

LONG RANGE FINANCIAL PLAN

Forecast 2006-2016

City of Palo Alto
December 2005

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Ramona Street

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LONG RANGE FINANCIAL PLAN

FORECAST 2006-2016



1 STATE OF THE ECONOMY

NATIONAL ECONOMIC OUTLOOK

The national economy has grown slowly but steadily over the past year and is expected to continue to do so through 2006. Real Gross Domestic Product (GDP) grew at an annual rate of 3.8 percent in the 3rd quarter compared to the 2nd quarter, which in turn had increased by 3.3 percent.¹ UCLA Anderson Forecast, an often-cited economic outlook, projected economic growth in the 2 percent range over the next two years, but “an abrupt plunge in housing starts and housing prices - a bursting of the housing bubble - could still drive a slump.”²

The national economy has grown steadily over the past year and is expected to continue to do so...but a bursting of the housing bubble could cause a slump.

In the fall, the two hurricanes in the Gulf Coast and continued high oil prices disrupted the growth trend. Consumer confidence has dipped and consumer spending is expected to decline. The University of Michigan Index of Consumer Sentiment, a measure of consumer confidence, fell from 89.1 in August to 76.9 in September, and further to 75.4 in October. In addition, the Conference Board's Consumer Confidence Index, based on a survey of household spending plans, fell to 86.6 in September from 105.5 in August, its biggest drop in 15 years. Consumer confidence indicators are closely watched since two-thirds of economic output is driven by consumer spending.³

Although the hurricanes did not produce consumer spending cuts in September, the consumer confidence indices indicate that “consumers are distressed,” according to Robert Brusca, chief economist at FAO Economics, a New York-based research firm, and therefore longer-term spending cuts are likely.

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“The problem is the consumers are [still] spending all of their income. This is unsustainable,” and energy prices will eventually take their toll among lower- and middle-income consumers.⁴ Personal saving as a percent of disposable income dropped below zero in the third quarter of 2005, to -1.1 percent compared to +1.2 percent a year earlier.⁵ This supports the notion that consumers are tapped out and may be unable to sustain their level of spending in the near future.

EMPLOYMENT TRENDS

Jobs have increased every month in the past year, except September. Over the 12 months ending in August, payroll employment grew by an average of 194,000 per month, and the unemployment rate trended downward. In September, the number of unemployed persons, 7.7 million, and the unemployment rate, 5.1 percent, rose, although they had been trending down in the previous months and remain lower than a year earlier.⁶

Hurricanes Katrina and Rita may cause larger, long-term job losses. The nonpartisan Congressional Budget office estimated that the two hurricanes will ultimately cost the economy between 293,000 and 480,000 jobs.⁷

In addition, although total jobs have increased in the last year, job cuts have continued. In June, U.S. corporations announced plans to cut 110,996 jobs—the highest monthly total in 17 months—and overall job cuts in 2005 reached 538,274 that month.⁸ In July, workers at Eastman Kodak Co., Hewlett-Packard Co. and Kimberly-Clark Corp., among others, were warned about tens of thousands of layoffs. Hewlett-Packard announced a major reorganization that would cut 10 percent of its workforce, or 14,500 employees, by the end of 2006. This move closely followed a similar announcement by IBM, which also plans to cut 14,500 jobs. In late November, General Motors announced plans to cut 30,000 jobs and close nine plants. Merck and Co. then followed with planned reductions of 7,000 jobs and the shuttering of 5 plants.

The technology sector is “one of the few areas of the economy that has failed to add jobs consistently over the last 12 months.” In the last year, while the US economy has created nearly 2.2 million jobs, computer and communications-equipment manufacturers have added a total of 6,000 workers.

According to John Challenger, CEO of Challenger, Gray and Christmas, a global out-

FROM PAGE 1:

1 Bureau of Economic Analysis, “News Release: Gross Domestic Product,” October 28, 2005

2 UCLA Anderson Forecast, September 28, 2005: “UCLA Anderson Forecast Continues to Warn of Slow Growth for National Economy”

3 Tom Abate: “Weak outlook for State seen,” San Francisco Chronicle, 9/28/05

PAGE TWO:

4 Mark Glassman: “Inflation isn't so bad for business,” SmartMoney.com, 10/14/05

5 Bureau of Economic Analysis, www.bea.gov, 10/28/05

6 www.bls.gov, Bureau of Labor Statistics of the U.S. Department of Labor, October 7, 2005: “Employment Situation Summary”

7 Mark Glassman: “September Payrolls Beat Expectations,” SmartMoney.com, 10/7/05 quoting a statement issued by CBO Director Douglas Holtz-Eakin before the House Committee on the Budget

8 Ben Dobbin: “Thousands Losing jobs: Kodak, HP, Kimberly-Clark start to worry analysts,” San Francisco Chronicle, 7/23/05

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placement firm, “The economy is growing at a healthy pace and employers are adding workers, but the tech sector...is strangely absent from the recovery.”⁹ Challenger pointed to increased merger activity and outsourcing as the culprits. “Consolidation appears to be driving employment trends in the tech sector. Companies may be adding workers through the purchase of other firms...and even though outsourcing appears to have fallen off the front of the business pages as the hot issue of the day, the practice is still widely used as a cost savings device...”¹⁰

Tech-sector job cutting through the third quarter was nearly 20 percent ahead of 2004 tech employment cuts for this same period. In the first three quarters of 2005, tech job cuts totaled 140,696, compared to 118,427 in the same three quarters of 2004.

Continued outsourcing worries tech industry employees. EE Times, a trade publication, conducted a survey of 150,000

engineers. Among the 4,000 respondents, competition from overseas engineers was of foremost concern, with nearly half of the respondents saying their companies “had sent electronics design work offshore.”

In addition, only 1 in 10 respondents felt that “the US will always maintain its technology leadership position.” Only 16 percent of survey respondents termed their job security “good.” More than half said they were “concerned” about outsourcing. And 10 percent said they had either lost or were in danger of losing jobs because of it. In addition, an October report published by the National Academies, a top science and technology policy group, stated that India

... the technology sector is “one of the few areas of the economy that has failed to add jobs consistently over the last 12 months.”

and China together trained more than 13 times as many engineers last year as did the United States. “For the cost of...one engineer in the United States, a company can hire about...11 engineers in India,” the report said.¹¹ This trend is significant to the local economy, as discussed in the State and Local Economic Outlook section below.

Regional Layoff Activity: July 2005

Company	City	Affected	Cause
Cherry Pie Graphics	Santa Clara	2,000	RIF
Chordiant Software	Cupertino	35,000	RIF
Fairchild Imaging	Milpitas	10,000	RIF
Finisar	Sunnyvale	50,000	RIF
GE Healthcare	Sunnyvale	-	RIF
KLA Tencor	Milpitas	60,000	RIF
Kulicke & Soffa Ind.	Santa Clara	75,000	Closure
Mercury Interactive	Mountain View	132,000	RIF
SGI	Mountain View	50,000	RIF
Spherion	Cupertino	10,000	Closure
Veritas Software	Mountain View	-	RIF

RIF: Reduction in Force

Source: NOVA Workforce Board, “Workforce Review, July 2005”

⁹ “Hewlett-Packard to Slash 14,500 Jobs, After IBM Move,” Spacedaily.com 7/19/05

¹⁰ T.K. Maloy: “Tech-Sector job Cuts up 20 percent,” Spacedaily.com; 10/18/05

¹¹ Tom Abate: “Tech engineers fear US is falling behind,” San Francisco Chronicle, 11/14/05

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Economic analysts seem to be most worried by the over-inflated housing market.

September also saw additional planned layoffs in the airline and auto industries and consolidation in the retail industry – for a total of

71,836 planned layoffs in September (a rise from August's 70,571). At the same time, planned hirings fell to 15,666 in September from August's 27,581 – breaking three consecutive months of increases in announced hirings.¹²

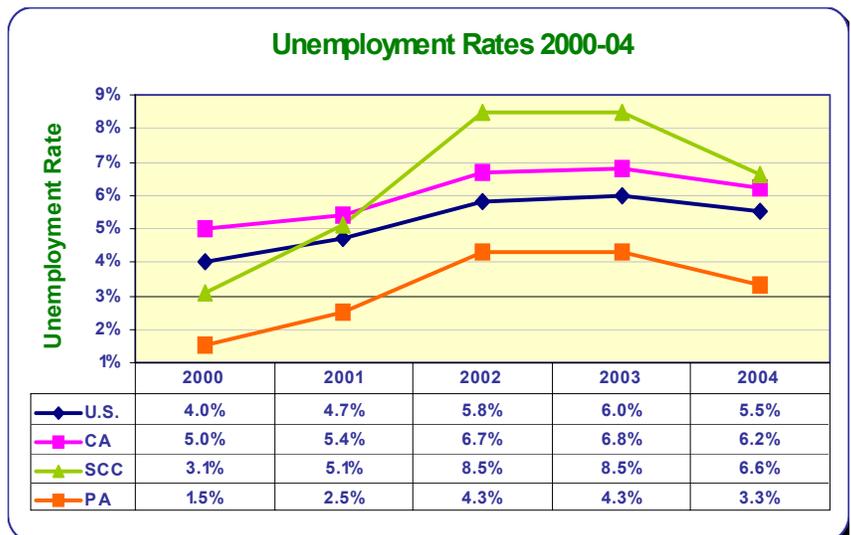
Despite overall gains in the number of jobs, real wages are down 2.3 percent since 2004.¹³ Although this national trend does not apply to Silicon Valley, this means working families are having a harder time paying their bills.

Economic analysts seem to be most worried by the over-inflated housing market. According to the National Association of Realtors, last year's quick rise in housing prices, along with the longer sales times seen this fall, are typical signs foreshadowing a market slow-down.¹⁴ The impacts of a slowed-down housing market are discussed in greater detail in the section below.

STATE AND LOCAL ECONOMIC OUTLOOK

Like the nation, California experienced gradual, broad-based growth in the past year. Gross State Product increased 7.3 percent in 2004 to \$1.54 billion, compared to the 2003 increase of 5.5 percent over the prior year. Each of the state's eleven industry sectors showed a year-over gain in September, with the largest job increase in construction (58,600 jobs), followed by professional and business services (41,100 jobs).

California's unemployment rate continued to drop more steeply than that of the nation as a whole. The state unemployment rate fell 1.0 percent over the last year, to 5.2 percent, and by 1.7 percent over the last 2 years. In contrast, the U.S. unemployment rate fell by just 0.3 percent over the last year and by 1.0 percent over the last 2 years.¹⁵



Sources: Bureau of Labor Statistics and California Employment, Development Department || SCC = Santa Clara County

12 "Airlines, autos and retail lead September layoffs," Reuters: 10/5/05, www.msnbc.msn.com

13 Jared Bernstein: "Economy continues to expand, while real average wages experience fastest decline on record," Economic Policy Institute, Oct. 28, 2005

14 "Slowing is seen in housing prices in hot markets," New York Times, 10/4/05

15 www.labormarketinfo.edd.ca.gov 10/24/05: "California Employment Highlights- September 2005

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However, the healthy image may be skin-deep. According to Christopher Thornberg, an economist with UCLA Anderson Forecast, "the forecast for California is mediocre at best."¹⁶ Of concern to Thornberg and other economists is the inevitable cooling of the superheated housing market and its effect on the state. Scott Anderson, Northern California economic specialist for Wells Fargo, commented, "The job recovery in the nation as a whole, but in California especially, has been tremendously dependent on housing and remodeling." 12.3 percent of all net payroll growth nationwide from August 2004 to August 2005 came directly from construction. In California, it was 27.3 percent.¹⁷

In addition, the housing sector has been strongly linked to consumer spending. Consumers borrow against their home equity to finance remodeling projects and other spending. A recent San Jose Mercury News article describes it this way:

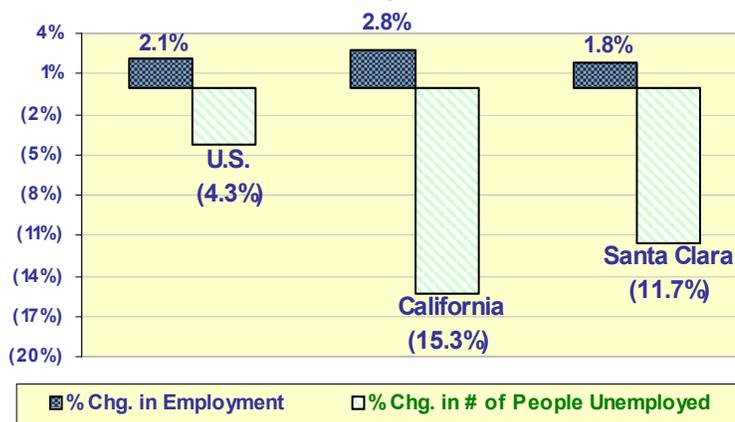
"...buyers today are willing to take on dizzying debt to get into a home. Once in, many borrow heavily against their rising property values, taking out equity loans to pay for college tuition or to buy a new car. Because recent history tells them Silicon Valley real estate values go ever

upward--with many houses now worth 30 times what they cost 30 years ago--many homeowners assume there will be enough equity left over to pay for retirement, too."¹⁸

With mortgage interest rates rising, "home prices could flatten or fall, in which case construction employment would probably be hit within three to six months," according to economist Joe Hurd, with Rosen Consulting Group in Berkeley.¹⁹

According to an August Field poll, Californians are aligned with the national downward trend in consumer confidence. For the first time since 2001, more Californians predict the economy will worsen over the next 12 months than think things will improve. Thirty percent foresee a decline; 22 percent predict improvement. In contrast, last year the survey showed 44 percent thought

Percent Change in Employment and Number of People Unemployed From 9/04 to 9/05



Source: California Department of Finance

16 UCLA Anderson Forecast: "UCLA Anderson Forecast Continues to Warn of Slow Growth for National Economy," September 28, 2005

17 Tom Abate: "Weak outlook for state seen," San Francisco Chronicle, 9/28/05

18 Sue McAllister: "How the Boom Has Hit Home," San Jose Mercury News, 10/3/05

19 Tom Abate: "State's job picture brightens," San Francisco Chronicle, 9/17/05

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things would improve, and just 14 percent predicted a decline in the state's economy.²⁰

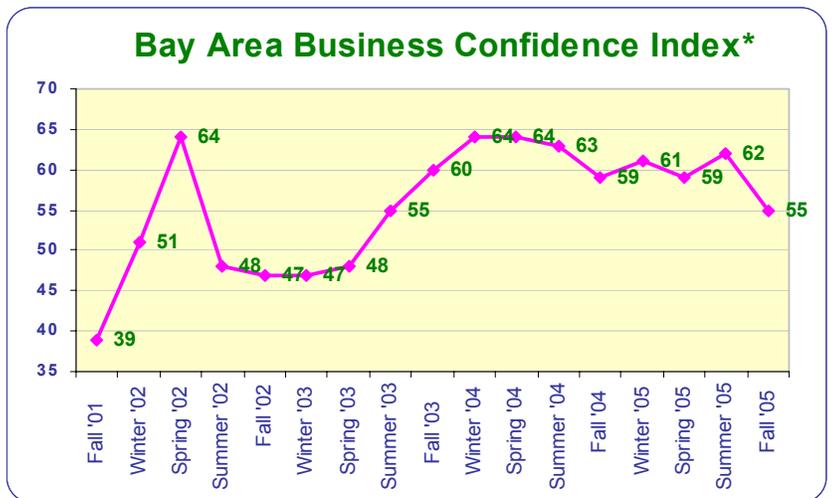
Within a State with consistent job growth, distinct regional variations were evident. In the Bay Area, although unemployment declined more steeply, job creation was the softest in the State for the first half of 2005.²¹

Silicon Valley is, in turn, the slowest growing area within the Bay Area economy. Palo Alto's unemployment rate declined from 3.1 percent to 2.7 percent between August 2004 and August 2005.²² The Valley's unemployment rate slipped to 5.2 percent in September, down from a revised 5.4 percent in August and 6.0 percent a year ago. But it's still higher than the rest of the State. Without Santa Clara County, the Bay Area would post year-over-year job growth through August of 1.34 percent, which beats Southern California's 1.23 percent, according to Gary Schlossberg, senior economist at Wells Capital Management. Throw in Silicon Valley, and growth slows to 0.85 percent.²³

Bay Area executives' confidence in the local economy has also declined. The Bay Area Business Confidence Survey, conducted by the Bay Area Council, a business-backed public policy group, conducted a survey in October

showing the "gloomiest assessments on the Bay Area Council's business confidence index in nearly three years." 20 percent of Bay Area executives surveyed expected the local economy to worsen over the next six months. In July, only 7 percent were downbeat in their six-month outlook. "That's a pretty big drop" in mood, said Jim Wunderman, chief executive for the Council.²⁴ The fact that the survey was taken in October may indicate that the hurricanes in the Southeast had an effect on the results.

In interviews with 517 Bay Area business leaders representing a mix of firms by size and industry, the survey determined that 33 percent expected to hire workers over the next six months, while 10 percent planned layoffs. Santa Clara County (SCC) execs have typi-



*The Index value is the average of the percent of positive responses to the questions in the survey. An Index above 50 means there are more positive than negative responses. **Source:** Bay Area Council, www.mercurynews.com/business 11-15-05

20 9/21/05 AP: "Poll: Californians grow pessimistic on economy, inflation" (Poll drawn from polls to 465 registered voters of a 10-day period ending Aug. 29.)

21 Department of Finance Bulletin, July '05

22 California Employment Development Department

23 Nicole C. Wong: "Valley makes job gains," San Jose Mercury News, 10/22/05

24 Matthai Chakko Kuruvila: "Execs say Bay Area economy 'weaker'," San Jose Mercury News, 11/15/05

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cally been the most pessimistic in the nine-county Bay Area, but the gap was slightly less this time around. Twenty-two percent of SCC executives believed the economy was worse in October than it was six months prior, compared to 17 percent Bay Area-wide.²⁵

The slower job growth—and greater pessimism—in the Valley may be due to the changing nature of the high tech industry. According to the Silicon Valley Leadership Group in its 2006 Projections report:

“Technology company payroll growth will continue to be held back by the high cost of doing business and the structural changes occurring in the technology industry... [As the tech industry has become more global since 2000,] major technology bellwethers like Intel have announced their intention to do much of their future hiring outside the United States, closer to where their fastest growing markets and an increasing share of their customers now reside.”²⁶

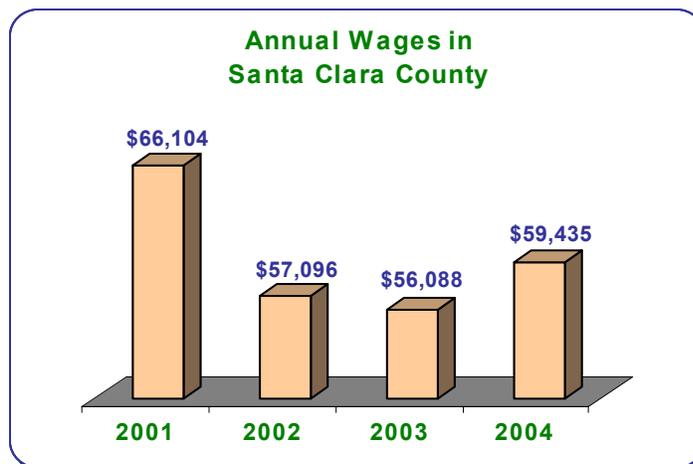
Yet even this sobering report predicts a solid if slow-growing future:

“On balance the Silicon Valley's economic recovery continues to broaden and sustainability is likely... Employment is expected to grow by 1.6 percent in 2006, adding approximately 21,282 jobs. Yet longer-term, employment growth through 2016 will likely average far below the rates experienced

from 1993 to 2000, as the evolving structure of supply and demand in the technology industry creates a growing share of the employment growth overseas.”²⁷

Brightening that outlook is the fact that high tech jobs, if relatively scarce, are paying increasing wages. Wages earned in Santa Clara County were 6 percent higher in 2004 than in 2003. First quarter 2005 wages were 3.5 percent higher than first quarter last year. As Stephen Levy of the Center for Continuing Study of the California Economy stated, “It's possible to have increased revenues without job growth,” due to the relatively healthy and increasing salaries provided in the technology sector.

The key to the region's long-term economic health, according to Levy and many others, is its continued desirability as a place in which businesses can incubate. As evidence that the Valley continues to fulfill that role, venture capital (VC) investment increased



Source: U.S. Dept. of Labor/Bureau of Labor Statistics

25 Matthai Chakko Kuruvila: “Execs say Bay Area economy ‘weaker’,” San Jose Mercury News, 11/15/05

26 Silicon Valley Leadership Group, “2006 SVLG Projections,” page 2

27 Silicon Valley Leadership Group, “2006 SVLG Projections,” pages 2-3

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The local economy, as well as the national economy, is likely to continue a slow, bumpy ascent towards stability.

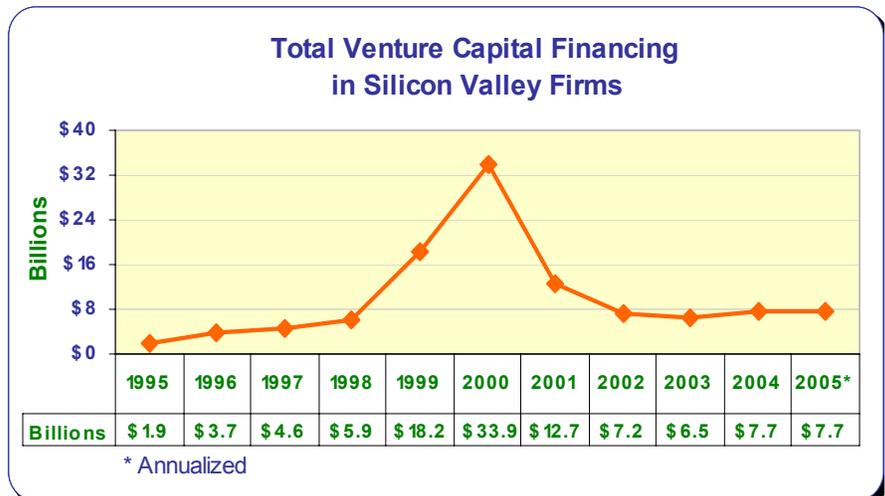
for the first time in three years, from \$6.5 billion in 2003 to \$7.7 billion in 2004, an increase of 18 percent. VC investment peaked in 2000 at \$34 billion. Since that time, venture capital investment in Silicon Valley has declined by about 80 percent, but the Valley's share of national venture capital investment has grown every year since 1995, rising from 14 percent that year to 35 percent by 2004.²⁸

exchanges involving international scholars, researchers and students.²⁹

The Bay Area Science and Innovation Consortium (BASIC) pointed out in a recent report that "In an era of growing competition for jobs, investment and economic leadership, the ability to attract and retain this human capital constitutes a key competitive advantage." Regulations and immigration policies are worth noting as they negatively affect the region as a destination for worldwide technical entrepreneurs and workers.

In summary, both national and local economic outlooks are brighter than they were a year ago. However, the trends are not overwhelmingly positive. The local economy, as well as the national economy, is likely to continue a slow, bumpy ascent towards stability.

Technology executives have expressed concern that certain government policies and programs are detracting from the region's competitive assets. At a TechNet conference in San Jose on November 16, executives blamed mediocre public education, federal regulations, and restrictive immigration policies for weakening Silicon Valley competitiveness. They urged additional spending on math and science education and a review of the post-9/11 immigration procedures, which are restricting scientific



Source: PricewaterhouseCoopers MoneyTree™ Survey as graphed by Joint Venture. Silicon Valley Network's "2005 Index of Silicon Valley"

28 Joint Venture Silicon Valley: 2005 Index of Silicon Valley; PriceWaterhouseCoopers MoneyTree survey, www.pwcmoneytree.com

29 Verne Kopytoff: "Tech leaders say Silicon Valley's edge is growing duller," San Francisco Chronicle, 11/17/05

2

PROJECTION AND ANALYSIS OF REVENUES
AND EXPENDITURES**FORECAST**

The ten year forecast of revenues and expenditures (Exhibit 1) for the Long Range Financial Plan can be found at the end of this chapter. The forecast is followed by the assumptions or percentage changes for each revenue and expense category (Exhibit 2) and by a table summarizing the effects of the forecast on reserves (Exhibit 3). The intervening text describes how staff arrived at the forecast presented in this report and highlights important facts, issues and trends.

**FORECASTING METHODOLOGY:
REVENUES**

As in past Long Range Financial Plans, it is assumed that the compound annual rate of growth (CAGR) for economically sensitive revenue sources between 2005-06 and 2015-16 will be roughly similar to that between the years 1994-95 and 2004-05. For example, the CAGR for sales taxes between 1994-95 and 2004-05 was 2.7 percent. The forecast for 2005-16 assumed a 2.7 percent growth rate, implying that future growth will mimic that of the past decade.

Using the CAGR methodology produces a somewhat conservative growth rate, since it does not recognize the extraordinary revenue gains of 1999-00 and 2000-01. Similarly, if a dip in revenues had occurred in the last ten years, the CAGR methodology would

even that out by averaging the growth rate. A drawback in this methodology is it does not account for structural changes in revenue generation, such as the departure of automobile dealerships or the addition of new electronics businesses. In these types of events, staff adjusts base revenues before developing a projection. On balance, staff believes that using the CAGR methodology and adjusting the revenue base up or down, given specific information and events, is a sound approach to forecasting.

The forecast assumes that the City will channel any revenue windfalls into reserves or one-time capital improvements. In this way, the City may avoid 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 levels.

Included in the forecast is a projected economic downturn that begins in approximately six years, around 2011. Most economists will say that timing the next recession comes down to guesswork, but incorporating a two-year downturn is useful due to the following:

- In the past, California has experienced a recession approximately once per decade.
- Planning for a two-year downturn in the next ten years encourages prudent planning and fiscal management.

The downturn projected in years 2010-11 and 2011-12 is relatively mild compared to

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that experienced from 2001-02 through 2004-05. A deficit of \$1 million emerges in 2011-12. Staff does not believe the City needs to take any corrective action at this time. If no recession occurs in this time period, the City will be in a better-than-projected position.

BACKGROUND FORECAST: REVENUES

State Budget Actions and Revenue Changes

The forecast continues to incorporate city revenue source changes included in the 2004 State budget-balancing package. These include the “triple-flip” and “ERAF III” adjustments involving sales tax, vehicle license fees, and property taxes.

The “triple-flip” is a swapping of revenue sources to allow the State to issue bonds without voter approval. The State will pay directly to local jurisdictions three quarters of the one percent of sales tax due to them. The remaining quarter percent will be paid to localities via property tax remittances from the counties. While it is anticipated the City will eventually receive the full one percent of sales taxes, the timing of the quarter percent payments affects cash flow and interest income earned. The City's General Fund (GF) will lose a little over \$71,000 in interest earnings per year from this change. Once the “triple-flip” bonds are repaid (estimate is 10 to 20 years), direct payment of the full one percent should resume.

As part of the State budget compromise, the City of Palo Alto lost \$1.543 million in annual vehicle license fee (VLF) revenue in 2004-05 and in 2005-06. This revenue loss was “offered” in exchange for legislative and

gubernatorial support for Proposition 1A, and will not be repaid. The State is to resume full VLF payment in 2006-07, and this expectation is reflected in the forecast. 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 In-Lieu VLF payment will increase over time according to the growth in the property tax roll.

In a rare piece of good news from the State, the \$1.03 million “borrowed” by the State in 2003 (known as the “VLF Backfill Loan Gap”) has been repaid a year early. This revenue, anticipated for receipt in 2006-07, will be booked in 2005-06, improving this year's budget projection.

Impact of Recent Economic Trends on Revenue

As Chapter One discusses, there is slow but steady economic growth at the local, State, and national levels. Correspondingly, after stabilizing in the latter half of 2004-05, sales and transient occupancy taxes have turned modestly upward. The local economy appears to be on firmer ground, but causes for concern continue to be:

- Higher energy costs and rising interest rates have eroded consumer spending power
- Modest job growth on the Peninsula
- The continuing exodus of high-paying technology jobs overseas
- Competition from malls, discount chains, and hotels in surrounding communities
- The potential exit of automobile dealerships from Palo Alto
- Local resistance to economic development initiatives such as those at the Hyatt Rickey and Alma Plaza sites

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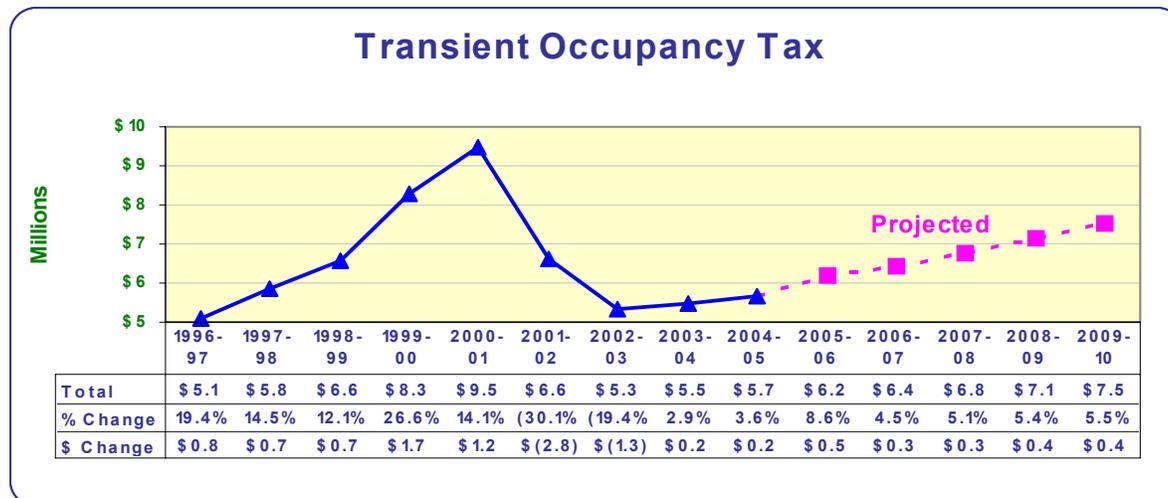
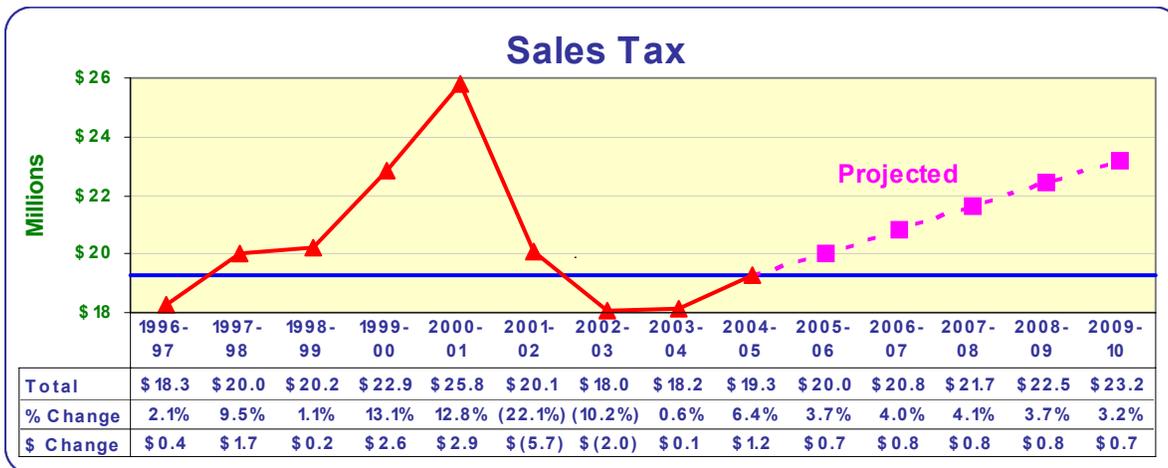
PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

These factors impact primarily sales and transient occupancy taxes, which comprise 21 percent of GF resources. Because of the concerns cited above, staff has assumed a lower rate of growth in the next ten years than occurred in the past decade. Total revenues in the forecast have a CAGR rate of 2.8 percent from 2005-06 through 2015-16, in comparison to 1994-95 through 2004-05 when the CAGR was 5.1 percent.

DISCUSSION OF SPECIFIC REVENUE PROJECTIONS IN THE FORECAST

Sales Tax

Sales tax revenues rebounded in 2004-05, and early data for 2005-06 indicate increases for this year will be in the range of 3 to 4 percent. Recent concerns about consumer spending during the holiday season, rising interest rates, and a potential burst of the housing bubble suggest a growth rate slightly below that range. Therefore, the



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1994-2005 CAGR of 2.7 percent was used for sales tax projections through 2015-16.

Key economic segments that displayed weakness in 2004-05 were business services and computer retail sales. Automobile sales-generated revenues have been flat at 10 percent of total sales tax revenues. Service stations, electronic equipment, and drug store segments have shown sales growth. (See **Sales Tax** chart on page 11.)

Transient Occupancy Tax

Following a 40 percent decline since 2001, transient occupancy tax (TOT) revenues improved toward the end of 2003-04 and improved further in 2004-05. During the first quarter of 2005-06, TOT revenues ran \$0.09 million or 6.1 percent higher than last year. Occupancy rates have exceeded 60 percent on a regular basis and daily room rates have risen. It is expected that TOT revenues will be on budget in 2005-06; however, the emergence of high-end hotels in Los Altos, Menlo Park, and East Palo Alto means competition for hotel taxes will stiffen. In addition, although other Palo Alto hotels will absorb part of Hyatt Rickey's business, it is antici-

pated that a good portion of Hyatt TOT revenue will be lost. This loss has been factored into the Long Range Financial Plan (LRFP). The forecast includes a CAGR of 3.7 percent in TOT receipts over the next ten years compared to 4.6 percent in the past 10 years. (See **Transient Occupancy Tax** chart on page 11.)

Property Taxes

Property tax revenues were healthy in 2004-05, with secured taxes rising 9.1 percent or \$1.1 million over 2003-04. This is attributed to a robust residential market, as well as to a few high-worth commercial transactions. The remainder of the increase in 2004-05 was derived from the State payment of the \$1.7 million Vehicle License Fee (VLF) Backfill through property taxes (discussed earlier). In 2006-07, there is a significant increase over 2005-06 due to the cessation of the \$1.5 million ERAF III takeaway (also discussed earlier).

The graph on page 13 titled "Property Taxes and ERAF" depicts the State Educational Revenue Augmentation Fund (ERAF) takeaways from the City of Palo Alto since 1991-92. The State has used these monies to solve its

Property Tax



PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

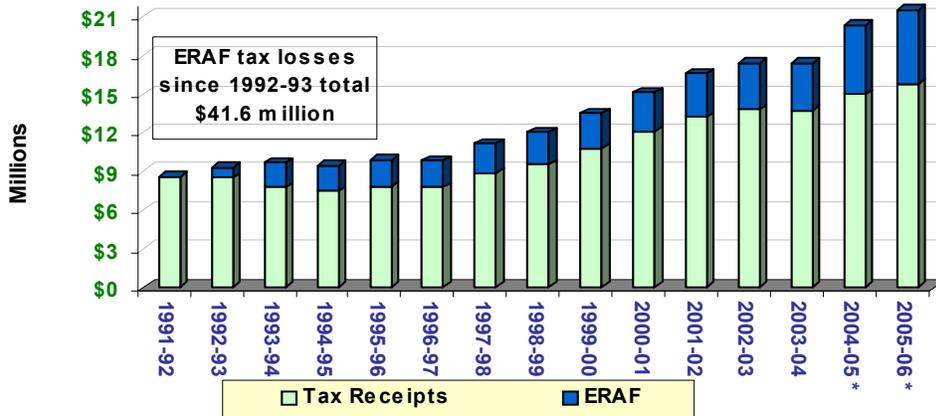
unceasing budget problems--monies that could have been used by the City to fund its infrastructure needs. To date nearly \$42 million has been taken from the City.

Utility Users Tax

The Utility Users Tax is based on telephone usage and sales of water, gas, and electricity. UUT forecasts utilize the Utility Department's long range forecasts which take into account commodity, operating and capital costs as well as necessary reserve and rate changes. The UUT CAGR for the past ten

years has been 2.9 percent, and staff is projecting revenues will grow by an average rate of 3.8 percent. The higher growth rate is attributable to planned water, gas and electric rate increases. The high overall rate is offset by lower growth (2 percent) in telephone UUT revenues. This results from a concern over the emerging Voice-Over Internet Protocol (VOIP) which staff believes will slowly chip away at telephone UUT receipts.

Property Taxes and ERAF



Utility Users Tax



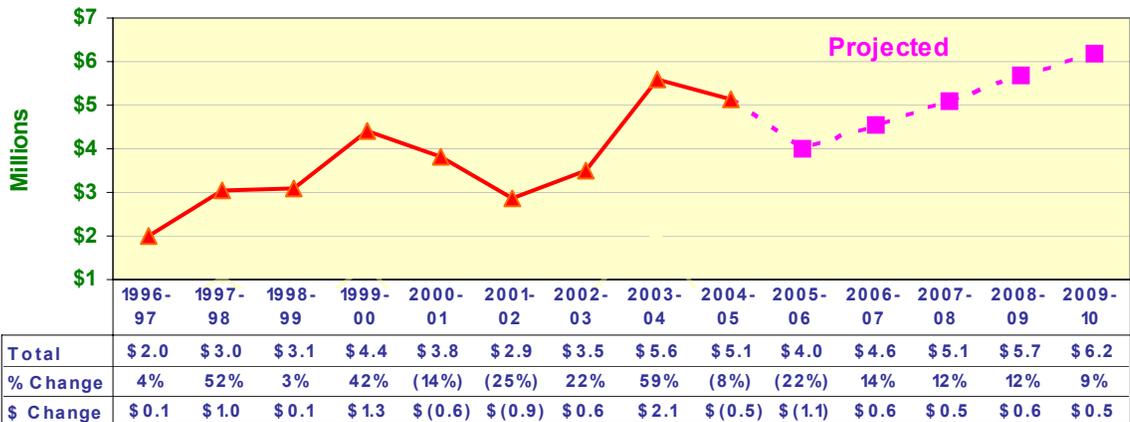
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PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

Documentary Transfer Tax

Documentary Transfer Tax revenue is acutely sensitive to the volume and size of property sales and the mix of residential and commercial transactions, and it varies widely from year to year. In 2003-04, it jumped to \$5.6 million due to a one-time Stanford Shopping Center lease transaction. Then, in 2004-05 it reached \$5.1 million, as a result of the all-time low interest rate environment and the high demand for local housing. Growth is projected at 5.4 percent (compared to the CAGR of 13.8 percent for the past ten years), assuming a softening in the housing market, as discussed in Chapter One.

Documentary Transfer Tax



Interest Income

As a consequence of the transfer of the Infrastructure Reserve (IR) from the General Fund (GF) to the Capital Fund, interest income declined by \$1 million in 2004-05. Over the past two years, average yields on the City's portfolio decreased from 4.29 percent at the end of 2003-04 to 4.17 percent at the end of 2004-05. Yields declined further to 4.13 percent in the first quarter of 2005-06 as older, higher yielding investments continued to mature. Yields are anticipated to gradually increase for the remainder of 2005-06 as the Federal Reserve pushes interest rates higher. The forecast shows General Fund (GF) interest income stabilizing at \$2.2 million in 2005-06. (See **Interest Income** chart on page 16.)

Based on an annual investment survey conducted by the City of San Mateo, staff is proud to report that for the past three years the City of Palo Alto's portfolio yield has been at least a half percent higher than the next highest city - Mountain View. Based on the City's \$350 million portfolio, this half percent translates into an additional \$1.8 million in interest earnings (\$0.26 million for the General Fund). Cities in the survey included San Jose, Mountain View, Redwood City, Alameda, and San Mateo, among others.

Fines and Penalties, Service Fees and Permits, and Joint Service Agreements

These categories include:

- Fines and Penalties: parking violations, library fines, administrative citations, and other fines and penalties

- Service Fees and Permits: service and permit revenues generated from 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
- Joint Service Agreement: the contract with Stanford University for fire and communication services

Fines and Penalties declined by \$0.7 million in 2004-05 and are projected to increase by 18 percent in 2005-06 due to the Police Department's commitment to traffic safety. Parking violations account for \$1.9 million or 77 percent of total fines and penalties revenue in 2005-06.

Service Fees and Permits revenue is expected to increase by 12.7 percent in 2005-06 but level out over the remaining nine years to approximately three percent annually. Early data for 2005-06 indicate strong growth in new construction permits. Staff also expects incremental paramedic revenue from the newly implemented Basic Life Support (BLS) ambulance program. This program allows paramedics on the scene to relegate non-emergency, lower-level medical calls to be transported by the BLS unit, increasing the availability of Advance Life Support (ALS) units for priority calls. The Community Services and Planning and Community Environment Departments have also increased some of their fees to maintain cost recovery levels.

The Joint Service Agreement with Stanford funds 30 percent of the Fire Department budget. In 2004-05, revenue increased by \$0.8 million due to increasing healthcare and retirement pension costs along with rising fuel costs. In 2005-06, staff expects a



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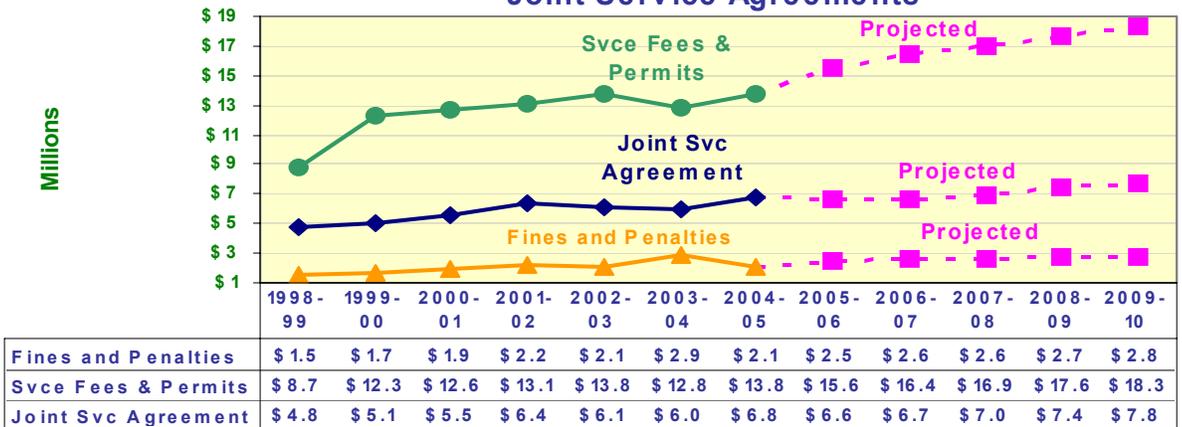
PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES



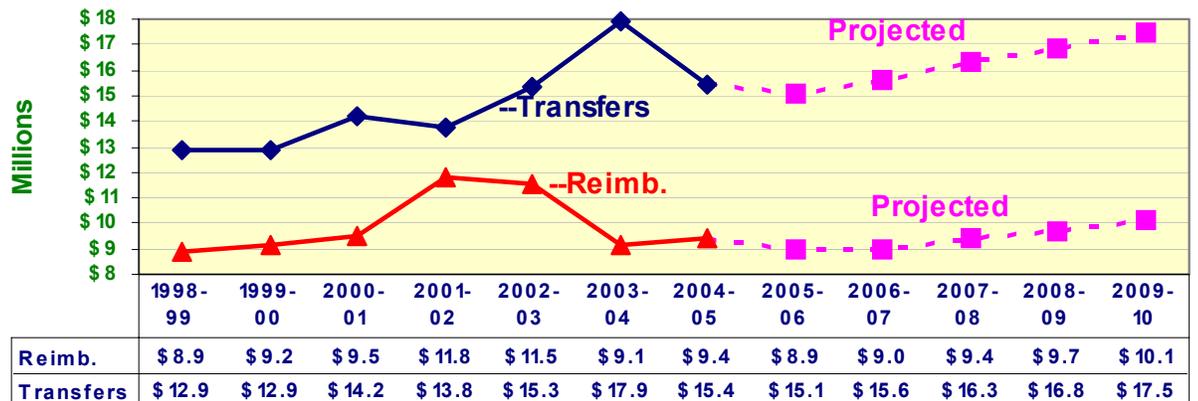
Interest Income



Fines & Penalties, Service Fees & Permits, Joint Service Agreements



Reimbursements and Transfers



PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

decrease of \$0.2 million due to a staffing reduction in the Fire Department. Since the majority of fire service expenses consist of staffing, the growth of this revenue stream is directly related to the Department's personnel expenses.

Reimbursements and Transfers

Reimbursements are payments to the General Fund (GF) for services rendered to the Enterprise Funds such as accounting, payroll, purchasing, human resources, and legal advice. In 2005-06, reimbursements to the GF are expected to be \$8.9 million, a 4.8 percent decrease from 2004-05. Reimbursement revenues are projected to grow at a 2.5 percent average annual rate over the next ten years.

Transfers between funds are a common means, within governmental fund accounting, of moving resources for general operations and capital projects. The main component of this category is the equity transfer from the Enterprise Funds (\$14.2 million), which represents a return on the City's original capital investment in the Utility Department operations (Water, Gas,

and Electric). The growth of this funding source is budgeted at 3 percent per year--the growth rate incorporated into the equity transfer methodology.

Other Revenues

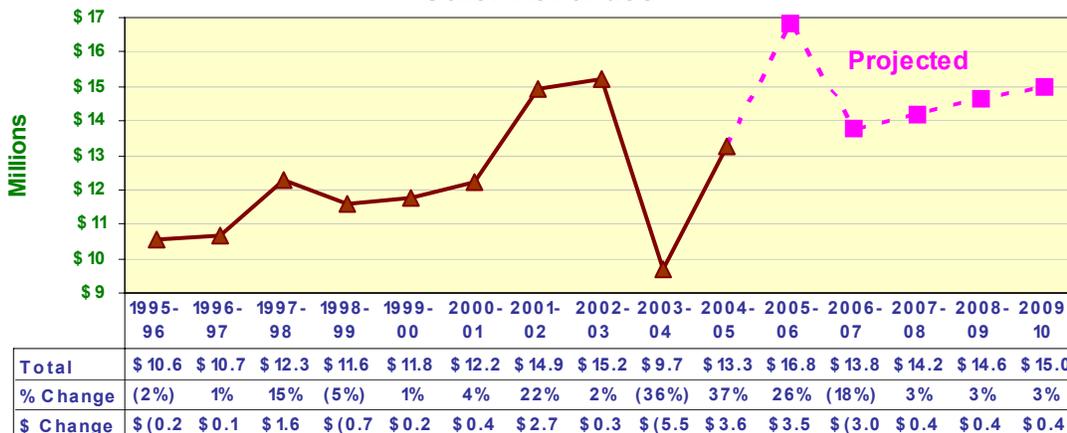
Other revenues comprise 13 percent of the total sources of General Fund revenue in 2005-06. A significant component of this category is the rental of land and facilities by Utilities and Public Works Enterprise Funds. About half of this rental revenue, or \$4.3 million, is paid by the Refuse Fund and will cease with the closure of the landfill. A new revenue source or expense reduction must be identified before 2013. The spike in 2005-06 is due to \$2.6 million in grants received for the purchase of the Bressler Open Space property.

FORECASTING METHODOLOGY: EXPENDITURES

Expenditure projections, like revenue projections, are based on a combination of historical trends, assumptions about future growth rates, and other judgments deemed appropriate. Salary projections are based



Other Revenues



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PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

primarily on previously negotiated labor agreements. For timelines beyond those contracts, salary growth is projected by using a weighted average of historical trends and regional labor cost increases.

Because healthcare and pension costs have grown so rapidly over the past several years and indications are that rates are moderating, these costs are projected to slow to a 5 to 8 percent growth rate over the next ten years. The City will continue to seek controls on the 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 is the basis for the first half of the LRFP capital transfers, and the last five years are estimated based on historical spending patterns.

BACKGROUND FOR FORECAST OF EXPENDITURES

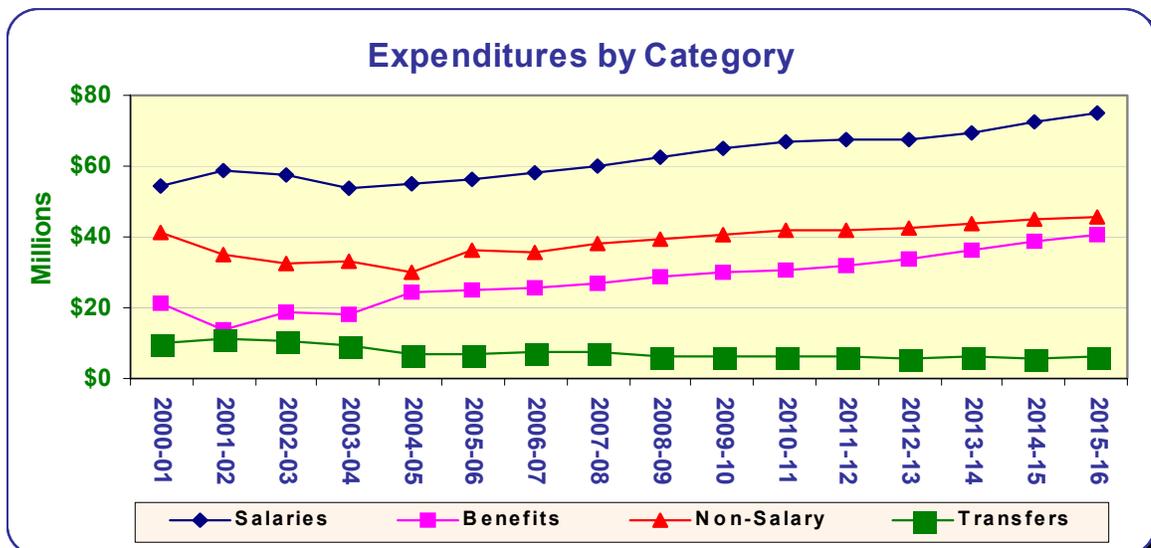
The City's broad range of community programs and services has a direct impact on staffing levels, which in turn affect the main component of expenditures: salaries and ben-

efits. The graph below depicts the projected trend lines for salaries, benefits, non-salary expenses, and transfers.

Please note the following regarding that graph:

- Salaries remain at about 45 percent of total expenditures from 2005-06 through 2015-16
- Benefits increase from 20 to 24 percent of total expenditures from 2005-06 to 2015-16
- The average annual increase in total expenditures from 2005-06 to 2015-16 is 3.4 percent
- Non-salary expense and transfers represent about one-third of General Fund expenditures
- Reimbursements for General Fund expenditures total \$15.5 million. These reimbursements include payments related to the Stanford Fire agreement, external IT services, health and human service agreements, utilities tree line clearing, animal control services, and services rendered to the Enterprise Funds.

Another salient point about General Fund expenditures is that the two largest functional areas of the budget are public safety (police and fire) and community services. The former comprises 36 percent of total expenditures in



PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

2005-06 and the latter 16 percent. Together these services comprise 52 percent of City expenditures.

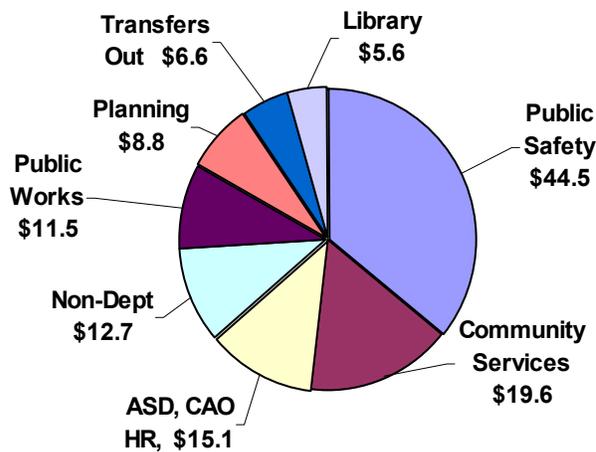
The pie chart below shows \$15.1 million in expenditures for "ASD, CAO, and HR." This category includes Administrative Services, the City Attorney, City Auditor, City Clerk, City Council, City Manager, and Human Resources. The Enterprise Funds reimburse the General Fund for administrative services in the amount of \$7.6 million.

DISCUSSION OF SPECIFIC EXPENDITURE PROJECTIONS

The City of Palo Alto is a labor-intensive and service-driven organization; hence the salaries and benefits category represents approximately 66 percent of the General Fund budget in 2005-06. In the past several years, the City has undergone multiple restructuring efforts to contain the rising costs of salaries and benefits. As a

result of "Strengthening the Bottom Line" efforts, projected annual growth for salaries and benefits over the next ten years has declined from 5.0 percent (1996-2006) to 3.5 percent, an annual savings of \$1.5 million. This is primarily due to the reduction of 30 positions in the General Fund during the 2005-07 budget process, which followed the reduction of 40 positions in prior years. (See **General Fund Staffing** chart below.)

2005-06 Expenditures by Function



General Fund Staffing



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Other factors contributing to slower growth in salaries and benefits include:

- Slowing healthcare cost increases
- Slower growth in pension expense due to higher PERS portfolio returns and rate smoothing

Salaries and Benefits

Salaries

For the next ten years, salary and overtime expense is projected to grow by 2.9 percent per year--declining from a 4.4 percent rate during the prior ten years. The slower growth trend is a result of staff reductions and an anticipated loosening in the labor market. It is possible, however, that prevailing labor market differentials may surface over the next few years as comparisons are made with benchmark cities. This will lead to complex labor negotiations as budget-balancing efforts weigh against regional wage standards. Specific labor negotiations anticipated include: contracts for classified and hourly units under the Service Employee's International Union (SEIU), International Association of Fire Fighters (IAFF), and Fire Chiefs' Association (FCA), scheduled to expire in 2006; and the union contract for Palo Alto Peace Officer's Association (PAPOA), set to expire in 2007.

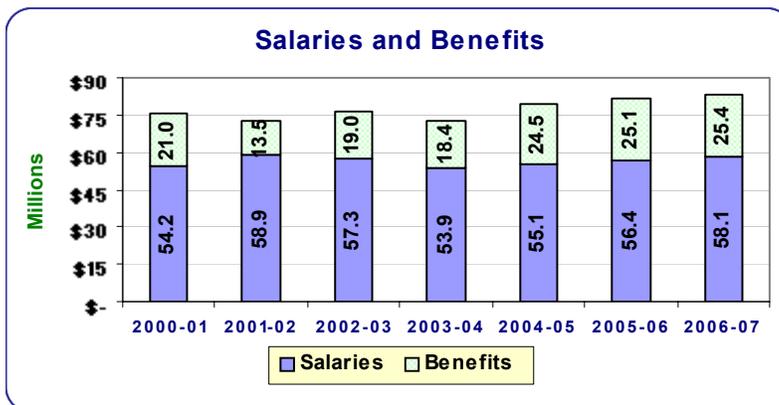
The City will continue to seek opportunities to restructure the organization around staffing vacancies and retirements. An important goal of the restructuring effort will be to balance and increase managers' spans of control.

Benefits

The rise in benefit costs is primarily responsible for the swelling of salaries and benefits, as a proportion of total expenses, from 63 to 69 percent over the period 1995 through 2015. The average growth rate in benefit expense is projected to be 4.7 percent annually over the next 10 years. Healthcare and pension cost growth is beginning to slow after several years of double-digit increases. However, these two components continue to be the main source of benefit cost increases.

Pension Expense: The single largest challenge on the expense side of this long-range plan is the pension costs from the statewide CalPERS retirement system. Annual General Fund expense in this area has more than doubled since 2003--from \$5.7 million to \$12.4 million due to significant negative stock market returns. In 2005, the CalPERS Board enacted a new rate policy with the goal of stabilizing rates over the long term. With the new stabilization policy, market gains and losses are spread over 15 years rather than over three

years when calculating the value of assets. The impact of this policy is appearing for the first time in 2006, with rates reduced by 3-4 percent compared to the prior year. Pension expenses are expected to flatten out in the upcoming years: from 2000-2005, the average annual growth was approximately 37 percent; in 2006-2016, an average annual growth of 5 percent is forecasted.



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Healthcare Costs: Having grown by more than 50 percent over the past five years to \$11.4 million in 2006, 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 at a slightly faster rate than that for active employees; in the long term, this will be partially offset by 20-year retirement medical benefit vesting requirements for all new employees, including those represented by PAPOA (as of November 2005).

The City has taken steps to solve these fiscal challenges. This includes capping City medical contributions and the 20-year vesting requirement. These steps have helped lower the City's healthcare expense. The City of Palo Alto is one of a few jurisdictions that completely funds all employee health insurance plans and a retiree medical plan. (See **Healthcare Expenses** chart on page 22.)

Non-Salary Expenses

Non-salary expenses represent 29 percent of the General Fund budget in 2005-06. These expenses include contract services, supplies, general expenses, rents and leases, and allocated charges. Consistent with the prior year's LRFP, this plan assumes no program growth beyond general cost inflation over the next ten years. The pie charts on page 22 show the breakdown of non-salary expenses.

Included in general expense is the lease payment of \$6.1 million to the Palo Alto Unified School District (PAUSD) for the Covenant Not to Develop surplus school facilities. From 2002-03 to 2005-06, this payment is projected to increase by 9.1 percent.

This contract requires CPI adjustments to the annual lease payment, with a projected growth rate for the next ten years of 2.8 percent. (See **2005-06 Non-Salary Expenses** chart on page 22.)

Interfund Allocated Charges

The General Fund receives a number of services from the City's Internal Service Funds (ISF) and from the Enterprise Funds such as electric, gas, and water service, vehicle maintenance and replacement, printing and mailing, and technology. These costs are distributed to all funds citywide based on a usage methodology. The Technology Fund's allocation of costs are once again being charged back to the General Fund over a three-year period, starting in 2005-06, until their full allocation is achieved. These allocations were reduced by \$3.5 million in 2004-05 as part of General Fund budget-balancing efforts. (See **Breakdown of Allocated Charges** chart on page 22.)

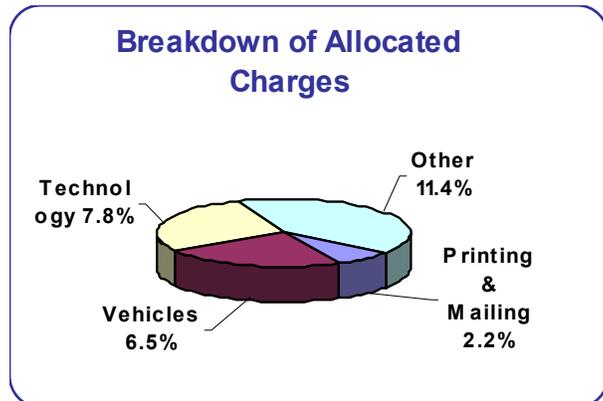
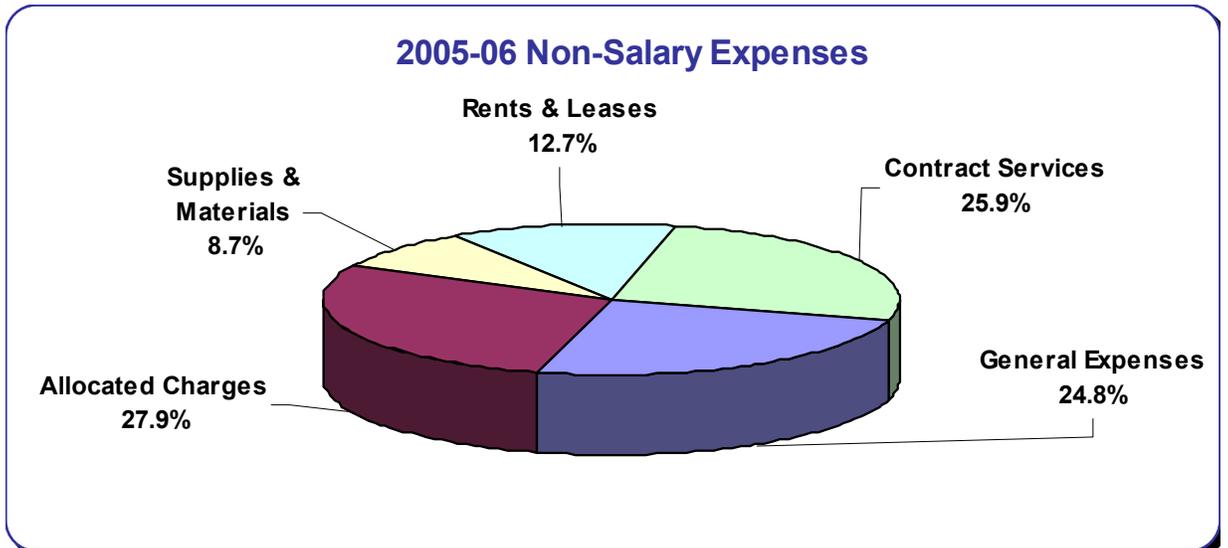
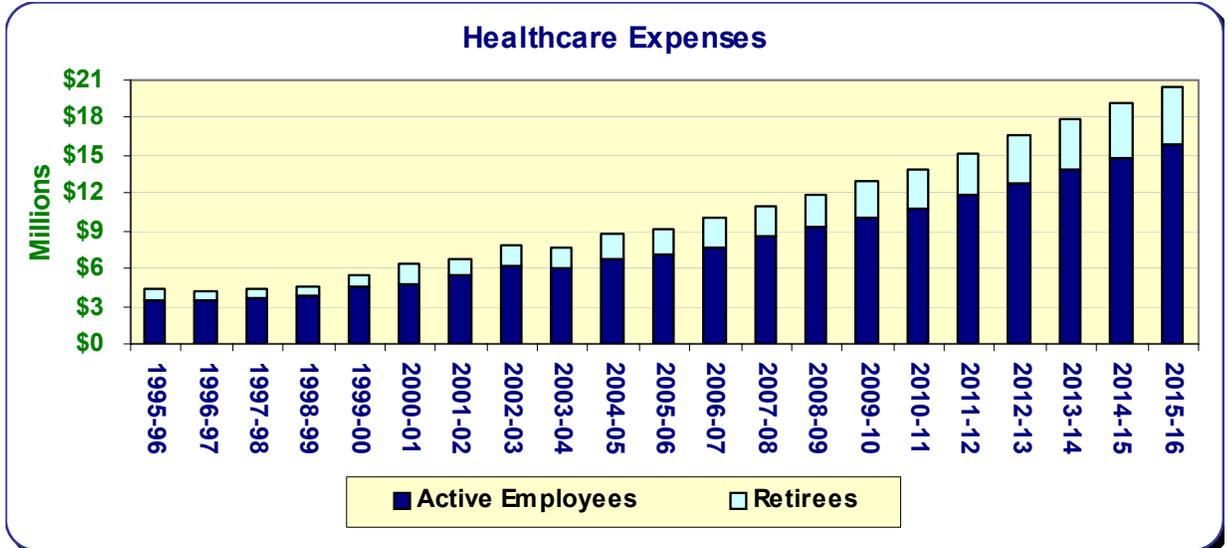
Transfers to Other Funds

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 LRFP 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 "CityWorks," began in 1999-00 as a 10-year, \$100 million plan, designed to eliminate the City's backlog of infrastructure rehabilitation projects. The GF has a base

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commitment to transfer \$3.6 million annually to fund these projects. It is now anticipated that the "City Works" commitment will continue for the foreseeable future as the City continually reinvests in infrastructure.

Non-IMP Capital Projects: Transfers for non-infrastructure projects, including those for traffic calming and technology, are estimated to increase by an average rate of 4 percent annually over the next ten years.

Debt Service: Total current outstanding debt is \$11.5 million, one of the lowest debt levels of any city in the Bay Area. The model assumes that no new GF-funded debt will be incurred in the next ten years. The projected transfer to the Debt Service Fund until 2010-11 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.

Other Transfers: Through a mail ballot in April 2005, property owners approved an increase of the monthly Storm Drainage Fee, thereby alleviating the need for continued supplemental funding from the General Fund. In order to accelerate construction of capital improvements, the plan reflects the pre-payment of the Storm Drainage Fees attributable to City-owned General Fund properties for twelve years. These advance payments are shown from 2005-06 through 2007-08. The fee increase will expire after twelve years due to a sunset provision in the approved ballot measure.

THE BOTTOM LINE

In the past five years, the City has faced unprecedented challenges due to tax reve-

nue declines, state take-aways, and escalating healthcare and pension costs. As shown in the **6 Year Trend - Before** chart on page 24, expenditures were on pace to exceed revenue on an annual basis. The projected deficits would have depleted the General Fund Reserve by 2010 if steps had not been taken to deal with the imbalance.

Over the past five budget cycles the City has reduced General Fund expenditures by approximately \$20 million, including \$5.2 million in 2005-06. These cuts have included the elimination of a total of 70 positions from the City's payroll. In the 2005-07 budget, the City met the challenge by reducing the expense base by \$4.2 million on an ongoing basis. In the past several years, the reduction included the elimination of 30 positions among other departmental reductions. The City has addressed the structural deficit through numerous restructuring and cost-saving efforts. As shown in the **6 Year Trend - After** chart, revenue and expenditures are trending upward evenly.

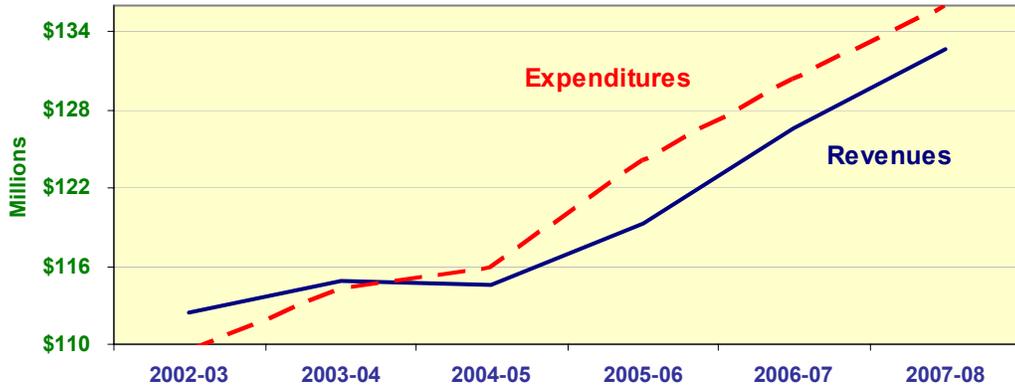
One of Council's top priorities is to restore the Infrastructure Reserve (IR). The IR is devoted to funding infrastructure projects related to streets, sidewalks, parks, libraries, fire stations, and other facilities. This year's forecast assumes \$1 million annual contributions to the Reserve. However, the City must find other ways to fully fund the IR. (See Chapter 3, Financial Challenges, for further discussion of the IR.)

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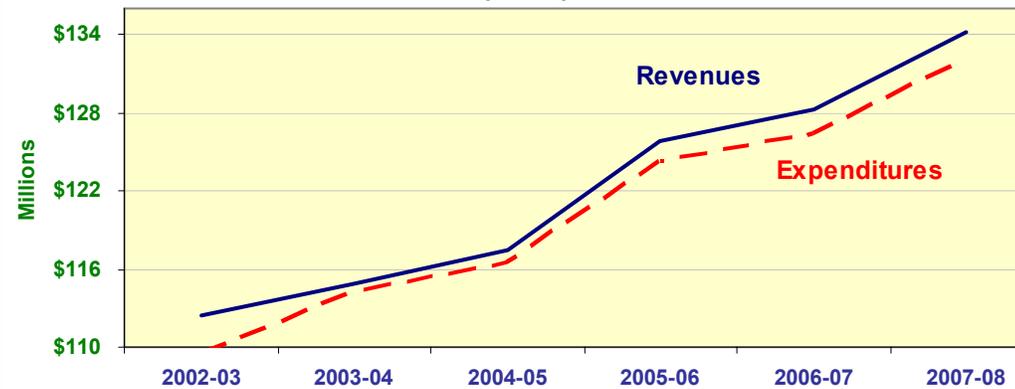
PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES



6 Year Trend - Revenues/Expenditures
(Before)



6 Year Trend - Revenues/Expenditures
(After)



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PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

EXHIBIT 1 - Base Forecast

LONG RANGE FINANCIAL PLANNING MODEL 2005 (\$000)												
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
	Actual	Adjusted										
Revenues												
Sales Taxes	19,308	20,020	20,815	21,662	22,467	23,190	22,893	22,142	22,826	23,550	24,425	25,395
Property Taxes	16,657	17,968	20,360	21,297	22,321	23,417	23,373	23,096	24,544	25,972	27,627	29,499
Utility User Tax	7,269	8,522	9,412	10,067	10,156	10,229	10,289	10,772	11,300	11,584	11,995	12,378
Transient Occupancy Tax	5,686	6,173	6,449	6,774	7,137	7,528	7,419	7,238	7,629	8,017	8,442	8,894
Other Taxes, Fines & Penalties	7,678	7,975	7,551	8,178	8,874	9,476	9,556	9,495	9,508	9,512	9,982	10,542
Subtotal: Taxes	56,598	60,658	64,587	67,978	70,955	73,840	73,530	72,743	75,807	78,635	82,471	86,708
Service Fees & Permits	13,801	15,556	16,396	16,948	17,598	18,348	18,555	18,740	18,827	19,373	20,135	20,926
Joint Service Agreements (Stanford University)	6,772	6,587	6,659	6,961	7,428	7,757	7,992	8,204	8,599	9,113	9,618	10,092
Interest Earnings	2,146	2,116	2,227	2,346	2,474	2,598	2,559	2,495	2,601	2,715	2,851	2,998
Other revenues	13,286	16,805	13,788	14,202	14,628	14,993	15,293	15,676	13,886	14,303	12,575	12,952
Reimbursements from Other Funds	9,385	8,934	8,979	9,382	9,707	10,084	10,333	10,468	10,659	11,039	11,478	11,914
Total Revenues	101,988	110,656	112,636	117,817	122,790	127,620	128,262	128,326	130,379	135,178	139,128	145,590
Transfers from Other Funds	15,425	15,108	15,584	16,284	16,848	17,502	17,934	18,168	18,499	19,159	19,921	20,677
TOTAL SOURCE OF FUNDS	117,413	125,763	128,220	134,101	139,638	145,122	146,196	146,494	148,878	154,337	159,049	166,267
Expenditures												
Salaries & Benefits	79,548	81,573	83,470	86,695	91,106	95,033	97,536	99,237	101,648	106,036	111,007	115,894
Contract Services	9,063	9,341	9,360	9,669	9,984	10,333	10,566	10,618	10,671	10,831	11,135	11,406
Supplies & Materials	2,989	3,130	3,134	3,237	3,343	3,460	3,537	3,555	3,573	3,627	3,728	3,819
General Expense	8,103	8,972	9,035	9,299	9,569	9,855	10,126	10,372	10,632	10,916	11,223	11,476
Rents, Leases, & Equipment	924	4,591	1,009	1,042	1,076	1,113	1,139	1,144	1,150	1,167	1,200	1,229
Allocated Expenses	9,194	10,080	13,078	15,009	15,497	16,039	16,400	16,482	16,565	16,979	17,488	17,982
Total Expenditures	109,821	117,687	119,086	124,951	130,575	135,833	139,303	141,409	144,239	149,556	155,781	161,806
Transfers to Other Funds												
GF transfer for non-IMP capital projects	903	950	950	1,348	1,390	1,433	1,471	1,507	1,544	1,590	1,645	1,645
GF transfer for IMP capital projects	3,855	3,988	4,127	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600
Debt Service	1,208	1,168	1,172	1,172	1,171	1,177	1,173	929	752	749	649	763
Other	737	547	1,155	1,097	13	13	14	14	15	15	15	15
TOTAL USE OF FUNDS	116,524	124,339	126,490	132,168	136,749	142,056	145,561	147,459	150,149	155,510	161,690	167,829
Net Operating Surplus/(Deficit)	889	1,424	1,730	1,933	2,889	3,066	634	(966)	(1,272)	(1,173)	(2,642)	(1,563)
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	889	424	730	933	1,889	2,066	(366)	(1,966)	(2,272)	(2,173)	(3,642)	(2,563)

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PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

EXHIBIT 2

PERCENTAGE CHANGES IN FORECAST FOR REVENUES AND EXPENSES

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
	%	%	%	%	%	%	%	%	%	%	%	%
	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change
Revenues												
Sales Taxes	6.37%	3.69%	3.97%	4.07%	3.72%	3.22%	(1.28%)	(3.28%)	3.09%	3.17%	3.72%	3.97%
Property Taxes	21.52%	7.87%	13.31%	4.60%	4.81%	4.91%	(0.19%)	(1.19%)	6.27%	5.82%	6.37%	6.78%
Utility User Tax	1.58%	17.24%	10.44%	6.96%	0.88%	0.72%	0.59%	4.69%	4.90%	2.51%	3.55%	3.19%
Transient Occupancy Tax	3.59%	8.56%	4.47%	5.04%	5.36%	5.48%	(1.45%)	(2.44%)	5.40%	5.09%	5.30%	5.35%
Other Taxes, Fines & Penalties	(32.02%)	3.87%	(5.32%)	8.30%	8.51%	6.78%	0.84%	(0.64%)	0.14%	0.04%	4.94%	5.61%
Subtotal: Taxes	1.44%	7.17%	6.48%	5.25%	4.38%	4.07%	(0.42%)	(1.07%)	4.21%	3.73%	4.88%	5.14%
Service Fees & Permits	7.57%	12.72%	5.40%	3.37%	3.84%	4.26%	1.13%	1.00%	0.46%	2.90%	3.93%	3.93%
Joint Service Agreements (Stanford University)	12.68%	(2.73%)	1.09%	4.54%	6.71%	4.43%	3.03%	2.65%	4.81%	5.98%	5.54%	4.93%
Interest Earnings	(38.28%)	(1.40%)	5.25%	5.34%	5.46%	5.01%	(1.50%)	(2.50%)	4.25%	4.38%	5.01%	5.16%
Other revenues	37.24%	26.48%	(17.95%)	3.00%	3.00%	2.50%	2.00%	2.50%	(11.42%)	3.00%	(12.08%)	3.00%
Reimbursements from Other Funds	2.57%	(4.80%)	0.50%	4.49%	3.46%	3.88%	2.47%	1.30%	1.82%	3.57%	3.97%	3.80%
Total Revenues	5.20%	8.50%	1.79%	4.60%	4.22%	3.93%	0.50%	0.05%	1.60%	3.68%	2.92%	4.64%
Transfers from Other Funds	(13.77%)	(2.06%)	3.15%	4.49%	3.46%	3.88%	2.47%	1.30%	1.82%	3.57%	3.98%	3.79%
FUNDS	2.25%	7.11%	1.95%	4.59%	4.13%	3.93%	0.74%	0.20%	1.63%	3.67%	3.05%	4.54%
Expenditures												
Salaries & Benefits	10.00%	2.55%	2.33%	3.86%	5.09%	4.31%	2.63%	1.74%	2.43%	4.32%	4.69%	4.40%
Contract Services	(0.52%)	3.07%	0.20%	3.30%	3.26%	3.50%	2.25%	0.50%	0.50%	1.50%	2.80%	2.44%
Supplies & Materials	0.71%	4.72%	0.13%	3.29%	3.27%	3.49%	2.25%	0.50%	0.50%	1.50%	2.80%	2.44%
General Expense	(4.52%)	10.72%	0.70%	2.92%	2.90%	2.99%	2.75%	2.43%	2.50%	2.67%	2.82%	2.26%
Rents, Leases, & Equipment	(7.69%)	396.86%	(78.02%)	3.27%	3.26%	3.49%	2.25%	0.50%	0.50%	1.50%	2.80%	2.44%
Allocated Expenses	(18.39%)	9.64%	29.74%	14.77%	3.25%	3.50%	2.25%	0.50%	0.50%	2.50%	3.00%	2.82%
Total Expenditures	4.44%	7.16%	1.19%	4.93%	4.50%	4.03%	2.55%	1.51%	2.00%	3.69%	4.16%	3.87%
Transfers to Other Funds												
GF transfer for non-IMP capital projects	100.00%	5.21%	0.00%	41.89%	3.12%	3.09%	2.65%	2.45%	2.46%	2.98%	3.46%	0.00%
GF transfer for IMP capital	(30.55%)	3.45%	3.49%	(12.77%)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Debt Service	22.93%	(3.38%)	0.34%	0.06%	(0.11%)	0.50%	(0.29%)	(20.84%)	(19.07%)	(0.40%)	(13.34%)	17.54%
Other	(55.26%)	(25.79%)	111.31%	(5.02%)	(98.81%)	2.82%	2.82%	2.82%	2.82%	2.82%	2.82%	0.00%
TOTAL USE OF FUNDS	1.92%	6.71%	1.73%	4.49%	3.47%	3.88%	2.47%	1.30%	1.82%	3.57%	3.97%	3.80%
Surplus/(Deficit)	76.06%	60.17%	21.50%	11.72%	49.48%	6.11%	(79.31%)	(252.20%)	31.70%	(7.78%)	125.27%	(40.84%)

2006

PROJECTION AND ANALYSIS OF REVENUES AND EXPENDITURES

EXHIBIT 3

GENERAL FUND RESERVE SUMMARY (\$000)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
	Actual	Adjusted										
Budget Stabilization Reserve												
Beginning Balance	21,467	21,066	21,759	23,401	24,451	25,299	26,280	26,929	27,280	27,778	28,769	29,913
Net Operating Surplus/(Deficit)	889	1,424	1,730	1,933	2,889	3,066	634	(966)	(1,272)	(1,173)	(2,642)	(1,563)
Yearly BAOs	(1,290)	(1,110)	0	0	0	0	0	0	0	0	0	0
Year End Savings Target	0	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Subtotal BSR Balance	21,066	22,380	24,490	26,334	28,340	29,364	27,915	26,963	27,008	27,605	27,128	29,350
Transfer to IR*	0	621	1,089	1,882	3,042	3,084	986	(317)	(769)	(1,164)	(2,785)	(1,699)
Ending Balance	21,066	21,759	23,401	24,451	25,299	26,280	26,929	27,280	27,778	28,769	29,913	31,048

*Due to the purchase of the Bressler property in 2005-06, the BSR is projected to be 17.5 percent of total use of funds, slightly below the 18.5 percent target.

3 FINANCIAL CHALLENGES AND ACCOMPLISHMENTS

As the long range forecast shows, the City's "Strengthening the Bottom Line" (SBL) effort was successful in aligning expenses with revenues. This major undertaking has placed the City in a better position to meet future expense and revenue challenges discussed below. A consequence of SBL was the elimination of 70 full-time positions. This reduction has had an impact on existing staff workload and a modest effect on the delivery of services. Should additional reductions be required in the future, it is expected that service impacts would be more severe.

There is an inextricable link between revenues and services, as illustrated by the table below.

Declines in revenue due to a soft economy, key revenue-generating businesses leaving town, or a declining shopping area mean that expenses and services must be cut unless new revenues are generated. The City must carefully protect and enhance its revenue base to improve its position in facing such challenges.

Toward this end, the Council and its Mayors have formed a series of ad hoc committees to reach out to the business community. These committees

have identified concerns businesses have with regard to the City and, where feasible, have implemented solutions. These include forming City staff or "red" teams to reach out to businesses; providing information and assistance to businesses interested in locating to Palo Alto; improving signage to facilitate business traffic; and identifying potential sites for automobile dealerships. The ultimate goal of the committees is to maintain and attract businesses that generate revenues to support City services.

One of Council's major priorities is to restore and maintain the City's General Fund infrastructure.

City Programs	Program Costs	City Tax Revenues	Examples of Revenue Sources
Police Investigation & Crime Prevention Services	\$3,194,000	\$3,000,000	One half of City's Transient Occupancy Tax
Open Space	\$1,852,000	\$1,900,000	Sales tax from all new automobile vehicle sales
Children's Performing Arts	\$1,218,000	\$1,310,000	Sales tax from all City apparel stores
Fire Suppression Services and Hazardous Materials	\$2,042,000	\$2,000,000	One half of the City's documentary transfer tax
Trees	\$2,122,000	\$2,198,000	Sales taxes from all restaurants within the City
Visual Arts	\$1,158,000	\$1,100,000	One half of General Fund's interest income earnings

2006

FINANCIAL CHALLENGES AND ACCOMPLISHMENTS

CHALLENGES

Infrastructure Reserve Funding

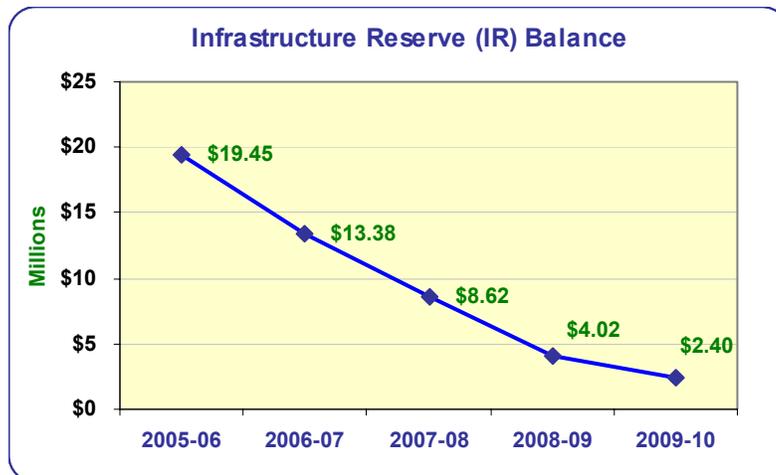
One of Council's major priorities is to restore and maintain the City's General Fund infrastructure. To deliver services, the City must devote continuing resources to its public safety buildings, streets, sidewalks, parks, libraries, and a host of other facilities. An Infrastructure Reserve (IR), currently valued at \$25.2 million, was created to address this top priority and to ensure future project funding. Council directed staff to replenish the IR annually by \$2 million. Half of the goal was achieved by moving the IR into the Capital Fund and allowing interest to accrue to the fund. The remaining \$1 million was to be achieved through General Fund surpluses at year end, and the current LRFP forecast indicates this will occur through the year 2009-10.

When the Infrastructure Master Plan (IMP) was initiated nearly ten years ago, it was estimated the City needed to devote \$10 million annually to both eliminate an infrastructure backlog and maintain existing infrastructure into the future.

The table and chart **Infrastructure Reserve Balance** show the ending balance of the infrastructure reserve through 2009-10. The table does include after-surplus transfers from the General

Fund as projected in the LRFP. Based on the projection below, staff expects the IR to be depleted by 2011-12. If the transfers from the General Fund are increased, the reserve may deplete at a slower rate. However, a contribution to the IR in the range of \$3 to \$5 million annually is needed to increase the reserve to sufficient levels to complete the original IMP. The need for this increased contribution to the IR is a result of the original cost of the IMP having increased due to inflation and the use of the IR for projects not originally identified in the IMP.

Infrastructure Reserve (IR) Balance (in 000s)					
	2005-06	2006-07	2007-08	2008-09	2009-10
Sources	\$10,516	\$9,836	\$6,317	\$5,947	\$5,847
Uses	(15,585)	(15,901)	(11,079)	(10,544)	(7,444)
Surplus (shortfall) of Sources over Uses	(5,069)	(6,065)	(4,762)	(4,597)	(1,597)
Infrastructure Reserve Balance, beginning	24,516	19,447	13,382	8,620	4,023
Infrastructure Reserve Balance, ending	\$19,447	\$13,382	\$8,620	\$4,023	\$2,426



2006

FINANCIAL CHALLENGES AND ACCOMPLISHMENTS

...new funding sources need to be identified for new infrastructure efforts.

Should the City be unable to replenish the IR through savings alone, Council may want to consider a new or enhanced revenue source, such as a Business License Tax or an increase in the Transient Occupancy Tax, specifically targeted for the IR. Another alternative is to reallocate resources from an operating program to infrastructure improvements.

Retiree Medical Liability

Government Accounting Standards Board (GASB) Statement 45 requires employers to measure and report the long-term costs of retiree health benefits for employees 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 which the City of Palo Alto pays annually. Under the GASB ruling, the accrual of these liabilities must be recognized by the City beginning with fiscal year 2007-08.

As part of these requirements, cities must perform an actuarial valuation of the retiree medical liability every two years. The City of Palo Alto has hired an actuarial firm to do the valuation, which should be complete in December 2005. Once the valuation is finished, financial strategies will be developed to reduce and pay the accrued liability. The results of the report and management recommendations will be presented to the Finance Committee in early 2006.

It should be noted that the City has funded a Retiree Health Benefit reserve to help pay for

its accrued retiree medical liability. As of June 30, 2005, the unrestricted balance of this reserve totaled \$18.3 million. Compared to other jurisdictions, the City is unique in having the foresight to set aside funds to meet this obligation.

Major New Facility Projects

The City is considering several major new facility proposals. These include realignment of the Golf Course to accommodate athletic fields and facilities; the replacement or re-siting of the Municipal Services Center to accommodate an auto center; a new or expanded police building; rebuilding of existing fire stations; and new or enhanced library buildings, among other proposals.

As a consequence of Council policy, the constraints of the current budget, and the mild surpluses identified in the current LRFP forecast, new funding sources need to be identified for new infrastructure efforts. New revenue sources such as a Business License Tax are currently being explored with the Council and could be used toward financing one of these projects.

Labor Issues

Like most other Bay Area cities, Palo Alto is highly unionized. Approximately three-quarters of total employees are represented by union contracts. In 2005, over 100 temporary employees formed a new hourly bargaining unit. In 2005-06, some Management and Professional employees initiated an organizing effort and an election in an attempt to form a new Managers and Professional Association.

In 2006-07, the City will face a number of issues relating to organized labor. These include the renegotiation of the IAFF, FCA,

2006

FINANCIAL CHALLENGES AND ACCOMPLISHMENTS

and SEIU (classified and hourly) contracts. Depending on the results of the Management and Professional election, another contract may need negotiation.

Labor negotiations in 2006 may be challenging, as prevailing standards in labor market compensation are reconciled with the economic realities of the City's financial condition. Although the local economy and revenue sources are improving somewhat, the City does not have the fiscal flexibility to meet all the demands of the labor market in which it operates. For example, an expected proposal from SEIU will be a new retirement plan calling for 2.5 or 2.7 percent at 55. The union will state that Palo Alto is one of the few remaining cities in the Bay Area that does not offer this benefit. The cost of this change is over \$6 million per year, representing a significant issue for City finances.

City's Economic Base

The following statistics demonstrate the sensitivity of City revenues to business and to a relatively small number of enterprises within the City:

- 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 just under \$2.0 million annually
- The Stanford Shopping Center department stores and a major electronic retail outlet generate around 21 percent or \$4 million of sales tax revenue

In addition to the City's dependence on key businesses, there are significant competitive

pressures on these and other businesses, including:

- Retail competition from regional shopping centers such as Valley Fair and Santana Row
- The competition of big-box stores such as Best Buy, Home Depot, Costco, REI, and supermarkets in Mountain View and East Palo Alto
- The emergence of high-end hotels in Los Altos, Menlo Park and East Palo Alto
- The transformation of the Stanford Research Park from firms producing taxable sales to those providing non-taxable research and administration and business services
- Opposition to business development within the City
- Lack of adequate space for automobile dealerships and the efforts of nearby cities to lure dealerships from Palo Alto

While the City has made important strides in understanding the needs of businesses, it must enhance its efforts to maintain a sound economic base. The direct link between revenues and the provision of services must be considered as the City considers other policy goals such as the provision of housing, controlling traffic, and regulating growth.

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

2006

FINANCIAL CHALLENGES AND ACCOMPLISHMENTS

Voice Over Internet Protocols (VOIP) and Telecommunications Regulatory Challenges

VOIP is an emerging technology that will impact telephone UUT revenues. Since the City will not have the capacity to tax this service based on the passage of a recent Federal Communications Commission ruling, this \$2 million revenue source will probably erode over time. The extent of the negative impact will not be known until VOIP matures as a technology and as a product.

In addition to the VOIP threat, there are initiatives at the Federal level to limit the ability of localities to charge franchise fees to cable providers. The cable and telecommunications industries bridle at local taxes and controls and are actively pursuing state and federal legislation to eliminate them. The success of such opposition will translate into revenue threats to the City. The City currently receives \$0.4 million in franchise fees.

Landfill Closure and Loss of Refuse Rent

The General Fund (GF) receives rent payments of approximately \$4.3 million annually from the Refuse Fund. The rent payment is expected to decrease by \$2.2 million in 2012-13 and by an additional \$2.1 million in 2014-15. The loss of these funds is included in the current forecast. Staff will present this issue to Council for consideration in December 2005.

State's Financial Condition

Although Proposition 1A, which protects local revenues, was passed by voters, the State still faces budget issues and could be tempted to raid local coffers. If a fiscal "emergency" were declared, the protections of 1A could be reversed.

Until this fiscal year, California outlays have exceeded revenues every year since 2000. In 2005-06, the state will have an unexpected \$5.2 billion surplus, but in 2006-07 it expects to run a \$4 billion deficit. Furthermore, California has doubled its debt load in the past five years and has the lowest bond rating of the 50 states. The recent defeat of the Governor's proposition to limit state spending and allow him greater veto power portends additional conflict in resolving budget deficits. Whether

the state can make the structural changes necessary to stabilize state and local revenues remains to be seen.

In addition to the possibility of State revenue raids, there are annual efforts to change the local fiscal structure. Bills have been proposed, for example, to redistribute property and sales tax revenues on a regional rather than local basis. Such efforts are likely to be detrimental to cities like Palo Alto which have the advantage of strong retail outlets like the Stanford Shopping Center and vibrant downtown areas.

Whether the State can make the structural changes necessary to stabilize State and local revenues remains to be seen.

2006

FINANCIAL CHALLENGES AND ACCOMPLISHMENTS

ACCOMPLISHMENTS

The City has emerged successfully from a grueling economic downturn with a balanced budget. While navigating through the economic slump of the past four years, the City achieved several financial milestones.

The City has managed to maintain its Triple-A credit rating from Standard and Poor's and Moody's. Both the City's Budget Document and Comprehensive Annual Financial Reports continue to receive awards and recognition from State and national associations for their excellence. In the annual reports to the City's Finance Committee, the City's Outside Auditor commended the City for the quality and accuracy of its financial statements.

The City has emerged successfully from a grueling economic downturn with a balanced budget.

The final evaluation of how the City is performing should come from the community. In the 2003-04 Service Efforts and Accomplishments Report, the annual Citizen Survey revealed that "90 percent rated the overall quality of City services good or excellent.... This included 33 percent rating the overall quality of services as excellent, 57 percent good, 9 percent fair, and only 1 percent poor." Based on projections in this report, the overall community should continue to expect the quality of services it so resoundingly endorses.

4 STATISTICAL ANALYSIS

METHODOLOGY RESEARCH BACKGROUND

As a foundation for last year's Long Range Financial Plan, staff researched existing methodologies for projecting revenues and expenditures. This research is summarized in the 2004 Long Range Financial Plan.

This report replicates the quantitative analysis of variables performed in 2004, in addition to staff's primary forecasting methodology – i.e., the CAGR as a base from which specific events and trends are added or subtracted. The purely quantitative forecasts were then compared to the more qualitative forecast contained in the model. Results are discussed below.

INFLUENCE OF KEY ECONOMIC INDICATORS: USING "EXPERT PREDICTIONS"

The 2004 analysis showed that the key indicators correlating with growth in City revenues are State per capita resident income, Gross State Product (for California), and number of employed Santa Clara County residents. Charts 1, 2, and 3 show the correlation between each of these indicators and General Fund Revenue. **Chart 1** illustrates the relationship between Gross State Product and General Fund revenues, and shows the R^2 or degree of correlation between the two variables. An R^2 of 1.0 would indicate a 100 percent correlation. In addition, the charts show the regression equation -- showing the relationship between the two variables. In the case of Chart 1, General Fund Revenues (not

including reimbursements or transfers) for a given year equal the Gross State Product for that year times .0663 plus 428.37. We use these regression equations later in the document to explain what the experts predict for the State means for City revenues and for our forecast.

Charts 2 and 3 illustrate, respectively, the relationship between the number of employed Santa Clara County residents and General Fund revenues, and the relationship between California per capita income and General Fund revenues. (Please note that all General Fund revenues referenced in this

Chart 1: Gross State Product v. General Fund Revenues

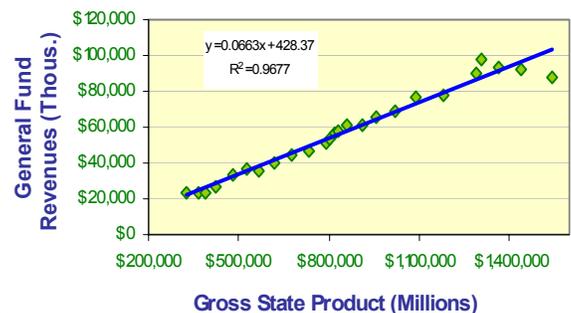
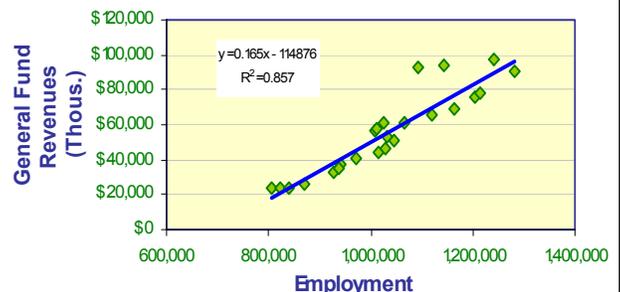


Chart 2: No. Employed in SCC v. General Fund Revenues



chapter exclude reimbursements and operating transfers.)

The high degree of correlation between the above three variables and General Fund revenues provides another point of reference with which to evaluate our model forecasts. Using “expert forecasts” for any of the three variables, we can use the regression equations above to predict General Fund revenues in the future. Then we can compare this with the model's forecasted revenues.

The Center for Continuing Study of the California Economy (CCSC) predicted a state per capita income of \$43,297 -- as a moderate projection -- in 2012. Plugging that into the regression equation from chart 3 below, we derive total General Fund revenue of \$126.1 million in 2012. That is 7 percent

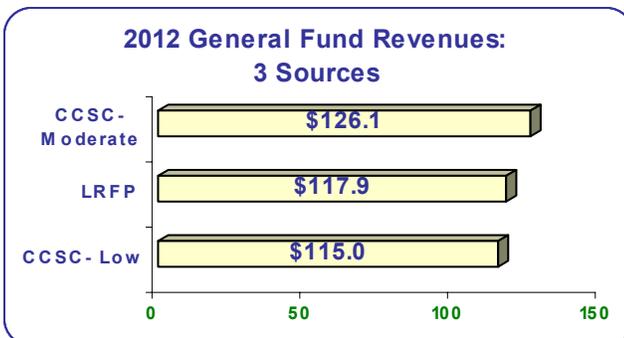
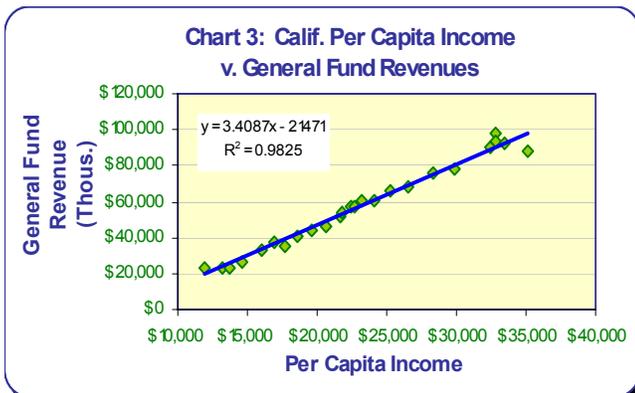
above the Long Range Financial Plan model's projection of \$117.9 million. If we use CCSC's low projection or \$40,043, we get \$115.0 million in General Fund revenue in 2012, or 2.5 percent below the revenue forecasted in the model. (See **2012 General Fund Revenues** chart below.) Applying these expert forecasts as a frame of reference, the revenues forecasted in our model fall within the conservative-to-moderate range.

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 weighted equally -- that is data from 1981, for example, were weighted equally with data from 2003. This approach de-emphasizes the intervening boom or bust periods. The second approach, called “Crystal Ball” after the software used to do the regressions, used weighted data, placing greater emphasis on more recent periods and less weight on earlier periods. This had the effect of emphasizing the recent large fluctuations in the economy. Neither approach is necessarily more accurate or correct, but the two sets of results provide a range of possible outcomes.

The following four charts compare the projections in the model with (a) the non-weighted trend-based projections and (b) the weighted historical-based projections.

Chart 4 shows Sales Tax Revenue projected three different ways: by a trend line, by the weighted “Crystal Ball”



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STATISTICAL ANALYSIS

method, and by the Long Range Financial Plan model.

The fact that the linear trend line is consistently above the projections of the other two methods shows how drastic the changes have been since 2001. Crystal Ball gives more weight to the recent declines in sales tax revenues, and so does the staff model. Furthermore, the model's forecast dives below the Crystal Ball forecast in the out years, due to the assumed recession beginning 2011.

Chart 5 maps out the three types of projections on Property Tax Revenues. The model forecast exceeds both the linear trend line and the weighted forecast in the early years - due to the soaring home prices and the cessation of ERAF III state takeaways. After 2010 it goes between the other two forecasts. This chart illustrates the advantage of inserting qualitative information into a forecasting model: the recent irregularities due to state budget-balancing measures and trading of revenue sources, among other phenomena, are impossible for a strictly quantitative model to capture.

Chart 6 illustrates that TOT revenues will rebound more quickly according to the non-weighted analysis. Staff's forecast falls somewhere between the two, as staff believes that the recent upturn will continue.

Chart 7 shows a wide range between UUT revenues projected by staff and those projected by the weighted and trend-line methodologies. This is due to the rate increases being implemented by Utilities to cover rising water, gas, and electric commodity costs. The strictly quantitative analyses could not take that known change into account.

Chart 8 shows a 30 percent difference between the weighted forecast and the Long Range Financial Plan model in 2015. The model follows the trend line fairly closely, rather than predicting low or flat revenues

Chart 4. Sales Tax Revenue Projections

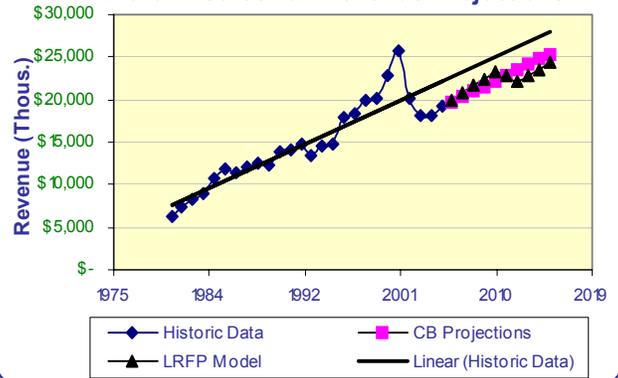


Chart 5. Property Tax Projections

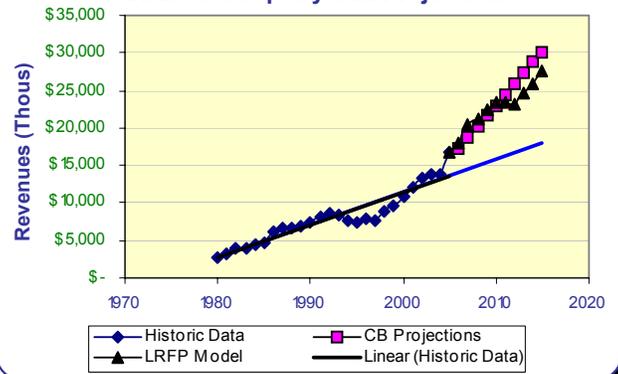
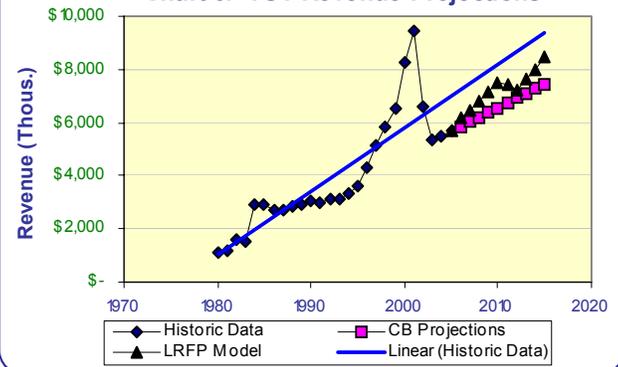


Chart 6. TOT Revenue Projections

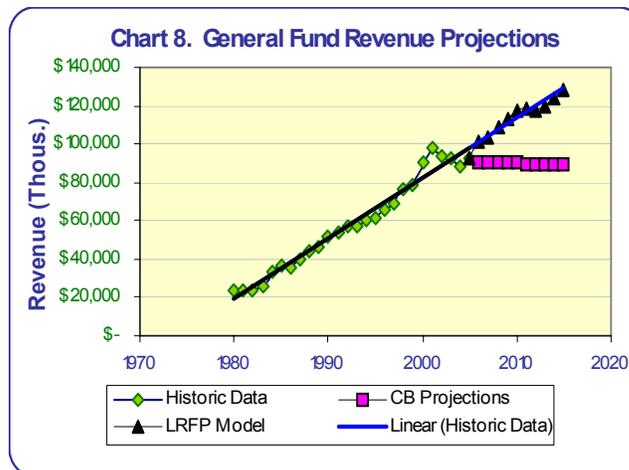
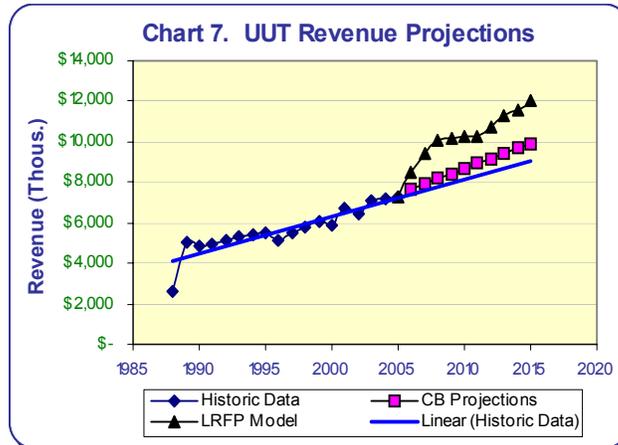


2006

STATISTICAL ANALYSIS

mirroring those of the past few years. The expert predictions discussed earlier validate staff's assumption of future moderate growth in revenues.

In conclusion, the alternative quantitative forecasting methods enabled a critical review of the model's forecast. It caused staff to check assumptions used in the model. By and large, the judgments incorporated into the model's forecast seemed reasonable and explained the variations from the quantitative forecasts.





AMERICANS WITH DISABILITIES ACT STATEMENT

*In compliance with
the Americans with Disabilities Act (ADA) of 1990,
this document may be provided
in other accessible formats.*

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