and national levels. For example, toward the end of 2003-04, the City saw an uptick in occupancy rates and room charges that affected transient occupancy tax (TOT) revenue. However, soon after the City saw these improvements, TOT revenue declined. In addition, sales taxes jumped over the prior year quarter at the end of 2003-04, only to retreat, in terms of percentage growth, during the first quarter of 2004-05. This suggests that the local economy has not completely stabilized and that a strongly positive revenue forecast is not justified.

In addition, the following factors have tempered the revenue forecast:

- The continuing exodus of high-paying technology jobs overseas
- Competition from surrounding malls and discount chains
- The potential exit of automobile dealerships from Palo Alto
- Anticipated loss of Hyatt Rickey Hotel's TOT revenues
- High cost of gasoline crimping consumer spending and travel
- Continued opposition to economic development initiatives that may create additional traffic

These factors have a major impact on two key General Fund (GF) revenue sources – sales and transient occupancy taxes – comprising 18 to 20 percent of GF resources.

Overall, total revenues in the forecast have a CAGR rate of 3.4 percent from 2004-05 through 2014-15, which represents a decline from the prior 10-year rate of 4.8 percent. This growth rate barely covers anticipated general inflation increases. Although the City has a diverse and comparatively healthy revenue base, staff cannot foresee revenue growth from existing revenue sources keeping pace with current service levels and associated employee-related expenses. With sales tax and TOT revenue declines of \$11.6 million since 2000-01, it is unlikely the City will make up this substantial loss over the next ten years.

The link between employment and the level of General Fund revenues is inextricable and is statistically shown in Figure 3 at the end of Chapter 5. While Santa Clara County employment levels show some improvement, they lag that of San Francisco and the greater Bay Area. This portends an uphill battle in restoring robust revenue levels.

DISCUSSION OF SPECIFIC REVENUE PROJECTIONS IN FORECAST

Sales Tax

In 2003-04, these revenues were \$18.1 million, essentially the same as prior year receipts. Since the revenue peak in 2000-01, sales tax revenues have fallen by \$7.6 million or 30 percent. Since stabilizing somewhat toward the end of 2003-04, early data for 2004-05 indicate modest revenue increases in the range of 2 to 3 percent over last year. From 1993-94 through 2003-04, the CAGR was 2.2 percent, which was used to project sales tax revenues over the next 10 years. Last year, a 3.4 percent rate was applied in the forecast. Staff believes the 2.2 percent growth rate is a more realistic assumption given the local economic trends discussed above.

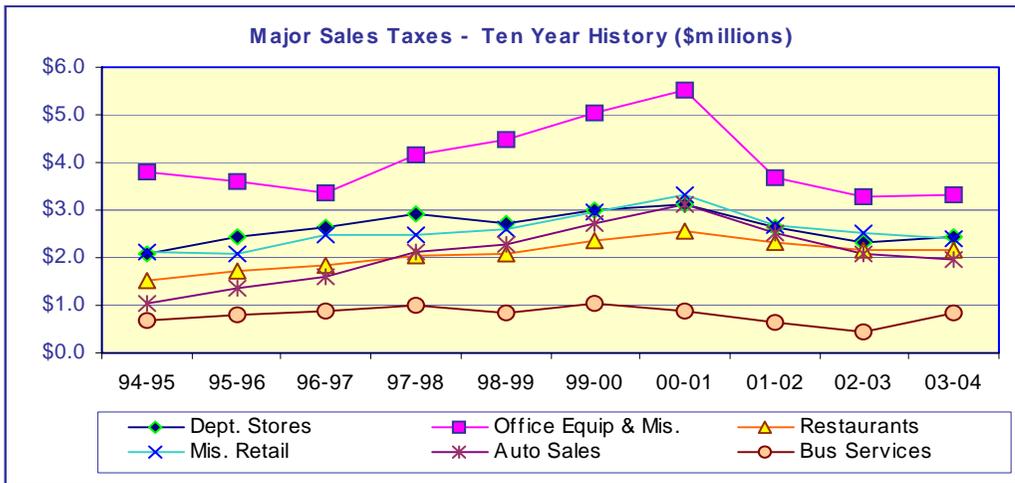
Key economic segments that have displayed weakness in 2003-04 and in early 2004-05 are automobile and electrical equipment sales. Staff is concerned about the falloff in automobile sales and about dealerships leaving Palo Alto, since auto sales represent approximately 12 percent or \$2.0 million of annual sales tax revenues. Economic segments showing positive growth rates include restaurants and department stores.

Transient Occupancy Tax (TOT)

TOT revenues in 2003-04 were \$5.5 million, a modest \$0.2 million or 3.8 percent higher than the prior year. Since 2000-01, TOT has decreased by \$4.0 million or 42 percent. Vacancy rates and charges per day showed improvement

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015



toward the end of 2003-04, fell back in July 2004, and then rallied in August and September. Through the first quarter of 2004-05, TOT revenues were running \$0.05 million or 4 percent higher than the prior year's first quarter. Occupancy rates and charges per day have also improved this fiscal year, but this may have resulted more from the closure of a poorly performing hotel than from a rebound in demand. Palo Alto's TOT revenue performance closely parallels that of other Peninsula cities.

While staff is cautiously optimistic that TOT revenues may be turning a corner, the fact that Hyatt Rickey's will be closing in the next few years and the increasing competition from East Palo Alto and Los Altos temper that optimism. Although other Palo Alto hotels will absorb part of Hyatt Rickey's business, staff anticipates an annual loss of nearly \$400,000. This loss has been factored into the forecast. The forecast includes a CAGR of 4.4 percent in TOT receipts over the next ten years compared to 5.2 percent in the past 10 years.

Property Tax

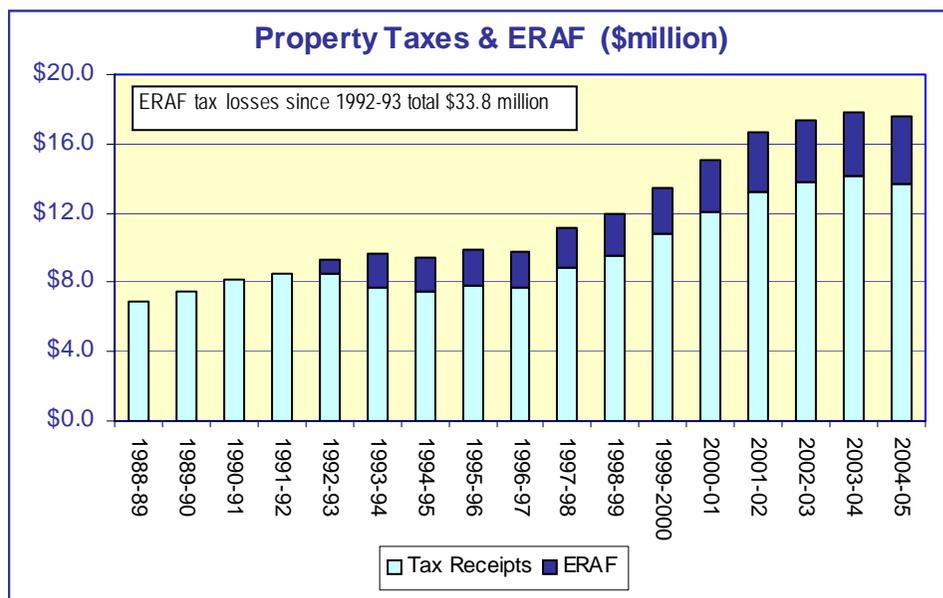
These receipts were a disappointing \$13.7 million in 2003-04, \$0.1 million or 0.7 percent below the prior year. This drop occurred as a result of assessed valuation appeals, particularly in commercial properties experiencing high vacancy rates. Personal property or unsecured property tax receipts fell as a result of businesses not purchasing new equipment and

extending the use of old equipment. Property tax revenue changes tend to lag those in more economically sensitive revenue sources such as sales and TOT. Therefore property tax revenue has declined this year, while sales tax and TOT revenues have somewhat stabilized.

Although pressure on commercial property values is expected to continue through the current year, it is anticipated that residential values

will remain firm. In addition, the City will realize additional revenues as a result of the new lease and reappraisal of the Stanford Shopping Mall. Based on recent county data, property tax revenues are anticipated to rise by \$0.6 million over 2003-04 levels. The recent sale of the Town and Country center will also contribute to the tax rolls, but sale information was unavailable at the time of the forecast, so no additional tax was included in this plan.

In spite of the current-year decline in property tax revenues, the forecast shows significant increases in property taxes in 2004-05 and 2006-07. This results from the payment of former vehicle license fee revenue through property taxes (discussed earlier).



Utility Users Tax (UUT)

UUT revenues were \$7.1 million in 2004-05, the same as in the prior year. Both components of UUT revenues, receipts from telephone usage and the sale of water, gas and electricity, were flat year-to-year. UUT revenues have grown at a 2.6 percent rate over the last ten years, and staff is projecting they will grow by 3.9 percent in the forecast. The higher growth is driven mainly by planned utility rate increases. The telephone UUT is anticipated to grow at a rate of 1.6 percent over the next decade. This low rate results from concern that the emerging Voice Over Internet Protocol (VOIP) may chip away at growth for the \$2.0 million in annual telephone UUT receipts (discussed in Chapter 4).

Vehicle License Fee (VLF)

VLF receipts will fall to \$0.3 million in 2004-05 as a result of the swap of VLF for property tax revenues. The direct VLF payment will increase annually according to the growth in the value and number of vehicles in the future. The estimated average annual increase over the next ten years is approximately 4.6 percent.

Documentary Transfer Tax

Transfer revenues increased dramatically in 2003-04 to \$5.6 million. This was primarily a result of the one-time Stanford Shopping Center lease transaction. Relatively low mortgage rates, higher home prices and steady demand for Palo Alto housing are anticipated to reinforce this revenue source. Staff projects \$3.7 million in taxes in 2004-05 with an average annual growth rate of 6.7 percent through 2014-15. Transfer taxes vary significantly year-to-year based on the volume, mix and value of the transactions.

Interest Income

Interest income declined to \$3.5 million in 2003-04, a drop of \$0.44 million or 11.1 percent from 2002-03. This primarily resulted from the low interest rate environment. Over the past two years, average yields on the City's portfolio decreased from 4.75 percent at the end of 2002-03 to 4.29 percent at the end of 2003-04. Yields will continue to decline in 2004-05 as older, higher yielding investments mature. At the end of the first quarter of this fiscal year, the portfolio yield declined to 4.21 percent.

The forecast shows General Fund (GF) interest income dropping to \$2.3 million in 2004-05. This is a consequence of moving the Infrastructure Reserve (IR) from the GF to the Capital Fund. In addition, delayed state sales tax payments are expected to curtail income by another \$0.06 million.

Fines And Penalties

This category includes parking violations, library fines, administrative citations and other fines and penalties. Parking violations account for \$1.8 million or 75 percent of fines and penalties revenue in 2004-05. Fines and penalties grew an average of 6 percent per year over the last ten years, due to increases in fees and in the number of enforcement staff. One-time receipts of bail forfeitures, administrative citations, and other items also contributed to the increase. Fines and penalties are projected to increase by a modest 3 percent per year, which approximates the Bay Area Consumer Price Index.

Service Fees And Permits

This category includes service and permit revenues generated from a variety of sources including golf course fees, class registration and admission fees in Community Services, permit, plan check and zoning fees in the Planning and Community Environment Department, and paramedic service fees in the Fire Department. Service Fees and Permits revenue accounts for 13 percent of the total sources of funds in the General Fund in 2004-05. Average growth is expected to slow from 6.5 percent over the past ten years to approximately 2.8 percent annually over the next 10 years. Revenues from the Planning and Community Environment Department decreased in 2003-04, and the trend is expected to continue in 2004-05 and 2005-06. Slower growth in development-related activities is the primary reason for this lower trend. The Fire Department also saw a reduction in its fee revenue, as 2003-04 actual revenues were less than projected by \$0.6 million (30 percent) from the budgeted revenue of \$1.9 million. The delayed implementation of planned Basic Life Support (BLS) services contributed to this variance. It is estimated that BLS will be fully operational by February 2005.

Joint Service Agreements

This category consists largely of the contract with Stanford University for fire and communication services, which funds 30.3 percent of the Fire Department budget. Revenue increased by \$0.4 million or 7 percent in 2004-05, due to higher negotiated salary increases and increasing benefits costs. The future growth of this revenue source is closely tied to future salary and benefit increases, since most fire service expense consists of staffing. Therefore, this category is projected to increase by an average of 4 percent per year over the next ten years.

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

Reimbursements

The reimbursement category refers to payments to the General Fund (GF) for services rendered to the Enterprise Funds. Fund-based accounting requires all government funds to pay their “fair share” of expenses associated with the administration of their activities. These GF services range from the Administrative Services Department's accounting and payroll functions to the Public Works Department's surveying services. These revenues offset GF expenditures specifically dedicated to providing these services. In 2004-05, reimbursements to the GF total \$9.3 million or 8 percent of the total expenditures of \$116.8 million. Reimbursement revenues are projected to grow at an average annual rate of 2.7 percent over the next ten years. This rate essentially trends that of overall expenditure growth.

Transfers

Within governmental fund accounting, transfers between funds are a common and necessary means of moving resources for both general operations and capital projects. The main component of this source of funding is the equity transfer from the enterprise funds (\$13.3 million), which represents a return on the City's original capital investment in the Utility Department operations more than 100 years ago. This source of funding contributes 11 percent of the City's annual expenditure budget – including both operations and capital work. The growth of this funding source is associated with the stable equity transfer methodology, currently budgeted at a 3 percent annual increase.

Other Revenues

Other revenues comprise 11 percent of the total sources of General Fund revenue in 2004-05. A significant component is rental of land and facilities paid by Utilities and Public Works Enterprise Funds. A key component to enterprise operations is to assure the public their activities do not burden basic city services. Paying rent in lieu of property tax or franchise fees not only pays the City for use of its property but also is an expected cost component of any business. About half of this rental revenue, or \$4.5 million, is paid by the Refuse Fund. This rent will cease in 2011 with the closure of the landfill. This plan includes the revenue loss in 2014-15 when the accrued rent is fully paid, and is the main reason for the increasing deficits in 2013-15. A new revenue source or expense reduction will need to be identified by 2013.

FORECASTING METHODOLOGY - EXPENDITURES

Expenditure projections, like revenue projections, are based on a combination of historical trends, assumptions about the future, and other judgments staff deems appropriate. Salary projections are based primarily on negotiated labor agreements. For timelines beyond those contracts, salary growth is projected by using a weighted average of historical trends, regional labor cost increases, and estimated headcount changes. A cyclical trend is assumed with salary increases, and a decrease is anticipated lagging the next anticipated recession.

Because healthcare costs have grown so rapidly over the past three years, these costs are projected to slow to an 8 to 10 percent growth rate over the next ten years – but still three to four times the rate of general inflation. The City is likely to enact controls on further growth of these expenses, but such controls are not assumed in the plan.

Operating transfers are primarily a function of capital work. The five-year capital plan drives the first half of the LRF estimates on capital transfers; historical trends drive the other half.

All expenses are also normalized with the CAGR formula.

BACKGROUND FOR FORECAST OF EXPENDITURES

The City of Palo Alto is a service-driven organization. The extensive portfolio of community programs and services has direct bearing on staffing levels and thus on the main component of expenditures, salary and benefit expense. Here are some key points to keep in mind on the expense side of the long-range plan:

- Salary and benefit expenses increase from 63 percent to 69 percent of total expenses during the 1995-2015 period.
- Non-salary expense and transfers represent about one-third of General Fund needs.
- From 1995 to 2015, salaries remain a fixed 45 percent of total expenses.
- Benefits over the 20-year period will grow from 17 percent in 1995 to 24 percent of all expenses in 2015, more than doubling in size.
- Expense growth is projected to slow from a 4.2 percent average annual rate over the past ten years, to a 3.8 percent rate during 2005-2015.
- Annual cost inflation is expected to decline from an average 3.0 percent (1995-2005) to 2.8 percent over the next ten years.

DISCUSSION OF SPECIFIC EXPENDITURE PROJECTIONS

Salaries and Benefits

This expense category is the City's largest and most complex, comprising 66 percent of the General Fund budget in 2005. Over the next ten years, salaries and benefit growth is projected to slow from an annual 4.8 percent (1995-2005) to 4.2 percent. This is primarily due the effects of a slower-than-expected economic recovery which moderates near-term salary increases. Controlling costs in this area is critical to an overall balanced financial strategy, both in terms of minimizing the growth of staff as well as managing benefit cost inflation— expected to run twice that of general expense.

Salary and benefit cost-containment are challenging due to the following:

- Costs in the statewide CalPERS pension system are a function of stock market returns and labor market trends.
- Palo Alto voter approval of binding arbitration requires the City to follow a prevailing standard in negotiating public safety labor agreements.
- Medical costs have grown at four times the rate of inflation over the past few years.
- The City is part of a larger employer marketplace and must remain competitive in retaining and attracting qualified talent.

Salaries: For the next ten years, basic salary and overtime expense is projected to grow 3.3 percent per year, declining from a 4.4 percent rate during the prior ten years. This slower-growth trend reflects both persistent weak near-term labor markets as well as an expectation of not adding to existing staffing levels. As the City works with labor groups to control costs, however, prevailing standard labor market differentials may surface over the next few years as comparisons are made with benchmark cities. This will result in complex labor negotiations as budget-balancing efforts weigh against regional wage standards.

Specifically, the agreement with the International Association of Fire Fighters allows a market-based adjustment in January 2006 based on regional salary levels. The Service Employee's International Union (SEIU) contract includes an April 2005 reopener to discuss health insurance and retirement benefits. The City's union contracts expire as follows:

- Service Employee's International Union-April 2006

- International Association of Fire Fighters-June 2006
- Fire Chiefs' Association-June 2006
- Palo Alto Peace Officer's Association (PAPOA)-June 2007

Challenges that the City faces in the salary cost area include:

- Needing to tie staffing levels and restructuring efforts to service reductions
- Difficult economic conditions conflicting with prevailing standards in the regional labor market
- Continuing to restructure City services around staffing vacancies
- Updating the City's compensation plan to correct inconsistencies

Benefits: This portion of the salary and benefit expense category is responsible for the 1995-2015 category growth from 63 to 69 percent of total General Fund expense. The benefit expense average growth rate is projected to be 6.3 percent annually for the next ten years, exceeding the 5.7 percent growth rate since 1995. The problem is that this rate is more than double that of general cost inflation.

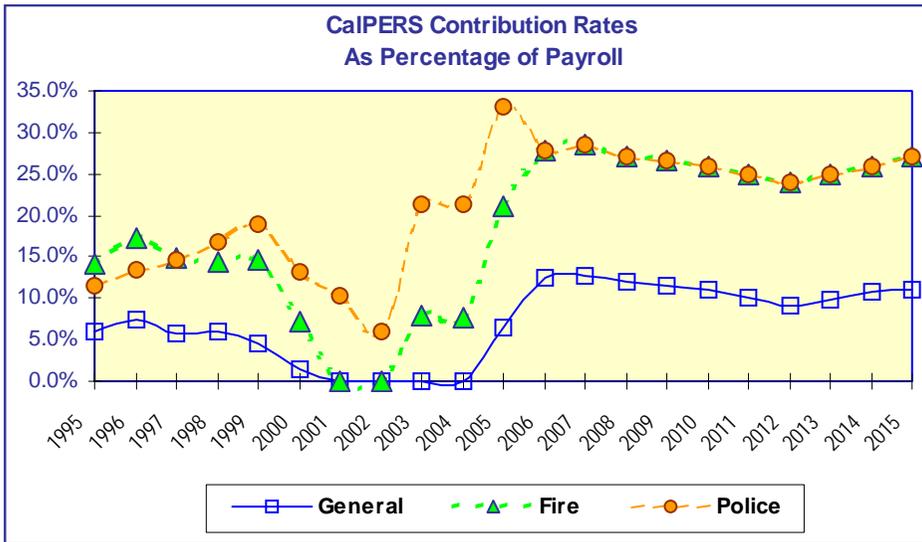
The two main components of the increased benefit expense are in the areas of pension and healthcare costs.

Pension Expense: The single largest challenge on the expense side of this long-range plan relates to pension costs from the statewide CalPERS retirement system. Annual General Fund expense in this area has nearly doubled since 2003—from \$5.7 million to \$10.7 million. Just as positive stock market returns through the 1990's resulted in pension contributions to CalPERS dropping to zero a few years ago, significant negative investment returns from 2000-2002 have resulted in pension costs reaching 22 percent of payroll in 2005. By 2015, these costs will have increased by 40 percent to \$15 million. The SEIU contract reopener allows discussion of possible enhancements to retirement benefits beginning April 2005. Enhancing the current retirement benefit from 2 percent to 2.7 percent of salary per service year would result in an immediate 71 percent increase (\$7.6 million) in annual citywide pension expense.

Healthcare Costs: Growing by more than 50 percent over the past four years to \$10.8 million in 2005, medical premium expense is expected to double by 2015. Premium increases in the range of 7-10 percent indicate cost inflation three to four times that of general consumer price increases. Retiree premium expense is projected to grow

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015



at a slightly faster rate than that for active employees; however, this will be partially offset by 20-year retirement medical benefit vesting requirements recently put in place for all new employees except those represented by PAPOA. It will be a priority to add this vesting requirement to the PAPOA contract when it is renegotiated in 2007.

Possible solutions to these fiscal challenges include negotiating an employee contribution towards pension or medical premium expense. The City of Palo Alto is one of the few jurisdictions that completely fund both of these employee benefits. Current economic conditions may require implementation of these and other cost-sharing arrangements with employees.

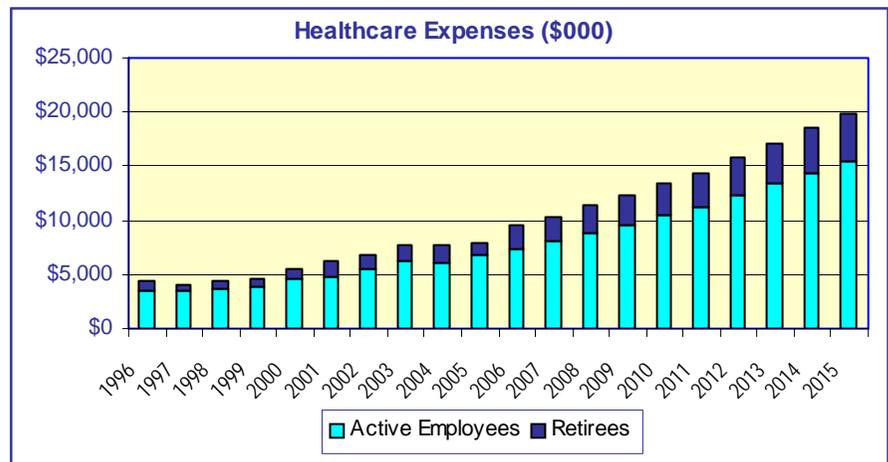
Contract services include contracts for such areas as the Children's Theater, golf professional services, park maintenance, class instructors, traffic studies, outside legal counsel, auditing, and financial services. Contract costs represent one-third of non-salary expenses, and have grown at an average rate of 5.2 percent annually over the past ten years. This higher rate was due to program growth that is not part of the 2005-15 plan. Accordingly, the projected growth rate of this expense over the next decade is pegged at 2.3 percent.

Supplies and materials expense represents 10 percent of non-salary costs in 2004-05, and includes office supplies, recreational and housekeeping supplies, City employees' uniforms, construction and planting materials, and library circulation. The average growth rate in the previous ten-year period was 3.5 percent. This expense is pro-

Non-Salary Expenses

Non-salary expenses consist of contract services, supplies, general expenses, rents and leases, and allocated charges. This category represents 23 percent of General Fund expense in 2004-05. Annual growth for the past ten years averaged 3.3 percent, slightly above the 3.0 percent average Bay Area Consumer Price Index (CPI). Due to projected deficits, this plan assumes no program growth beyond general cost inflation over the next ten years. This is a departure from previous plans.

Contract services include contracts for such areas as the Children's Theater, golf professional services, park



jected to grow 2.3 percent annually, primarily due to general cost inflation for the 2005-15 period.

General expense is 23 percent of total non-salary expenses in 2004-05. A primary component of this account is the annual Cubberley Community Center lease payment to Palo Alto Unified School District (PAUSD) in the amount of \$6.0 million. Contract covenants require CPI adjustments to the annual lease payment, with a projected growth rate for the next ten years of 2.8 percent. The projected lease payment to PAUSD is expected to reach \$7.7 million in 2014-15.

Interfund Allocated Charges

The General Fund receives a number of services from the City's Internal Service Funds (ISF) and from the Enterprise Funds. ISF expenses include vehicle maintenance and replacement, printing and mailing, and technology. These costs are distributed to all funds citywide based on a usage methodology. An example of this includes the Electric, Gas and Water Funds charges to the General Fund for its utility consumption.

Technology Fund allocations to the General Fund were reduced one-time by \$3.5 million, to both reduce the Technology Fund's reserve balance and balance the current year's budget. This forecast restores this one-time cut to the budget starting in 2005-06, over a three-year period. Over the last ten years, allocated charges grew by an average of 2.5 percent per year. They are projected to increase by a rate of 5.8 percent over the next ten years, due to the restoration of the one-time reduction.

Transfers to Other Funds

The General Fund (GF) has obligations to other funds such as the Capital Project Fund and Debt Service Fund. These transfers provide the necessary resources for capital expenditures and debt service payments. The LRFPP includes four main categories of transfers: Infrastructure Management Plan (IMP) capital projects, non-IMP capital projects, debt service, and other transfers.

IMP Capital Projects: The IMP, also known as "City-Works," began in 1999-00 as a 10-year, \$100 million plan, designed to eliminate the City's backlog of infrastructure rehabilitation projects. At present, the timeline has extended beyond the ten-year period. The GF has a base commitment to transfer \$3.6 million annually to fund these projects.

Non-IMP Capital Projects: Transfers for non-infrastructure projects, including those for traffic calming and tech-

nology, are estimated to increase by an average rate of 4 percent annually over the next ten years.

Debt Service: The Plan assumes that no new GF-funded debt will be incurred in the next ten years. The projected transfer to the Debt Service Fund until 2011-12 will remain near an annual average of \$1.2 million. Starting 2012-13, the transfer will decrease to \$0.7 million due to the retirement of the 1992 Civic Center Certificates of Participation. Total current outstanding debt is \$11.5 million, one of the lowest debt levels of any city in the Bay Area.

Other Transfers: The Storm Drainage Enterprise Fund does not generate sufficient revenue to pay for its basic operations and requires a \$1.0 million annual transfer from the GF. At present, various funding options are being considered to provide this fund's operating and capital needs, including a spring 2005 ballot initiative. These possible funding options are not included in this plan.

THE BOTTOM LINE

While much has been done over the past four years to bring expenditure growth within the City's revenue growth rates, the twin effects of a slow economic recovery and a \$12.9 million five-year spike in pension costs have resulted in substantial projected deficits for the next ten years. From 2005-2015, annual expense growth trends of 3.8 percent are expected to exceed revenue growth rates by 0.3 percent. Although expenses are growing faster than revenues, this forecast shows slight improvement from last year's forecast as expense growth rates have dropped from 4.0 percent to 3.8 percent.

Several things have changed since last year's plan was completed, including the conclusion of two labor agreements with costs above expectation, PERS pension rates doubling for non-safety employees from 6.5 percent in 2005 to 12.4 percent in 2006, and the loss of \$4.5 million in landfill rent in the latter years of the plan.

The following chart clearly shows that revenues have exceeded expenditures over the past ten years, and depicts forecasted deficits for the next ten years. It does not reflect deficit solutions that are yet to be implemented.

Plan to Reduce Deficits in 2004 LRFPP: Faced with annual deficits of \$1.5 million to \$7.4 million over the next ten years, the City of Palo Alto will act, as in years past, to balance its budget. The difference this time is that service

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

level reductions and layoffs will be needed to close the budget gaps. At the current time, staff's plan to solve the shortfalls is as follows:

2004-05 Deficit of \$1.5 Million

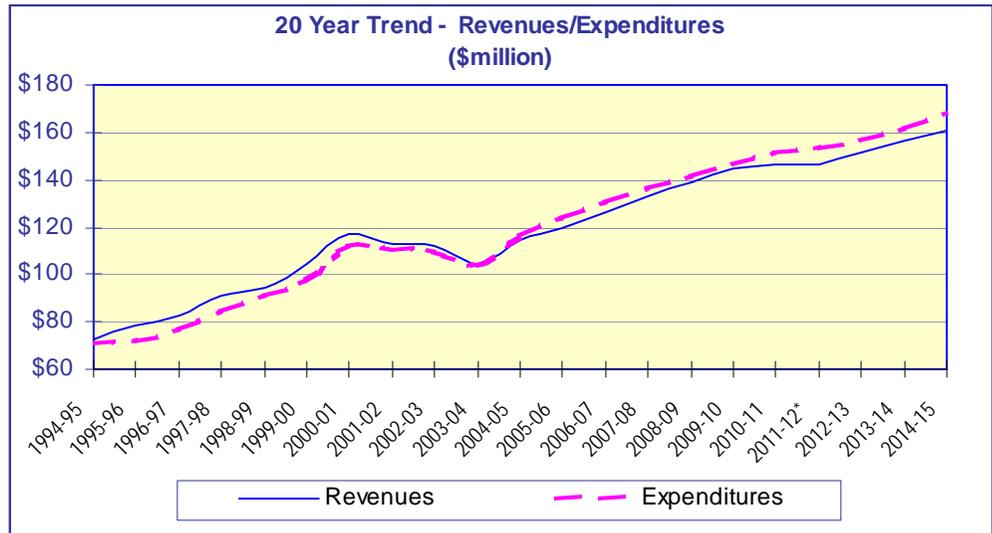
- Continue to restructure around retirements and vacancies
- Hiring freeze excluding public safety and special Enterprise Fund positions
- Cost reductions and one-time cost savings such as delaying sidewalk replacement program

2005-06 Deficit of \$5.2 Million

- Continue to restructure around retirements and vacancies from hiring freeze
- Continue to review non-salary expenses
- Prioritize all General Fund services for potential reductions

After Finance Committee review of the LRF, a study session to discuss the LRF will be held with Council in January 2005. Following the Study Session, budget options will be explored at the January 29 Council retreat.

The plan to reduce expenses is driven by the City's "pay as you go" General Fund reserve policy. The policy, as approved on June 28, 2004, does not allow the funding of operating deficits with reserves. The Budget Stabilization Reserve remains healthy and is presently at its target of 18.5 percent of expenses or \$21 million. Projected deficits, however, would eliminate these reserves by 2010 if nothing were done to correct the imbalance.



LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

EXHIBIT 1 - BASE FORECAST

LONG RANGE FINANCIAL PLANNING MODEL 2004 (\$000)												
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
	Actual	Adjusted										
Revenues												
Sales Taxes	18,151	18,100	18,701	19,416	20,254	21,028	21,726	21,362	20,362	20,835	21,526	22,349
Property Taxes	13,707	16,057	16,917	19,546	20,795	22,226	23,979	23,712	23,685	25,079	26,805	28,919
Utility User Tax	7,156	7,226	7,981	8,593	9,153	9,244	9,375	9,449	9,973	10,092	10,211	10,539
Transient Occupancy Tax	5,489	6,000	6,073	6,301	6,724	7,409	7,907	7,766	7,550	8,057	8,638	9,262
Other Taxes, Fines & Penalties	11,294	6,382	6,742	7,227	7,809	8,495	9,199	9,203	9,069	9,353	10,018	10,815
Subtotal: Taxes	55,797	53,765	56,414	61,083	64,735	68,402	72,186	71,492	70,639	73,416	77,198	81,884
Service Fees & Permits	12,830	15,004	15,376	15,837	16,313	16,802	17,306	17,825	18,360	18,911	19,478	20,062
Joint Service Agreements (Stanford University)	6,010	6,413	6,876	7,201	7,513	7,795	8,100	8,354	8,479	8,621	8,929	9,287
Interest Earnings	3,477	2,300	2,418	2,554	2,697	2,860	3,044	3,002	2,960	3,127	3,334	3,555
Other revenues	9,681	13,171	13,566	13,973	14,392	14,824	15,195	15,499	15,886	16,363	15,617	12,687
Reimbursements from Other Funds	9,150	9,309	8,981	9,406	9,813	10,181	10,579	10,911	11,075	11,261	11,662	12,130
Total Revenues	96,945	99,962	103,631	110,054	115,463	120,864	126,410	127,083	127,399	131,699	136,218	139,605
Transfers from Other Funds	17,888	14,618	15,673	16,415	17,126	17,768	18,462	19,042	19,327	19,652	20,352	21,170
TOTAL SOURCE OF FUNDS	114,833	114,580	119,304	126,469	132,589	138,632	144,872	146,125	146,726	151,351	156,570	160,775
Expenditures												
Salaries & Benefits	72,316	77,288	84,076	87,892	90,811	94,624	98,719	102,282	104,046	106,596	111,227	116,437
Contract Services	9,110	9,685	9,927	10,225	10,562	10,906	11,287	11,541	11,599	11,657	11,832	12,163
Supplies & Materials	2,968	3,147	3,226	3,322	3,432	3,544	3,668	3,750	3,769	3,788	3,845	3,952
General Expense	8,487	8,955	9,302	9,580	9,877	10,179	10,502	10,807	11,085	11,307	11,552	11,823
Rents, Leases, & Equipment	1,001	1,073	1,100	1,133	1,170	1,208	1,251	1,279	1,285	1,291	1,311	1,348
Allocated Expenses	11,266	8,548	9,762	11,055	12,919	13,339	13,806	14,117	14,187	14,258	14,615	15,053
Total Expenditures	105,148	108,696	117,393	123,207	128,771	133,800	139,233	143,776	145,971	148,897	154,381	160,776
Transfers to Other Funds												
GF transfer for non-IMP capital projects	1,000	1,573	1,260	1,302	1,348	1,390	1,433	1,471	1,507	1,544	1,590	1,645
GF transfer for IMP capital projects	5,551	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600
Debt Service	983	1,187	1,157	1,160	1,164	1,161	1,170	1,161	1,160	741	739	742
Other	1,646	1,041	1,070	1,099	1,129	1,160	1,192	1,225	1,259	1,294	1,329	1,366
TOTAL USE OF FUNDS	114,328	116,097	124,480	130,368	136,012	141,111	146,628	151,233	153,497	156,076	161,639	168,129
Net Operating Surplus/(Deficit)	505	(1,517)	(5,176)	(3,899)	(3,423)	(2,479)	(1,756)	(5,108)	(6,771)	(4,725)	(5,069)	(7,354)
Transfer to Infrastructure Reserve		(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)
Net of Reserve Transfer	505	(2,517)	(6,176)	(4,899)	(4,423)	(3,479)	(2,756)	(6,108)	(7,771)	(5,725)	(6,069)	(8,354)

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

EXHIBIT 2

PERCENTAGE CHANGES IN FORECAST FOR REVENUES AND EXPENSES												
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
	% Change	% Change	% Change	% Change	% Change	% Change	% Change	% Change	% Change	% Change	% Change	% Change
Revenues												
Sales Taxes	0.61%	(0.28%)	3.32%	3.82%	4.32%	3.82%	3.32%	(1.68%)	(4.68%)	2.32%	3.32%	3.82%
Property Taxes	(0.72%)	17.14%	5.36%	15.54%	6.39%	6.88%	7.89%	(1.11%)	(0.11%)	5.89%	6.88%	7.89%
Utility User Tax	1.26%	0.98%	10.45%	7.67%	6.52%	0.99%	1.42%	0.79%	5.55%	1.19%	1.18%	3.21%
Transient Occupancy Tax	2.93%	9.31%	1.22%	3.75%	6.71%	10.19%	6.72%	(1.78%)	(2.78%)	6.72%	7.21%	7.22%
Other Taxes, Fines & Penalties	20.21%	(43.49%)	5.64%	7.19%	8.05%	8.78%	8.29%	0.04%	(1.46%)	3.13%	7.11%	7.96%
Subtotal: Taxes	4.02%	(3.64%)	4.93%	8.28%	5.98%	5.66%	5.53%	(0.96%)	(1.19%)	3.93%	5.15%	6.07%
Service Fees & Permits	(7.08%)	16.94%	2.48%	3.00%	3.01%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Joint Service Agreements (Stanford University)	(1.65%)	6.71%	7.22%	4.73%	4.33%	3.75%	3.91%	3.14%	1.50%	1.67%	3.57%	4.01%
Interest Earnings	(11.12%)	(33.85%)	5.13%	5.62%	5.60%	6.04%	6.43%	(1.38%)	(1.40%)	5.64%	6.62%	6.63%
Other revenues	(36.42%)	36.05%	3.00%	3.00%	3.00%	3.00%	2.50%	2.00%	2.50%	3.00%	(4.56%)	(18.76%)
Reimbursements from Other Funds	(20.58%)	1.74%	(3.52%)	4.73%	4.33%	3.75%	3.91%	3.14%	1.50%	1.68%	3.56%	4.01%
Total Revenues	(6.98%)	3.11%	3.67%	6.20%	4.91%	4.68%	4.59%	0.53%	0.25%	3.38%	3.43%	2.49%
Transfers from Other Funds	16.80%	(18.28%)	7.22%	4.73%	4.33%	3.75%	3.91%	3.14%	1.50%	1.68%	3.56%	4.02%
TOTAL SOURCE OF FUNDS	(3.94%)	(0.22%)	4.12%	6.01%	4.84%	4.56%	4.50%	0.86%	0.41%	3.15%	3.45%	2.69%
Expenditures												
Salaries & Benefits	(5.20%)	6.88%	8.78%	4.54%	3.32%	4.20%	4.33%	3.61%	1.72%	2.45%	4.34%	4.68%
Contract Services	(9.43%)	6.31%	2.50%	3.00%	3.30%	3.26%	3.50%	2.25%	0.50%	0.50%	1.50%	2.80%
Supplies & Materials	(2.01%)	6.03%	2.51%	2.98%	3.31%	3.26%	3.49%	2.25%	0.50%	0.50%	1.50%	2.80%
General Expense	7.50%	5.51%	3.87%	2.99%	3.10%	3.06%	3.18%	2.90%	2.57%	2.00%	2.17%	2.34%
Rents, Leases, & Equipment	(6.01%)	7.19%	2.52%	3.00%	3.27%	3.25%	3.52%	2.25%	0.50%	0.50%	1.50%	2.80%
Allocated Expenses	10.62%	(24.13%)	14.20%	13.25%	16.86%	3.25%	3.50%	2.25%	0.50%	0.50%	2.50%	3.00%
Total Expenditures	(3.11%)	3.37%	8.00%	4.95%	4.52%	3.91%	4.06%	3.26%	1.53%	2.00%	3.68%	4.14%
Transfers to Other Funds												
GF transfer for non-IMP capital projects	(3.19%)	57.30%	(19.90%)	3.33%	3.53%	3.12%	3.09%	2.65%	2.45%	2.46%	2.98%	3.46%
GF transfer for IMP capital projects	(22.18%)	(35.15%)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Debt Service	(16.27%)	20.75%	(2.53%)	0.26%	0.34%	(0.26%)	0.78%	(0.77%)	(0.09%)	(36.12%)	(0.27%)	0.41%
Other	27.30%	(36.76%)	2.76%	2.74%	2.76%	2.75%	2.75%	2.76%	2.76%	2.76%	2.76%	2.76%
TOTAL USE OF FUNDS	(4.05%)	1.55%	7.22%	4.73%	4.33%	3.75%	3.91%	3.14%	1.50%	1.68%	3.56%	4.01%
Net Operating Surplus/(Deficit)	30.83%	(400.40%)	241.18%	(24.67%)	(12.20%)	(27.57%)	(29.17%)	190.88%	32.55%	(30.22%)	7.29%	45.06%

EXHIBIT 3

GENERAL FUND RESERVE SUMMARY (\$000)												
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
	Actual	Adjusted										
Budget Stabilization Reserve												
Beginning Balance	21,395	21,467	21,478	17,052	13,903	11,230	9,501	8,494	4,136	(1,885)	(5,860)	(10,180)
Net Operating Surplus/(Deficit)	505	(1,517)	(5,176)	(3,899)	(3,423)	(2,479)	(1,756)	(5,108)	(6,771)	(4,725)	(5,069)	(7,354)
Yearly BAOs	0	(300)	(250)	(250)	(250)	(250)	(250)	(250)	(250)	(250)	(250)	(250)
Year End Savings	0	1,828	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Subtotal BSR Balance	21,900	21,478	17,052	13,903	11,230	9,501	8,494	4,136	(1,885)	(5,860)	(10,180)	(16,783)
Transfer to IR due to 18.5% Cap	433	0	0	0	0	0	0	0	0	0	0	0
Ending Balance	21,467	21,478	17,052	13,903	11,230	9,501	8,494	4,136	(1,885)	(5,860)	(10,180)	(16,783)

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

CHAPTER FOUR

FINANCIAL CHALLENGES

The importance of a strong revenue base is indicated in the following chart, illustrating the critical connection between revenues generated by residents and businesses and the provision of services to the community. Sustained and severe challenges to the City's revenue base without new revenue sources will force a change in service delivery methods and levels. The programs below are supported by all General Fund resources. They are not tied to the specific sources cited below, which are provided for illustration only.

The following are the specific challenges anticipated in the coming years.

RESERVE FOR PERS RETIREMENT EXPENSES

The past experience with contribution rates from PERS has been like a roller coaster ride. There are periods when PERS rates cause super-funding (i.e., contribution plus high portfolio returns result in refunds) and periods when PERS rates cause under-funding (i.e., when contribution rates plus low portfolio returns result in steep rate increases). To mitigate this cyclical pattern, some cities have established a reserve for retirement expense. Similar to our Enterprise Fund Rate Stabilization Reserves, the retirement reserve would be established as a buffer against sharp rate increases. As the City's financial condition improves and as super-funding situations permit, staff recommends formation of a reserve for retirement expenses.

RETIREE MEDICAL LIABILITY

The Government Accounting Standards Board (GASB) recently issued statements 43 and 45 on "other post-employment benefits," including retiree medical liability. GASB 43 and 45 require employers to measure and report the long-term costs of retiree health benefits while employees are still working. Under current practice, cities are not required to book the accrued liabilities and are simply required to report the current-year premium

expense (pay-as-you-go). Under the rulings, the accrual of these liabilities must be recognized by the City beginning with the fiscal year ended June 30, 2007; the accrual of each year's expense must be recognized by the City starting with the fiscal year ended June 30, 2008.

City Programs	Program Costs	City Tax Revenues	Examples of Revenue Sources
Human Services Contracts	\$1,279,000	\$1,372,000	One quarter of City's Transient Occupancy Taxes
City Parks and Facilities	\$2,426,000	\$2,248,000	Sales tax from three major retailers
Police Investigation & Crime Prevention Services	\$2,824,000	\$2,745,000	One half of City's Transient Occupancy Taxes
Athletic Field Maintenance	\$1,640,000	\$1,870,000	Sales tax from all new vehicle sales
Fire Suppression Services and Hazardous Materials Response	\$2,156,000	\$1,938,000	Property tax from all commercial real estate in the City
Library Circulation	\$1,352,000	\$1,270,000	Sales tax from all restaurants
Junior Museum and Zoo	\$1,088,000	\$998,000	Sales tax from electrical equipment sold
Sidewalk Maintenance	\$826,000	\$964,000	One half of City's Telephone Utility Users tax
Visual Arts	\$937,000	\$987,000	Sales tax from all women's, men's, and family apparel stores
Children's Performing Arts	\$1,160,000	\$974,000	All sales tax revenue from California Avenue shops

As part of these requirements, cities must have an actuarial valuation of the retiree medical liability every two years. The City of Palo Alto is beginning the process of seeking an actuarial consultant to perform a valuation, after which financial strategies to reduce the accrued liability will be developed.

The City continues to fund annually the Retiree Health Benefit Reserve to pay for retiree medical premiums. As of June 30, 2004, the unrestricted balance of this reserve totaled \$18.2 million, which will go a long way to meet the requirements of GASB 43 and 45. The City is unique compared to other jurisdictions in establishing this reserve.

LABOR ISSUES

With 72 percent of positions represented by a union contract, the City faces a number of issues on the horizon relating to organized labor. These include:

- Negotiations with a newly recognized hourly employee unit
- Reopeners on current IAFF and SEIU contracts to negotiate salary and benefits
- Organization efforts of the Management and Professional group

The City faces difficult labor negotiations in fiscal 2006-07 as prevailing standards in labor market compensation are reconciled with the economic realities of the City's financial condition. The City does not have the fiscal leeway to meet all the demands of the labor market in which it operates. While some cost-cutting success has been achieved in restructuring efforts, these will need to be continued in the months leading up to pending labor negotiations.

MAJOR FACILITY PROJECTS

The City faces a number of major facility needs, including a potential new or expanded library building, renovation or replacement of the Municipal Services Center, and an expansion or new building to meet police space requirements. Although there is funding via the Infrastructure Reserve and General Fund for rehabilitating existing infrastructure, the magnitude of resources necessary to address these needs may require new revenue sources.

INFRASTRUCTURE RESERVE FUNDING

Over the past ten years, Council has given highest priority to restoring the City's infrastructure. To conduct essential business and deliver expected services, the City must devote resources to its streets, fire stations, parks, libraries, and other facilities. An Infrastructure Reserve (IR) was created to address this top priority and insure future project funding. Council directed staff to replenish the IR by \$2 million annually. Half of the goal is achieved by moving the IR into the Capital Fund and letting interest accrue to the fund. The consequence is that the General Fund will earn \$1 million less in interest earnings. The remaining \$1 million in IR funding will occur if the General Fund achieves a surplus as of fiscal year-end.

STORM DRAIN FUNDING

In 2004-05, the General Fund is subsidizing the Storm Drainage Fund operations by \$1.0 million. This significant subsidy is necessary because the Storm Drain fee has not risen since 1994-95 and does not cover operating expenses or any necessary capital improvements. Efforts to increase the fee in 2000 through a ballot election were defeated.

Staff anticipates conducting another election in Spring 2005. The current plan proposes to make the most critically needed improvements without utilizing debt. A central component of the plan is to have the General Fund advance its fee payment from reserves to pay for capital work, but only if the fee increase is approved by property owners. If the fee increase is not approved, no capital work will be completed, and resources will continue to be diverted away from General Fund services to support storm drain operations.

VOICE OVER INTERNET PROTOCOLS (VOIP)

VOIP is an emerging technology that will impact telephone UUT revenues. Since the City will not have the capacity to tax this service, given the passage of a recent Federal Communications Commission ruling, this \$2 million revenue source may erode. The extent of the inroads that VOIP will make into the existing (telephone) technology, and therefore the extent of the revenue erosion, cannot yet be determined.

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

STATE'S FINANCIAL CONDITION

Although Proposition 1A, which protects local revenues, was passed by voters, the state still retains the ability to raid local coffers in a fiscal emergency. If the state's fiscal condition does not improve, such an emergency could be declared. Areas such as the property tax offset for VLF revenues and local sales taxes could be targeted for state use. In addition, there have been efforts to redistribute property and sales tax revenues that could be detrimental to cities like Palo Alto. Such efforts pertain more to reform of the current local finance system (e.g., regional rather than local distribution of sales tax; de-fiscalization of land use) than to budget issues. Local jurisdictions must continue to be alert to further takeaways.

CITY'S ECONOMIC BASE

The following facts show how sensitive City sales tax and other revenues are to business activity and, moreover, to a relatively small number of enterprises:

- Approximately 55 percent of City revenue is associated with business activity.
- The top 25 sales tax generators yield 50 percent or \$9 million in sales tax.
- Auto dealerships generate \$2.0 million annually.
- The top 100 businesses generate 63 percent or \$11 million in sales tax.

The Stanford Shopping Center department stores and a major electronic retail outlet generate around 21 percent or \$4 million of sales tax revenue.

The City must remain vigilant in maintaining its economic base. The following trends present palpable threats to critical City resources:

- the exit of auto dealerships
- retail competition from regional shopping centers located in surrounding cities
- the emergence of big-box stores
- the transformation of the Stanford Research Park from firms producing taxable sales to those providing non-taxable research and administration
- opposition to businesses generating traffic

While the City has made important strides in understanding the needs of businesses, it must sustain its efforts to maintain a sound economic base.

LANDFILL CLOSURE

The final landfill closure is scheduled to occur in August 2011. Until then, the General Fund (GF) will continue to receive rent payments of approximately \$4.5 million annually from the Refuse Fund. Because of a planned redistribution of the GF rental payment over a longer number of years, the City will continue to receive rent through 2014-15. The rent payment is expected to decrease by \$1.2 million in 2013, and by an additional \$3.3 million in 2014. This loss has been included in this forecast and represents a major shortfall in resources that will require advanced budget planning.

CHAPTER FIVE

METHODOLOGY RESEARCH AND STATISTICAL ANALYSIS

METHODOLOGY RESEARCH AND UPDATE

As a foundation for this year's long range financial plan, staff researched existing methodologies for projecting revenues and expenditures, with an eye towards improving the forecast.

First, staff compared its forecasting methods with those included in the Government Finance Officers Association (GFOA) publication titled "An Elected Official's Guide to Revenue Forecasting." This guide describes the various qualitative and quantitative methods of forecasting, and discusses the strengths and weaknesses of each. GFOA refers to staff's current forecasting method as "judgmental" forecasting – that is, based upon an individual's or a small group's experience and intuition.

According to the GFOA guide, quantitative methods perform well when the administrative, economic, and political environments are stable and the revenue stream has a high degree of predictability. However, when any or all of these factors change rapidly, qualitative methods tend to produce more accurate revenue forecasts. GFOA recommends "the combined use of qualitative and quantitative forecasting."

Second, staff surveyed other cities about their financial projection methodologies. From the eight respondents, it was clear that projection methodologies vary and that generally they are neither particularly quantitative nor very rigorous.

Third, staff met with Stephen Levy, director and senior economist of the Center for the Continuing Study of the California Economy, to ask for his feedback on how the current forecasting methodology could be improved. His primary advice was to determine which factors might impact the next 10 years, in contrast to the factors that have impacted the last 10 years. Overall, he felt confident with the City's basic approach.

Lastly, staff met with the City of Sunnyvale Finance staff members who prepare the city's budget and long range

plan, in order to exchange ideas about forecasting methods. Their methods are primarily qualitative and quite rigorous, with selective use of likely economic trend lines to forecast growth.

The result of this research was the following set of conclusions:

- Palo Alto's judgmental methodology is appropriate given changing economic conditions and fluctuations in revenue sources, but would be strengthened by a more developed quantitative methodology done in parallel.
- Staff should build upon the statistical analysis of last year, developing a more comprehensive quantitative, trend-based future projection. This analysis would identify key independent variables correlated with revenues, and would serve as a baseline for evaluating the judgment-based forecast.
- Staff should compare the results of the judgment-based and trend-based projections and draw additional insights by asking the questions, "how much do the two diverge, and why?"

The following statistical analysis and forecasting implemented the above conclusions.

STATISTICAL ANALYSIS AND FORECASTING

Statistical analysis of economic and revenue data were carried out to 1) assess the influence of key economic factors on revenue; 2) predict future revenue growth based upon the historical revenue trends; 3) utilize expert forecasts of key economic factors, applying the correlation formulas derived in step 1 to project future revenue streams; and 4) compare the results of the trend-based and expert-based projections with those of the model's judgment-based projections to test and clarify the model's assumptions.

Influence of Key Economic Indicators

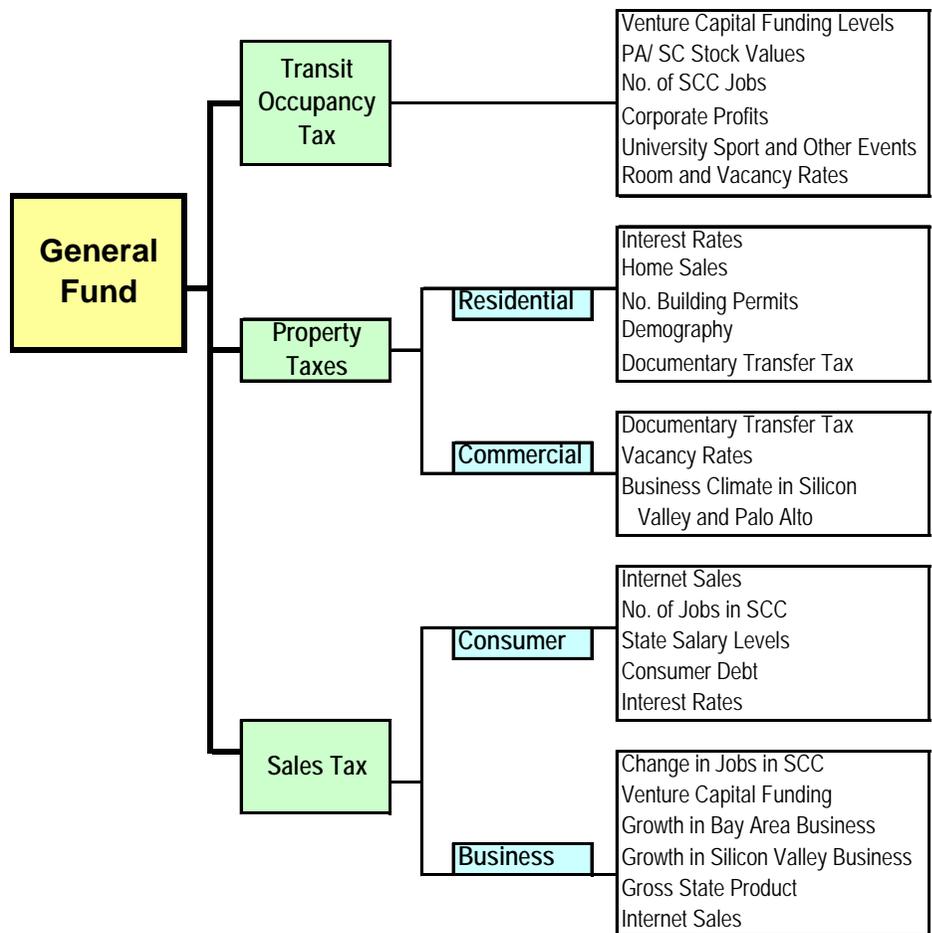
Staff collected data on a variety of local and statewide economic indicators. These data included employment levels in Santa Clara County, the assessed value of homes in Palo Alto and Santa Clara County, energy usage in Palo Alto (industrial, commercial and residential), interest rates, personal income in the county, average California resident income, unemployment rates in Palo Alto, and the level of venture capital funding in Silicon Valley. With the exception of interest rate data, national and global economic indicators were not included in this analysis. Figure 1 illustrates the economic indicators considered during this evaluation and the revenue stream impacts that were evaluated.

LONG RANGE FINANCIAL PLAN

Forecast 2005-2015

This analysis shows that several economic indicators have correlated closely with revenue levels in Palo Alto. The key indicators affecting the growth in revenues are average state resident income, Gross State Product (for California), and number of employed Santa Clara County residents. Figures 2, 3, and 4 show the correlation between each of these indicators and General Fund Revenue. A strong positive correlation was found between these three indicators and property tax revenues, sales tax revenues, transient occupancy tax (TOT) revenues and, consequently, General Fund revenues. Not unexpectedly, a negative correlation was found between interest rates and property tax revenues. This negative correlation may be explained by the fact that lower interest rates encourage home sales and re-financings that in turn fund home improvements, resulting in higher home valuations. Additionally, there was a fairly strong correlation between venture capital funding in Silicon Valley and TOT revenues, where TOT increased steadily with increased venture capital funding up to approximately \$15 billion, after which TOT leveled off.

Figure 1. Scope of Economic Indicators Considered in Statistical Analyses



Figures 2, 3, and 4 (following two pages) illustrate respectively the relationship between Gross State Product and General Fund revenues, the relationship between the number of employed Santa Clara County residents and General Fund revenues, and the relationship between average state resident income and General Fund revenues. (Please note that all General Fund revenues referenced in this chapter exclude reimbursements and operating transfers.)

Using Historic Projections to Forecast Future Revenue

Historic revenue data were used to forecast future revenues in two distinctly different approaches – a straight-line approach and a weighted data approach. In the first approach, all data were weighed equally – that is data from 1981, for example, were weighed equally with data from 2003. This approach tends to de-emphasize the boom-bust period experienced in 1998-2001. The second approach used weighted data, placing greater emphasis

on more recent periods and less weight on earlier periods, thereby emphasizing recent structural changes in the economy. Neither approach is necessarily more accurate or correct, but the two sets of results provide a range of possible outcomes.

Using the non-weighted data, all of the primary components of the General Fund showed a strong trend line over time. In other words, the revenue streams showed consistent growth over time, and this growth accounted for much of the variation in the data. The results of the analysis are presented in the Table 1 on the next page.

Using the weighted data, the decline in overall economic activity since 2001 significantly lowered the projections for future revenue growth for sales tax, TOT and the General Fund. Please see Table 2 below for a comparison of the expected revenues from the two forecasting methodologies. By 2010, the weighted projection shows sales tax

revenues \$7 million lower than the non-weighted projection. TOT revenues as predicted by the weighted projection are \$3.3 million lower in 2010 than those in the simple trend-based projection. The General Fund loses \$21 million in 2010 in the weighted projection, compared with the non-weighted one. On the other hand, property taxes and UUT revenues do not change significantly between the two projection approaches. This may be because utility user taxes are less impacted by overall economic growth and because property tax revenues are more impacted by interest rates and other factors.

Combining Correlations in Historic Revenue Data with Expert Projections

The third approach to revenue forecasting was to integrate expert predictions on key economic variables with the quantified relationships identified earlier. For example, given the regression equation between average state resident state income (state income) and General Fund revenue, and given an expert projection of state income in 2010, projected General Fund revenue for that year was calculated.

Staff used projections done by the Center for the Continuing Study of the California Economy for state income and for the number of employed Santa Clara County residents to establish additional projected revenue figures for the year 2010.

Those figures are presented in Figures 5 through 9, which are further described below.

Comparing Projections Derived from Three Different Approaches

Staff compared the results of the projections from the model with (a) the non-weighted trend-based projections, (b) the weighted historical-based projections, and (c) the expert-projection-based calculated projections.

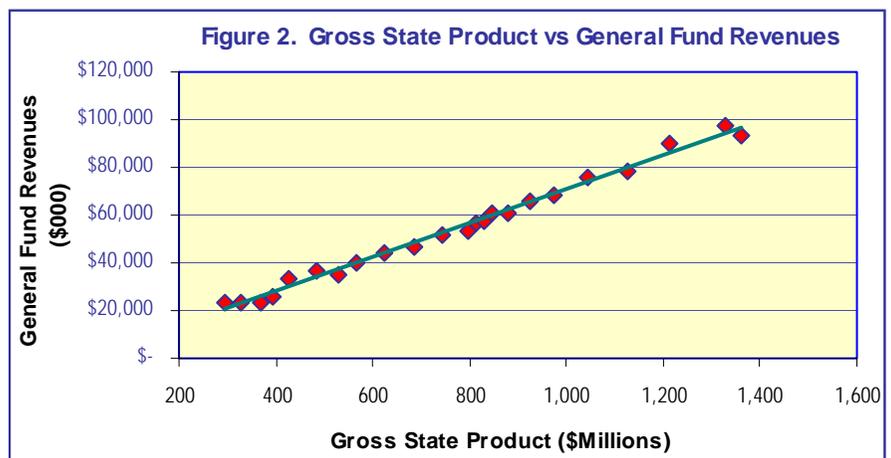
Figures 5 through 9, (pages 29 and 30) present the revenue forecasts for property tax, sales tax, UUT, TOT, and the General Fund and incorporate the weighted and non-weighted models presented above, along with the forecasts from the Long Range Financial Plan model. Additionally, each of the figures shows two point estimates for the year 2010. These points are based on expert economic projections of the average state resident income and the number of employed in Santa Clara

Revenue Stream	Growth per Year	Percentage of Variation Accounted for by Annual Growth
Property Tax	\$407,190	90.60%
Sales Tax	\$652,690	84.70%
TOT	\$268,248	74.60%
UUT	\$180,020	77.50%
General Fund	\$3,289,900	97.00%

Revenue Stream	Non-weighted Revenue Data (Millions)	Weighted Revenue Data (Millions)
Property Tax	\$15.50	\$15.60
Sales Tax	\$26.40	\$19.30
TOT	\$8.70	\$5.40
UUT	\$8.30	\$8.30
General Fund	\$117.90	\$97.10

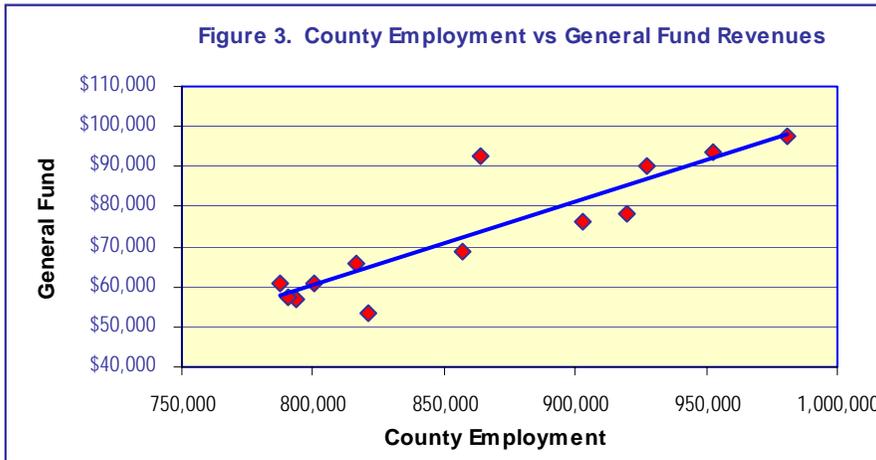
County, fed through the regression formulas derived in Step 1. These figures illustrate the range of revenues that can be expected given the set of analytical approaches.

With regard to property taxes, Figure 5 shows a \$5 million range for the year 2010 property tax projections, from \$13.8 million to \$18.9 million. The City's Long Range Financial Plan (LRFP) model forecast falls above other projections. The reason for this difference is that staff used the compound annual growth rate between 1993-94 and 2003-04, while the other projections used different growth calculation methodologies over longer spans of time. For example, the trend line (historical data) weights



LONG RANGE FINANCIAL PLAN

Forecast 2005-2015



each year since 1979-80 equally, and shows a less steep slope (slower growth rate) than the LRFP projection.

The LRFP forecast assumes a 5 percent annual increase in property taxes, and staff believes this is a reasonable assumption. While interest rates will probably rise in the near future, staff believes that demand for housing in Palo Alto and the momentum of converting old homes to new, larger ones will sustain a 5 percent growth rate. In addition, staff also expects that the unsecured portion of property taxes (personal property and equipment), which has declined by \$200,000 over the past 2 years, will rebound as the economy improves and businesses reinvest in technology.

Figure 5 does not include the value of the recent Stanford Shopping Center transaction or the In-Lieu Vehicle License Fee revenue. These new revenues were excluded in order to have an “apples to apples” comparison between historical results and the forecast. The Stanford and In-Lieu transactions are, however, included in the ten-year forecast financial statements.

In Figure 6, the LRFP model predicts sales tax revenues at slightly higher levels than the weighted forecast. But the model's results are lower than the expert predictions of employment and average income and the non-weighted predictions. Staff is comfortable with its lower forecast based on the potential for the departure of an auto dealership, competition from malls and big-box stores, and because revenues in the “dot-com” boom years were an aberration (those years heavily affect the non-weighted trend line and place it above model's forecast). Because sales tax

levels have returned to 1995-96 levels, staff believes its forecast is reasonable.

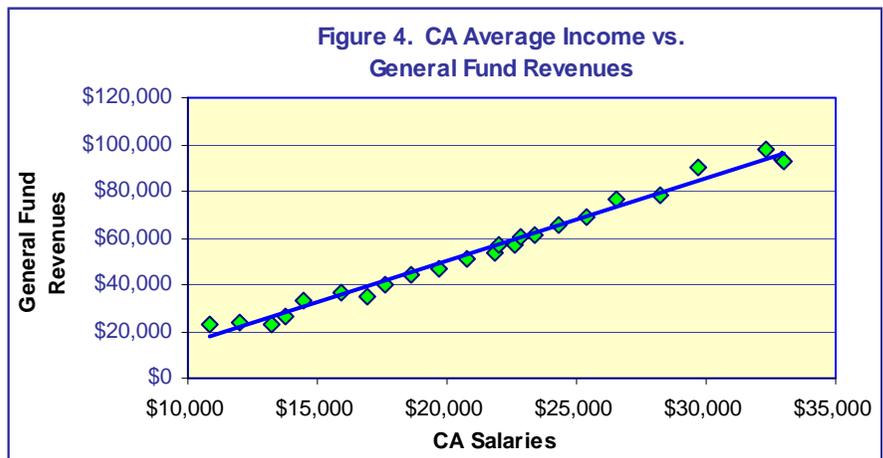
Figure 7 illustrates that TOT revenues will rebound more quickly according to the expert predictions as well as in the non-weighted analysis. This again shows that the non-weighted analysis and the expert inputs predict a faster recovery from the current economic environment.

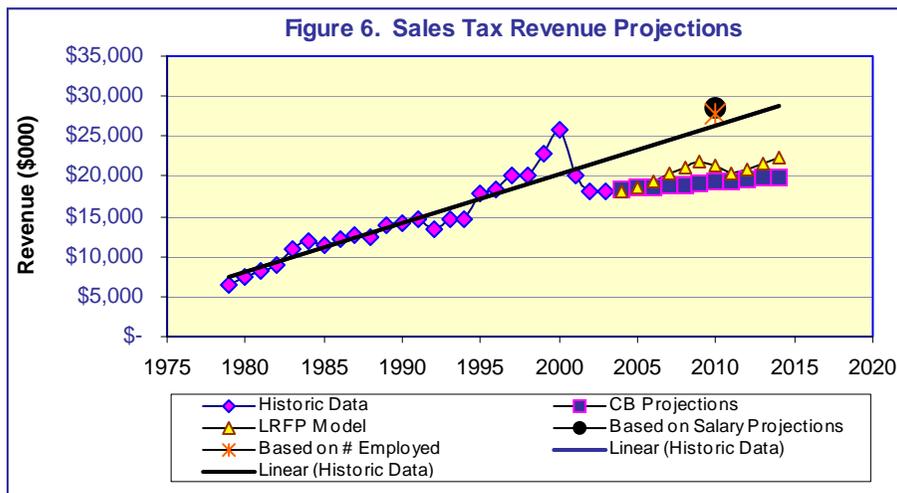
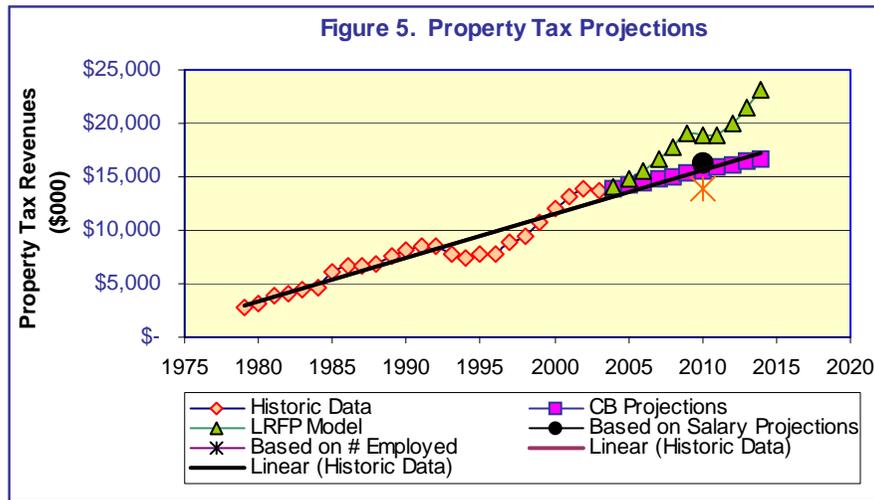
Figure 8 shows a relatively narrow range for UUT revenue projections from each of the projection methodologies, from \$7.0 to \$8.4 million. This is because the UUT has been a fairly stable revenue

source, and has not fluctuated as much with the local economy. The reason that the model projects a higher number than the other methodologies is the anticipated rate increases planned by Utilities.

Figure 9 shows that the expert predictions, the City's LRFP model and the non-weighted average all predict General Fund revenues in 2010 between \$97 and \$126 million.

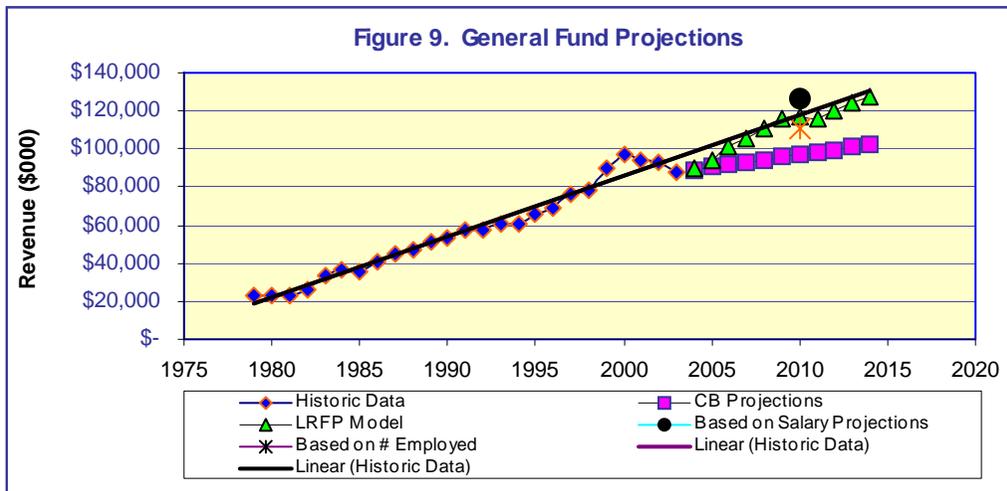
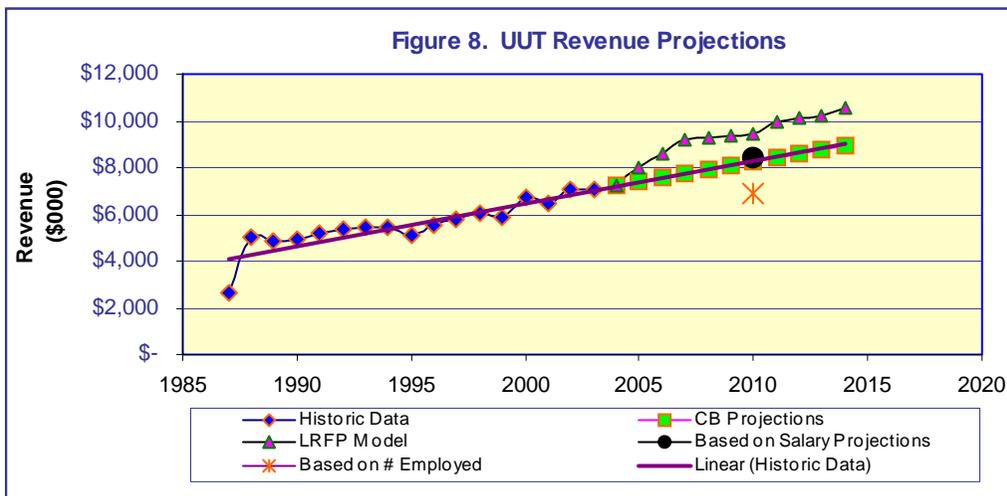
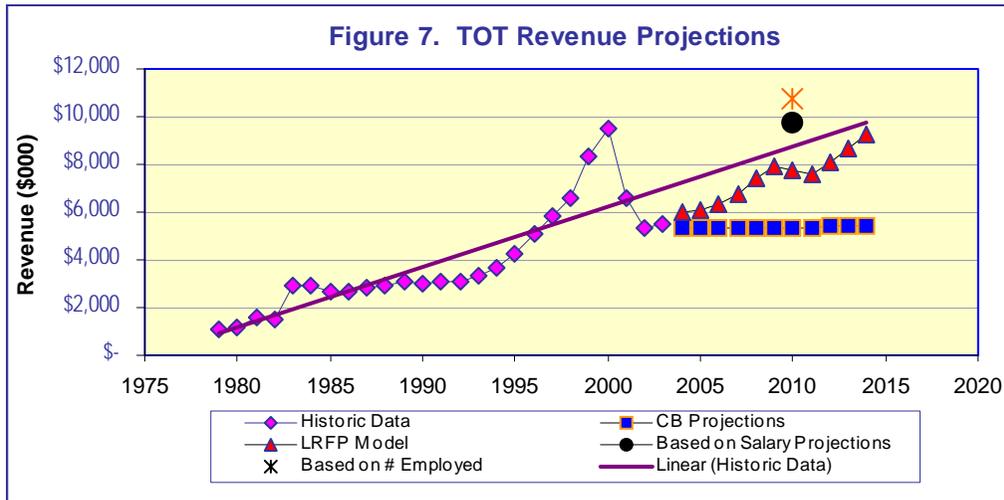
In conclusion, the alternative quantitative forecasting methods staff used produced results that varied within a reasonable range. To some extent, variations can be explained by the type or mechanics of the methodology utilized. The correlations established have helped validate the assumptions used in the model. In the future, staff may utilize the most closely correlated independent variables as a way of predicting future revenues.





LONG RANGE FINANCIAL PLAN

Forecast 2005-2015



City of Palo Alto City Officials

City Council

Bern Beecham, Mayor

Jim Burch, Vice-Mayor

Victor Ojakian

Dena Mossar

Hillary Freeman

Judy Kleinberg

Yoriko Kishimoto

LaDoris Cordell

Jack Morton

Finance Committee

Judy Kleinberg, *Chair*

Hillary Freeman

Dena Mossar

Vic Ojakian

Policy and Services Committee

Yoriko Kishimoto, *Chair*

Jim Burch

LaDoris Cordell

Jack Morton

Council-Appointed Officers

City Manager

Frank Benest

City Attorney

Gary Baum

City Clerk

Donna Rogers

City Auditor

Sharon Winslow Erickson

Administrative Services Organization

Administrative Services Department



Mission Statement

To provide proactive administrative and technical support to City departments and decision makers, and to safeguard and facilitate the optimal use of City resources.

AMERICANS WITH DISABILITIES ACT STATEMENT

*In compliance with
the Americans with Disabilities Act (ADA) of 1990,
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