


City of Palo Alto

# 2007-17 Long Range Financial Forecast

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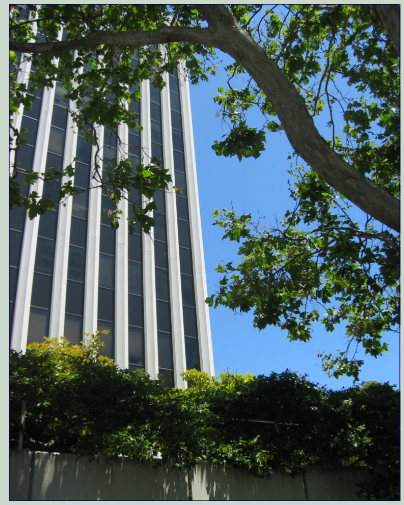


# INTRODUCTION

## PURPOSE OF THE FORECAST

The Long Range Financial Forecast takes a forward look at the City's General Fund revenues and expenditures. Its purpose is to identify financial trends, shortfalls, and issues so the City can proactively address them. It does so by projecting out into the future the fiscal results of continuing the City's current service levels and policies, providing a snapshot of what the future will look like as a result of the decisions made in the recent past. Any needed course corrections are thereby illuminated.

This Long Range Financial Forecast is not intended as a budget, nor as a proposed plan. The City has changed the name of the report from "Long Range Financial *Plan*" to "Long Range Financial *Forecast*" to make it clear that this document does not present a comprehensive financial plan for achieving City or Council objectives.

***This forecast is not a budget; nor is it a proposed plan.***

The Long Range Financial Forecast sets the stage for the upcoming budget process, facilitating both the City Manager and Council in establishing priorities and allocating resources appropriately.

## EXECUTIVE SUMMARY

In recent years, the economy has slowly but steadily recovered from the dot-com bust of 2001-2004. At the same time, the City has made changes resulting in long-term, structural cost reductions of $20.0 million. As a result of the enhanced revenue and expenditure environments, the City is in a stable financial position to address the significant financial challenges that lie ahead – both new challenges and old ones that persist.

The "new" challenges include, for example:

- The need to set aside $2.4 million per year for a retiree medical reserve *
- The need to invest an additional $3.0 million per year for the Infrastructure Management Plan

The "old" continuing challenges include, for example:

- Threats to the City's economic base
- Increasing healthcare and pension costs
- Erosion of the City's telephone UUT revenue stream

Among the significant changes the City has made that result in long-term cost reductions:

- Beginning 2007-08, SEIU and Management and Professional employees will contribute to their PERS retirement fund— for the first time since 1983.
- Beginning 2007-08, the City will limit its funding to the second-most-expensive health plan for employees and future retirees -- setting a new precedent of capping the City's liability for health care premiums.
- New hires must have 20 years of service to qualify for the full retiree medical benefit.
- 70 General Fund positions have been eliminated.
- Since 2001-02, $20 million has been eliminated from the base budget.

This ten-year forecast assumes that the City will continue to invest $1.0 million annually in the Infrastructure Reserve; that $2.4 million annually will be set aside to fund the retiree medical liability; that the economy, and therefore City revenues, will continue to grow steadily and slowly; and that a mild recession will appear in 2010-11, following the once-per-decade pattern of the state's recession history. Given those assumptions, the General Fund breaks even, roughly, until 2010-11, when annual deficits begin to appear.

In addition, in the section entitled "Options for Consideration in 2007-09 and Beyond," the $3.0 million plan for infrastructure is discussed, with results illustrated in terms of Net Operating Surplus/Deficit and Infrastructure Reserve Balance. That scenario incorporates the $3.0 million goal through 2009-10.

This year's Financial Forecast differs in format from that of prior years. For one, in an effort to reduce the length of the text describing the forecast, some information has been moved to the Appendices. We have now located in the Appendices: the definitions of the revenue and expenditure categories; the statistical analysis section testing the forecast's projection methodology; and a description of the projection methodologies. In addition, we have included an appendix showing Historical Trends in City revenues, expenditures, population, and other demographic information.

* The General Fund must set aside a total of $3.0 million per year. However, Enterprise Funds will reimburse $0.6 million to the GF for staff providing services to the Enterprise Funds, leaving a "net" set-aside of $2.4 million.

## TEN YEAR FORECAST

### GENERAL FINANCIAL OUTLOOK AND KEY POINTS

In recent years, the economy has slowly but steadily recovered from the recession of 2001-2004. At the same time, the City has undergone multiple restructuring efforts in which a cumulative 70 General Fund positions were eliminated.

Between 2000-01 and 2005-06, the City reduced General Fund expenditures by approximately $20.0 million. Prior to these cuts, expenditures were on a pace to exceed revenue on an annual basis. Now, revenue and expenditures are projected to trend upward more evenly.

Between 2000-01 and 2002-03, two of the City's main revenue sources (sales and transient occupancy taxes) declined by 33.7 percent or $11.9 million. Then, in 2003-04 these revenues began trending upward again.

There was sufficient surplus in 2005-06 to transfer $1 million to the Infrastructure Reserve; in 2004-05 the City had been unable to make the $1 million contribution, since there was no surplus.

As a result of both the improved revenue environment and the reduced base budget, the City is projected to have budget surpluses in each year going forward until 2010-11. It is now in a stable financial position to address the significant financial challenges that lie ahead, including the need to set aside at least $2.4 million per year for a retiree medical reserve and the need to invest an additional $3.0 million per year in rehabilitating General Fund infrastructure. The base Forecast model includes the $2.4 million annual retiree medical set-aside, but not the additional infrastructure investment. The latter is discussed as an alternate scenario in the "Options for Consideration in the 2007-09 Budget" section beginning on page 16.

## Retiree Medical Set-Aside

The Government Accounting Standards Board's (GASB's) new statement, GASB 45, requires jurisdictions to perform valuations of their future retiree medical obligations and report on their financial statements the unfunded liability for these benefits. Furthermore, it strongly suggests that cities fund an amortized amount of those liabilities, beginning next fiscal year. Therefore, the General Fund needs to set aside approximately $2.4 million per year* to fund its portion of the City's estimated $83.1 million unfunded liability. To its credit, the City has established a retiree medical reserve valued at $26.5 million that can be used to meet its unfunded liability. Note that staff previously reported to Council a liability of $106.6 million, assuming a 6 percent discount rate (CMR: 272:06). The $83.1 million figure assumes that (a) a trust will be established to fund the liability; and (b) a 7.75 percent discount rate is a more appropriate rate given that funds in an irrevocable trust may be invested in a more diversified portfolio than General Fund monies. If we assume that the funds already set aside by the City will be invested in the trust at its outset, the $83.1 million figure decreases to $56.6 million.

## Additional $3.0 Million for Infrastructure

The City must sustain a minimum $7.0 to $10.0 million per year investment to adequately maintain its existing infrastructure. The Council has mandated that $3.0 million in additional funds be found to support the declining Infrastructure Reserve (IR) and to offset higher-than-expected construction inflation costs. The Forecast includes an Infrastructure Scenario (see page 16) in which the revenue enhancement and cost-cutting options discussed by the Finance Committee on October 17 are added to the Forecast, enabling the additional $3.0 million investment per year.

***The General Fund needs to set aside $2.4 million per year to fund its retiree medical liability.***

This Infrastructure Scenario is revenue-neutral: it pays for itself through expense reductions and revenue enhancements.

Within the Forecast Model itself, the "Transfer to Infrastructure Reserve" line has been moved from beneath the Net Operating Surplus/Deficit line up to the "Transfers to Other Funds" section. This is because the City is in a position to commit firmly to making the annual $1 million contribution to the IR, rather than waiting until the end of each year to see whether the surplus is available for that contribution. This annual $1.0 million contribution is in addition to the $1.0 million in expected earnings on the IR.

The Ten Year Forecast Model which follows shows the General Fund's anticipated financial position for the next ten years. Details on assumptions driving the forecast appear on the pages following the model.

* The General Fund must set aside a total of $3.0 million per year. However, Enterprise Funds will reimburse $0.6 million to the GF for staff providing services to the Enterprise Funds, leaving a "net" set-aside of $2.4 million.

## LONG RANGE FINANCIAL FORECAST MODEL 2006 ($000)

| | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 | 2015-16 | 2016-17 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Actual | Projected | | | | | | | | | | |
| **Revenues** | | | | | | | | | | | | |
| Sales Taxes | 20,316 | 21,283 | 22,044 | 22,789 | 23,535 | 22,894 | 21,813 | 22,364 | 23,097 | 23,935 | 24,899 | 25,963 |
| Property Taxes | 18,730 | 21,145 | 22,153 | 23,143 | 24,156 | 24,224 | 24,052 | 25,410 | 26,936 | 28,675 | 30,558 | 32,626 |
| Utility User Tax | 8,760 | 8,946 | 9,603 | 10,114 | 10,165 | 10,586 | 10,800 | 11,034 | 11,291 | 11,547 | 11,856 | 11,856 |
| Transient Occupancy Tax | 6,393 | 6,743 | 6,985 | 7,272 | 7,562 | 7,853 | 7,704 | 7,480 | 7,861 | 8,293 | 8,757 | 8,757 |
| Other Taxes, Fines & Penalties | 9,289 | 7,552 | 7,854 | 8,223 | 8,558 | 8,502 | 8,322 | 8,216 | 8,392 | 8,794 | 9,223 | 12,634 |
| **Subtotal: Taxes** | **63,488** | **65,669** | **68,639** | **71,541** | **73,976** | **74,059** | **72,691** | **74,504** | **77,577** | **81,244** | **85,293** | **91,836** |
| Service Fees & Permits | 16,616 | 16,272 | 16,810 | 17,324 | 18,083 | 18,482 | 18,666 | 18,753 | 19,296 | 20,054 | 20,841 | 20,842 |
| Joint Service Agreements (Stanford University) | 6,489 | 6,921 | 7,168 | 7,384 | 7,681 | 8,037 | 8,277 | 8,568 | 9,008 | 9,445 | 9,888 | 10,354 |
| Interest Earnings | 2,247 | 2,100 | 2,190 | 2,285 | 2,381 | 2,339 | 2,274 | 2,365 | 2,463 | 2,579 | 2,705 | 2,837 |
| Other revenues | 15,463 | 14,373 | 14,804 | 15,248 | 15,629 | 15,942 | 16,340 | 14,571 | 15,008 | 13,301 | 13,700 | 14,111 |
| Reimbursements from Other Funds | 9,479 | 9,113 | 9,545 | 9,785 | 10,127 | 10,451 | 10,603 | 10,762 | 11,122 | 11,542 | 11,985 | 12,436 |
| **Total Revenues** | **113,782** | **114,448** | **119,156** | **123,567** | **127,877** | **129,310** | **128,851** | **129,523** | **134,474** | **138,165** | **144,412** | **152,416** |
| Transfers from Other Funds | 15,385 | 15,781 | 16,371 | 16,782 | 17,369 | 17,926 | 18,185 | 18,458 | 19,076 | 19,796 | 20,555 | 20,555 |
| **TOTAL SOURCE OF FUNDS** | **129,167** | **130,229** | **135,527** | **140,349** | **145,246** | **147,236** | **147,036** | **147,981** | **153,550** | **157,961** | **164,968** | **172,973** |
| **Expenditures** | | | | | | | | | | | | |
| Salaries & Benefits | 82,929 | 84,028 | 87,176 | 90,331 | 93,722 | 97,221 | 99,079 | 100,951 | 104,990 | 109,630 | 114,382 | 119,358 |
| Retiree Medical Liability | 0 | 0 | 2,400 | 2,472 | 2,546 | 2,623 | 2,701 | 2,782 | 2,866 | 2,952 | 3,040 | 3,131 |
| Contract Services | 8,662 | 9,743 | 10,065 | 10,392 | 10,756 | 10,998 | 11,053 | 11,108 | 11,274 | 11,590 | 11,961 | 12,320 |
| Supplies & Materials | 2,700 | 3,162 | 3,266 | 3,372 | 3,490 | 3,569 | 3,587 | 3,605 | 3,659 | 3,761 | 3,881 | 3,998 |
| General Expense | 8,556 | 9,210 | 9,480 | 9,756 | 10,048 | 10,324 | 10,574 | 10,838 | 11,127 | 11,441 | 11,707 | 11,979 |
| Rents, Leases, & Equipment | 4,373 | 1,127 | 1,164 | 1,202 | 1,244 | 1,272 | 1,278 | 1,285 | 1,304 | 1,340 | 1,383 | 1,425 |
| Allocated Expenses | 11,865 | 13,000 | 13,429 | 13,865 | 14,351 | 14,674 | 14,747 | 14,821 | 15,191 | 15,647 | 16,116 | 16,600 |
| **Total Expenditures** | **119,085** | **120,270** | **126,980** | **131,390** | **136,156** | **140,680** | **143,018** | **145,389** | **150,411** | **156,361** | **162,471** | **168,810** |
| **Transfers to Other Funds** | | | | | | | | | | | | |
| GF transfer for non-IMP capital projects | 1,182 | 1,200 | 1,348 | 1,390 | 1,433 | 1,471 | 1,507 | 1,544 | 1,590 | 1,645 | 1,645 | 1,645 |
| GF transfer for IMP capital projects | 4,030 | 4,327 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 |
| Infrastructure Reserve | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| Debt Service | 1,168 | 1,172 | 1,172 | 1,171 | 1,177 | 1,173 | 929 | 752 | 749 | 649 | 763 | 763 |
| Other | 597 | 1,155 | 1,097 | 13 | 13 | 14 | 14 | 15 | 15 | 15 | 15 | 15 |
| **TOTAL USE OF FUNDS** | **127,062** | **129,124** | **135,197** | **138,564** | **143,379** | **147,938** | **150,068** | **152,299** | **157,365** | **163,271** | **169,494** | **175,833** |
| **Net Operating Surplus/(Deficit)** | **2,105** | **1,106** | **330** | **1,785** | **1,867** | **(702)** | **(3,032)** | **(4,318)** | **(3,815)** | **(5,310)** | **(4,526)** | **(2,861)** |

## PERCENTAGE CHANGES IN FORECAST FOR REVENUES AND EXPENSES

| | 2005-06 % Change | 2006-07 % Change | 2007-08 % Change | 2008-09 % Change | 2009-10 % Change | 2010-11 % Change | 2011-12 % Change | 2012-13 % Change | 2013-14 % Change | 2014-15 % Change | 2015-16 % Change | 2016-17 % Change |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Revenues** | | | | | | | | | | | | |
| Sales Taxes | 5.22% | 4.76% | 3.58% | 3.38% | 3.27% | (2.72%) | (4.72%) | 2.53% | 3.28% | 3.63% | 4.03% | 4.27% |
| Property Taxes | 12.45% | 12.89% | 4.77% | 4.47% | 4.38% | 0.28% | (0.71%) | 5.65% | 6.01% | 6.46% | 6.57% | 6.77% |
| Utility User Tax | 20.51% | 2.12% | 7.34% | 5.32% | 0.50% | 4.14% | 2.02% | 2.17% | 2.33% | 2.27% | 2.68% | 0.00% |
| Transient Occupancy Tax | 12.43% | 5.47% | 3.59% | 4.11% | 3.99% | 3.85% | (1.90%) | (2.91%) | 5.09% | 5.50% | 5.60% | 0.00% |
| Other Taxes, Fines & Penalties | 20.98% | (18.70%) | 4.00% | 4.70% | 4.07% | (0.65%) | (2.12%) | (1.27%) | 2.14% | 4.79% | 4.88% | 36.98% |
| **Subtotal: Taxes** | **12.17%** | **3.44%** | **4.52%** | **4.23%** | **3.40%** | **0.11%** | **(1.85%)** | **2.49%** | **4.12%** | **4.73%** | **4.98%** | **7.67%** |
| Service Fees & Permits | 20.40% | (2.07%) | 3.31% | 3.06% | 4.38% | 2.21% | 1.00% | 0.47% | 2.90% | 3.93% | 3.92% | 0.00% |
| Joint Service Agreements (Stanford University) | (4.18%) | 6.66% | 3.57% | 3.01% | 4.02% | 4.63% | 2.99% | 3.52% | 5.14% | 4.85% | 4.69% | 4.71% |
| Interest Earnings | 4.71% | (6.54%) | 4.29% | 4.34% | 4.20% | (1.76%) | (2.78%) | 4.00% | 4.14% | 4.71% | 4.89% | 4.88% |
| Other revenues | 16.38% | (7.05%) | 3.00% | 3.00% | 2.50% | 2.00% | 2.50% | (10.83%) | 3.00% | (11.37%) | 3.00% | 3.00% |
| Reimbursements from Other Funds | 1.01% | (3.86%) | 4.74% | 2.51% | 3.50% | 3.20% | 1.45% | 1.50% | 3.35% | 3.78% | 3.83% | 3.76% |
| **Total Revenues** | **11.56%** | **0.59%** | **4.11%** | **3.70%** | **3.49%** | **1.12%** | **(0.36%)** | **0.52%** | **3.82%** | **2.74%** | **4.52%** | **5.54%** |
| Transfers from Other Funds | (0.26%) | 2.58% | 3.74% | 2.51% | 3.50% | 3.21% | 1.44% | 1.50% | 3.35% | 3.77% | 3.83% | 0.00% |
| **TOTAL SOURCE OF FUNDS** | **10.01%** | **0.82%** | **4.07%** | **3.56%** | **3.49%** | **1.37%** | **(0.14%)** | **0.64%** | **3.76%** | **2.87%** | **4.44%** | **4.85%** |
| **Expenditures** | | | | | | | | | | | | |
| Salaries & Benefits | 4.25% | 1.33% | 3.75% | 3.62% | 3.75% | 3.73% | 1.91% | 1.89% | 4.00% | 4.42% | 4.33% | 4.35% |
| Retiree Medical Liability | 0.00% | 0.00% | 100.00% | 3.00% | 3.00% | 3.00% | 3.00% | 3.00% | 3.00% | 3.00% | 3.00% | 3.00% |
| Contract Services | (4.42%) | 12.48% | 3.30% | 3.25% | 3.50% | 2.25% | 0.50% | 0.50% | 1.50% | 2.80% | 3.20% | 3.00% |
| Supplies & Materials | (9.67%) | 17.11% | 3.29% | 3.25% | 3.51% | 2.25% | 0.50% | 0.50% | 1.50% | 2.80% | 3.20% | 3.00% |
| General Expense | 5.59% | 7.64% | 2.93% | 2.91% | 2.99% | 2.75% | 2.42% | 2.49% | 2.67% | 2.82% | 2.32% | 2.33% |
| Rents, Leases, & Equipment | 373.27% | (74.23%) | 3.28% | 3.26% | 3.49% | 2.25% | 0.50% | 0.50% | 1.50% | 2.80% | 3.20% | 3.00% |
| Allocated Expenses | 29.05% | 9.57% | 3.30% | 3.25% | 3.50% | 2.25% | 0.50% | 0.50% | 2.50% | 3.00% | 3.00% | 3.00% |
| **Total Expenditures** | **8.44%** | **1.00%** | **5.58%** | **3.47%** | **3.63%** | **3.32%** | **1.66%** | **1.66%** | **3.45%** | **3.96%** | **3.91%** | **3.90%** |
| **Transfers to Other Funds** | | | | | | | | | | | | |
| GF transfer for non-IMP capital proj | 30.90% | 1.52% | 12.33% | 3.12% | 3.09% | 2.65% | 2.45% | 2.46% | 2.98% | 3.46% | 0.00% | 0.00% |
| GF transfer for IMP capital projects | 4.54% | 7.37% | (16.80%) | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Infrastructure Reserve | 100.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Debt Service | (3.38%) | 0.34% | 0.06% | (0.11%) | 0.50% | (0.29%) | (20.84%) | (19.07%) | (0.40%) | (13.34%) | 17.54% | 0.00% |
| Other | (18.93%) | 93.45% | (5.02%) | (98.81%) | 2.82% | 2.82% | 2.82% | 2.82% | 2.82% | 2.82% | 0.00% | 0.00% |
| **TOTAL USE OF FUNDS** | **9.04%** | **1.62%** | **4.70%** | **2.49%** | **3.48%** | **3.18%** | **1.44%** | **1.49%** | **3.33%** | **3.75%** | **3.81%** | **3.74%** |
| **Net Operating Surplus/(Deficit)** | **136.77%** | **(47.48%)** | **(70.16%)** | **440.95%** | **4.59%** | **(137.58%)** | **332.26%** | **42.40%** | **(11.65%)** | **39.18%** | **(14.76%)** | **(36.79%)** |

| GENERAL FUND RESERVE SUMMARY ($000) | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2005-06* | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 | 2015-16 | 2016-17 |
| | Actual | | | | | | | | | | | |
| **Budget Stabilization Reserve** | | | | | | | | | | | | |
| Beginning Balance | 21,066 | 22,731 | 23,837 | 24,167 | 25,951 | 27,818 | 27,117 | 24,084 | 19,766 | 15,951 | 10,641 | 6,115 |
| Net Operating Surplus/(Deficit) | 2,105 | 1,106 | 330 | 1,785 | 1,867 | (702) | (3,032) | (4,318) | (3,815) | (5,310) | (4,526) | (2,861) |
| Yearly BAOs | (440) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending Balance | **22,731** | **23,837** | **24,167** | **25,951** | **27,818** | **27,117** | **24,084** | **19,766** | **15,951** | **10,641** | **6,115** | **3,254** |
| % of Total Expenditures | 17.9% | 18.5% | 17.9% | 18.7% | 19.4% | 18.3% | 16.0% | 13.0% | 10.1% | 6.5% | 3.6% | 1.9% |

*Due to the purchase of the Bressler property in 2005-06, the BSR is projected to be 17.9 percent of total use of funds, slightly below the 18.5 percent target.

## KEY DRIVERS AND ASSUMPTIONS AFFECTING THE FORECAST

The Long Range Financial Forecast is based on assumptions regarding what will happen in the regional and state economy over the next few years, and on near-term and long-term revenue and expenditure drivers.

## ECONOMIC ASSUMPTIONS

The Forecast assumes continued slow but steady economic growth over the next few years, followed by a recession beginning in 2010-11. These assumptions are based on the economy's recent performance and on outside expert forecasts. The presumed recession is based upon the fact that, in the past, California has had a recession approximately once per decade.

### *The Past Year's General Economic Outlook*

The major issues both nationally and locally included:

- Housing Market Slowdown
- Gradual But Steady Growth in Payrolls and Economic Output
- Fluctuations in Energy Prices

### Housing Market Slowdown

The long-anticipated slowdown in the housing market arrived in 2005-06. The National Association of Realtors reported in September 2006 that the nationwide median home price fell 1.7 percent from $229,000 to $225,000 in August — the first decline since 1995. Home sales in California slowed in August for the fifth consecutive month. In September, the median home price in the nine Bay Area counties slipped 0.8 percent from $616,000 to $611,000 from September 2005 levels.[1] Furthermore, the pace of homebuilding decreased nearly 16 percent in the first eight months of 2006 compared to the same months in 2005.[2] This was partially offset by a healthy commercial real estate market.

***The Forecast assumes continued slow but steady growth.***

### Gradual but Steady Growth

The national economy grew slowly and steadily throughout the year. The national unemployment rate ranged from 4.6 to 4.8 percent in 2006, compared to 5.1 percent in 2005.[3]

In the summer of 2006, California's economy finally caught up with that of the nation, after years of running behind. July's unemployment rate matched that of the U.S. for the first time since April 1990.[4] Furthermore, California's job growth rate increased 1.3 percent between August 2005 and August 2006 — the same rate of increase as the nation as a whole.[5]

Unemployment rates have declined throughout the state in the past two years, and in 2006 ranged from 4.0 to 5.0 percent in the San Francisco Bay Area. In October, the state's unemployment rate fell to 4.5 percent — a 30-year low. Bay Area rates were even better than the state as a whole: Silicon Valley's rate was 4.2 percent. Palo Alto's unemployment rate declined from 3.4 to 2.7 percent over the last year -- far better than the nation, the state, and the Bay Area as a whole.

California employees expressed more confidence in their employment situations in July of this year. In a survey conducted by Harris Interactive on behalf of Spherion Corporation, 66 percent of workers said they are confident in their ability to find a new job — an 11 percent gain from June.[6]

### Energy Prices Fluctuations

Energy prices spiked and then fell in the last year. Between September 2003 and July 2006, the price of standard crude oil climbed from $25 per barrel to a record $78.40 per barrel — a 214 percent increase. The national average per-gallon price for unleaded gasoline rose from $1.83 in January 2005 to $3.04 in September 2006 — a 66 percent increase.[7] Then, late this summer, oil prices began to decrease. In early November, oil slipped below $60 per barrel[8] and the average nationwide per-gallon price for gasoline had dropped to $2.20.[9]

Many experts feared that the energy price spikes would drive up inflation and undermine the economy. Yet the price hikes were taken in stride. A February 2006 report issued by the California Legislative Analyst's Office stated:

> "Perhaps the most pleasant surprise in 2005 was that the higher energy costs did not have the more widespread adverse impacts that some analysts had feared. While there were some negative effects on automobile sales and inflation...the impacts on the broader economy were relatively mild.... The so-called 'core' inflation rate (that is, the CPI excluding food and energy costs) never exceeded 2.3 percent during the year, indicating that the jump in energy costs did not 'spill over' broadly into other sectors of the economy."[10]

### *Expert Economic Forecasts*

Expert forecasters, from the State Legislative Analyst's Office to UCLA Anderson Forecast to the Federal Reserve Bank of San Francisco, all predict that growth will continue slowly, and that housing market concerns will not bring the state into a recession. Some economists believe prices will plateau at the end of this year; others anticipate that prices will drop at an annualized rate of 2-3 percent for some time to come.[11]

***These expert forecasts provide the underpinnings of the Long Range Financial Forecast's moderate growth assumptions.***

The Legislative Analyst's Office predicted continued steady growth in both state and national economies, with annual job growth in the 1.2 to 1.5 percent range through 2008 for the nation and between 1.8 and 2.1 percent in California. (See Appendix D for details on LAO's and others' projected growth rates.)

In April, the Federal Reserve Bank of San Francisco's President and CEO, Janet Yellen, stated that after the nation's economy displayed resilience in the face of the energy price shocks and the hurricanes, she expected "economic activity to settle back to a more trend-like and sustainable rate as the year progresses."[12]

In summary, the Long Range Financial Forecast reflects a cautiously optimistic view of the economy with a corresponding, positive flow-through to the City's major revenue sources.

## Revenue Drivers

With the region's steady economic growth, the City realized increases in sales, transient occupancy, property, and documentary transfer tax revenues. Balancing the recent growth with housing market uncertainty, the Forecast assumes a 3.0 percent compound annual growth rate for total revenues from 2006-07 through 2016-17. (See Appendix C regarding statistical analysis utilized to validate these and other revenue assumptions and Appendix E: Historical Trends for revenue data from 1997 to 2006.)

The following describes the trends in the City's major revenue sources:

### *Sales Tax*

In 2005-06, sales tax revenues were $20.3 million, or 5.2 percent higher than in 2004-05. Excluding the revenue impacts of the loss of Agilent Technologies and Peninsula Ford, sales tax revenues grew by 6.0 percent. Sectors that grew noticeably in 2005-06 were miscellaneous retail, office and electronic equipment, and auto sales. Sectors that performed weakly included furniture and appliance outlets, recreation products, and business services. First quarter data for 2006-07 indicate a slower growth rate of approximately 4.7 percent.

### *Property Tax*

Secured property tax revenues rose 8.8 percent in 2005-06 or $1.1 million above 2004-05 levels. This healthy increase was attributed to a still-active residential market and a strong commercial market. Based on the Assessor Office's information indicating lower growth rates in assessed value and a cooling of the housing market, staff foresees a slowing of property tax revenue growth over the next few years. A growth rate of around 4.6 percent in property tax revenues is estimated for 2006-07 and 2007-08.*

### *Transient Occupancy Tax*

After modest growth over the past two years, transient occupancy tax (TOT) revenues surged upward by 12.4 percent in 2005-06. The average citywide occupancy rate consistently exceeded 70.0 percent in the latter half of 2005-06 for the first time since 2000-01. Average daily room rates rose by 9.7 percent in 2005-06. Per diem rates in 2005-06 exceeded $130, a level not seen since 2001-02. First quarter 2006-07 data show both room and occupancy rates rising further. It is anticipated, however, that the growth rate in 2007-08 will slow to nearly 4 percent given the competitive pressures from surrounding city hotels.

* The ERAF takeaway of $1.5 million (for each year from 2004-05 to 2005-06) ceased in 2006-07 and has been added to the Forecast. The 4.6 percent growth rate does not include that restoration.

### Documentary Transfer Tax

Documentary Transfer Tax (DTT) revenue is acutely sensitive to the volume and value of property sales and the mix of residential and commercial transactions. In 2005-06, DTT revenue reached a robust $5.7 million, or 11.3 percent above the prior year's revenues, primarily as a result of several commercial transactions. The cooling residential market will constrain near term growth in DTT revenue; therefore, annual growth in 2007-08 is projected at 4.6 percent.

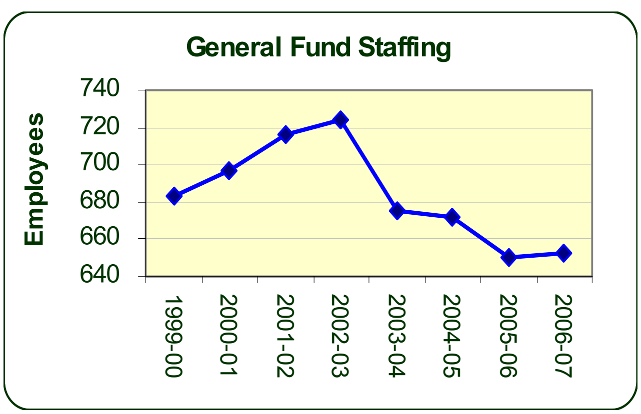
### Refuse Fund

With the landfill expected to close in 2010-11, annual revenues to the General Fund will drop by over $2 million starting in 2012-13. The Forecast incorporates this expected revenue loss. This loss may be partially offset pending decisions on obtaining rent for the closed and unused landfill areas (see Upside Potential section).

## EXPENDITURE DRIVERS

### Salaries and Benefits

The City of Palo Alto is a labor-intensive and service-driven organization; salaries and benefits represent approximately 65 percent of the 2006-07 General Fund budget. Upward pressure on salary and benefits is a continual issue given the cost of living in Silicon Valley and the labor market in which the City negotiates with its bargaining units.




In 2006-07, the City is scheduled to complete negotiations with all of its bargaining units except the Palo Alto Peace Officer's Association (PAPOA), with which negotiations are set to begin in early 2007-08. Currently, there are five union-represented groups in the City: Fire Chiefs' Association (FCA), International Association of Fire Fighters (IAFF), PAPOA, Service Employee's International Union (SEIU), and SEIU Hourly unit. There are two remaining groups that are not represented by a union: Management and Professional and Limited Hourly. In October, Council approved a labor agreement with SEIU that included an 11.5 percent cost increase over 38 months and the 2.7 percent at 55 retirement benefit. The cost of the retirement benefit is offset over time by a containment of medical costs and by employees paying a portion of the retirement benefit.

At the time of this writing, City management has proposed to the Management/Professional group the 2.7 percent at 55 retirement plan with the same containment of medical costs accepted by SEIU. The cost of the one-year Management proposal equals 3.63 percent of the unit's salaries and benefits.

As a result of the restructuring efforts of the past several years, projected annual growth for salaries and benefits over the next ten years is 3.8 percent — down from the 4.1 percent growth over the past ten years. The savings is primarily due to the reduction of 30 positions in the General Fund during the 2005-07 budget process, coming on the heels of a 40 position reduction in the preceding years. (See chart at left.) Within that category, salary and overtime growth are assumed at 3.1 percent per year; benefits are assumed to grow by 5.4 percent, including retiree medical.

Within the benefits category, the largest drivers are Pension and Healthcare Costs.

### Pension Expense

CalPERS retirement system pension costs have more than doubled since 2003 — going from $5.7 million to $12.2 million — due to negative stock market returns during the recent recession. In 2005, the CalPERS Board enacted a new rate policy that spreads market gains and losses over 15 years rather than over three years when calculating the value of assets. The financial impact of this new policy appears for the first time in 2006-07, with rates reduced by 3-4 percent compared to the prior year. It is critical to note that CalPERS investments have improved dramatically since 2000 to 2002. Over the past 5 years, CalPERS has earned an average of 10.3 percent per year. Pension expenses are expected to level out in subsequent years.

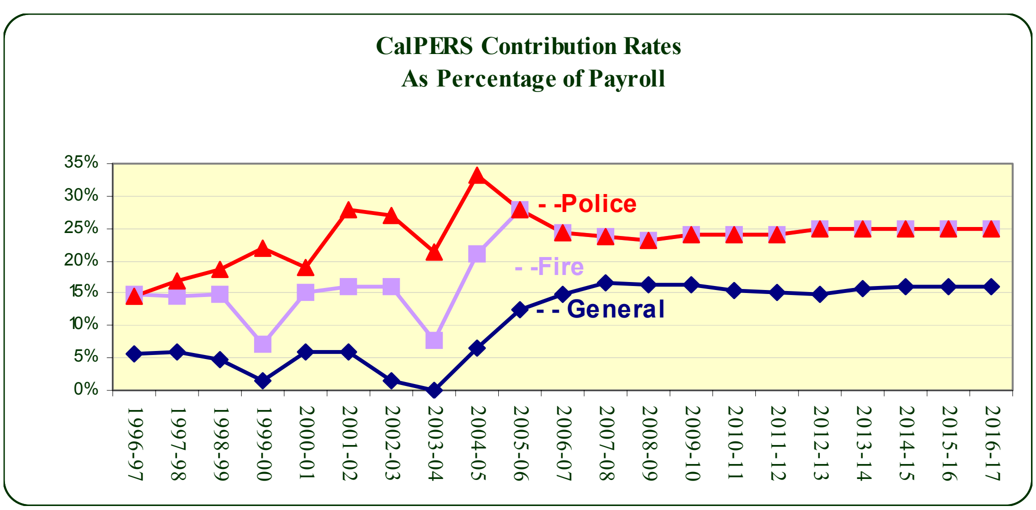
For the first time since 1983, Management and SEIU employees will be contributing part of their salary to their PERS retirement plan. This is a consequence of receiving the 2.7 percent at 55 package.

### Healthcare and Retiree Medical Costs

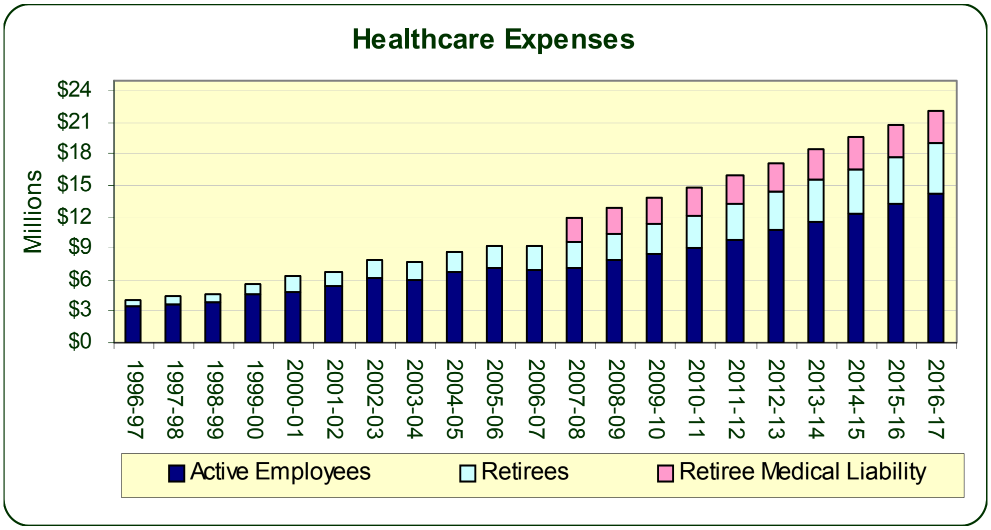
The City of Palo Alto has been one of the few remaining jurisdictions that fully funded employee health insurance premiums and retiree medical costs. That long-held practice was amended this year, when the City placed a limit on its contribution to medical premiums for both active and retired employees.

***Healthcare -*** Medical premiums are expected to double by 2015, having grown by nearly 60 percent over the past seven years to $12.2 million.

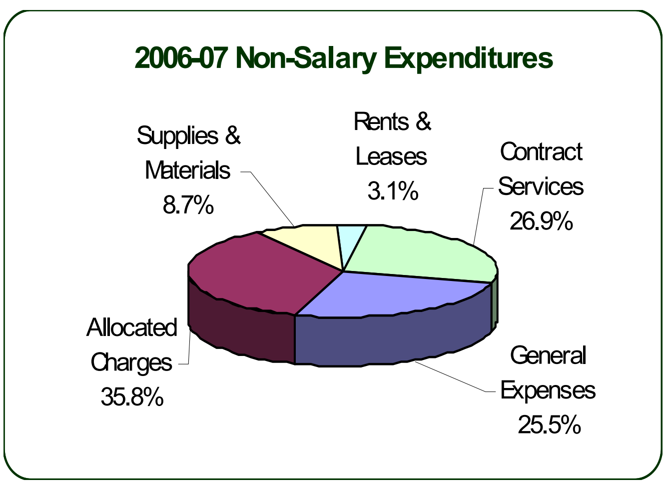
***Retiree Medical -*** As more of the workforce reaches retirement age, the costs for retiree medical will rise sharply. As a result of GASB 45, the City recently underwent an actuarial study which valued its retiree medical liability at $106.6 million (based on a 6.0 percent discount rate); a more recent estimate showed the liability at $83.1 million, assuming the establishment of an irrevocable trust and a 7.75 percent discount rate. The City has already funded a Retiree Health Benefit reserve valued at $26.5 million, which reduces the liability to $56.6 million. Having this reserve places the City at an advantage compared to most jurisdictions facing this issue. However, it will need to set aside an additional $2.4 million per year to fund the General Fund liability.



In its attempts to limit its healthcare costs, the City has accomplished the following:




- Placed a limit on the employer's contribution to medical premiums for both active and future retirees, thereby eliminating the most expensive health plan the PERS system offers, and reversing its long-held practice of funding 100 percent of every healthcare plan for employees and retirees. For example, as a consequence of Management and Professional employees being limited in 2003 to the PERS Choice medical plan (versus the most expensive PERS Care medical plan), the City has avoided $2.6 million in costs from 2003 through 2006. With the new SEIU agreement that also limits its medical plans to the second highest, the City will avoid an additional $450,000 in costs annually for current employees.




- Raised the full vesting requirement for retiree medical eligibility from 5 to 20 years for new employees.*

Going forward, the City will continue to explore strategies to reduce healthcare and retiree medical costs.

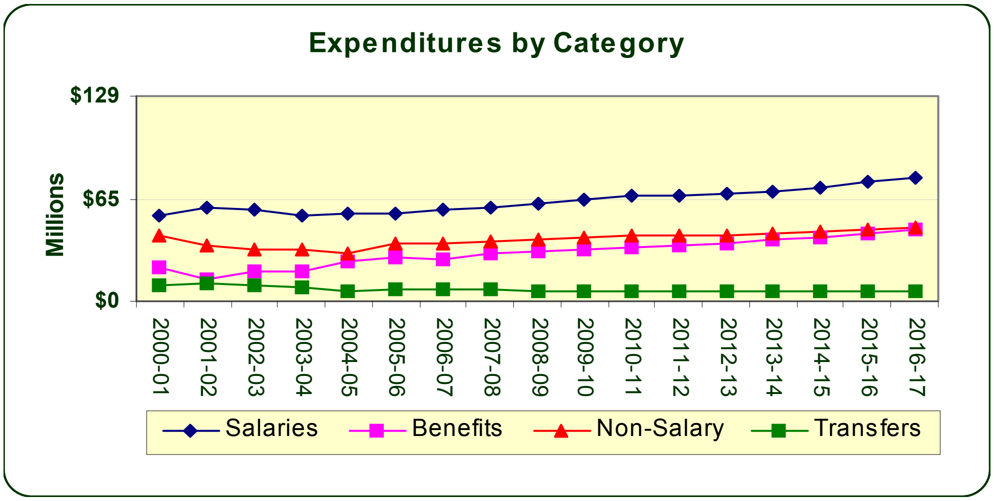
### Non-salary Expenditures

Non-salary expenditures represent 28 percent of the General Fund budget in 2006-07. Consistent with the prior year's LRFF, this forecast assumes no program growth beyond general cost inflation over the next ten years. The pie chart to the left shows the breakdown of non-salary expenditures.

General expenses include the lease payment of $6.2 million to the Palo Alto Unified School District (PAUSD) for the "Covenant Not to Develop" surplus school facilities. This contract requires CPI adjustments to the annual lease payment, with a projected annual growth rate for the next ten years of 3.0 percent, or at least $186,000 annually.

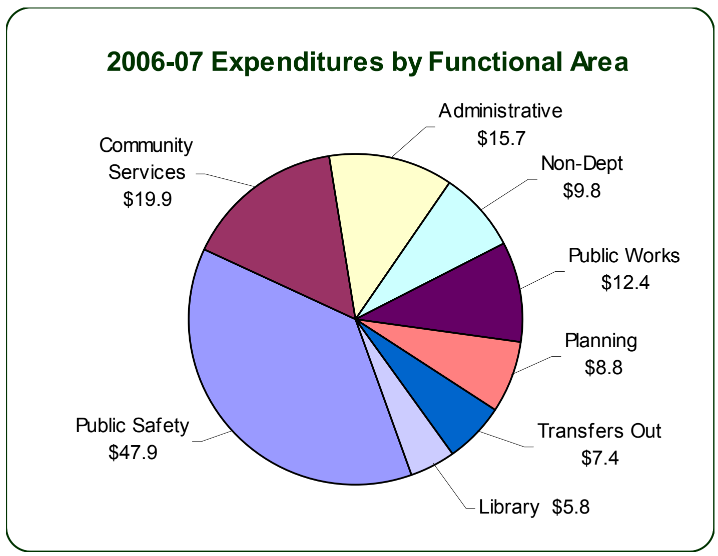
* "New employees" are defined as employees hired after January 1, 2004 for Management and Professional, Fire, and Fire Chiefs bargaining units; after January 1, 2005 for SEIU members, and after January 1, 2006 for Police.

### *Expenditure Trends by Category and Function*




The graph at right depicts the projected trend lines for salaries, benefits, non-salary expenses, and transfers. Please note the following:

- Salaries remain at about 44 percent of total expenditures from 2006-07 through 2016-17
- Benefits increase from 21 to 26 percent of total expenditures from 2006-07 to 2016-17 due primarily to the inclusion of the retiree medical liability starting in 2007-08
- The average annual increase in total expenditures from 2006-07 through 2016-17 is 3.4 percent
- Non-salary expense and transfers represent about one-third of General Fund expenditures




The pie chart on the right breaks out the budget by functional area. The two largest functional areas of the budget are Public Safety (Police and Fire) and Community Services. They comprise 38 percent and 16 percent of total expenditures in 2006-07, respectively.

The pie chart also shows $15.7 million in expenditures for Administrative activities. This category includes Administrative Services, the City Attorney, City Auditor, City Clerk, City Council, City Manager, and Human Resources. These functions represent 12.3 percent of total expenditures. Forty-one percent of this expense is reimbursed by enterprise funds for the services the administrative departments provide to the City's utility functions.

## RISKS

The City continues to face significant fiscal challenges and opportunities which create upside and downside risks in the Forecast.

### DOWNSIDE RISKS

The primary downside risks on the revenue side are related to the housing market and energy prices. If the housing market slump becomes more severe, or energy prices do not continue to stabilize as predicted, actual revenue growth rates will likely fall short of projections, and the City's revenues will not meet the forecasted figures.

The following are some additional downside risks related to revenues forecasted in the model.

### Economic Base

In the past few years, the City has proactively worked to grow its economic base. Efforts to retain and grow auto dealers, to expand the Stanford Shopping Center, and to attract a medium-sized hotel to Palo Alto have all been part of this attempt to enhance our economic base. (Further details appear below in "Upside Risks.") These efforts are necessary given the following competitive pressures on City businesses:

- Big-box stores such as Best Buy, Home Depot, Costco, REI, and supermarkets in Mountain View and East Palo Alto that draw sales away from Palo Alto businesses as well as sales tax revenues away from the City
- Nearby cities' efforts to attract automobile dealerships. For example, plans have emerged in Menlo Park (in conjunction with General Motors) to develop an automobile mall on Willow Road and Highway 101. Given the lack of suitable space in Palo Alto, this could lead to the departure of key local dealerships. The City has already lost three auto dealerships in the past five years: Ford, Nissan, and Porsche
- Retail competition from regional shopping centers such as Valley Fair and Santana Row
- The emergence of high-end hotels in Los Altos, Menlo Park and East Palo Alto, generating increased competition for Palo Alto hotels and for TOT dollars
- The transformation of Stanford Research Park from firms producing taxable sales to those providing non-taxable research, administration, and business services
- Opposition to business development within the City

The Forecast incorporates the most recent loss of automobile dealerships and hotels; however, should any of these trends become more significant, the City's revenues will decline accordingly.

### Telephone UUT Threat

Voice-Over-Internet Protocols (VOIP) technology will impact telephone UUT revenues as it penetrates homes and businesses. Based on a recent Federal Communications Commission ruling, the City will no longer have the authority to tax VOIP service; thus the $2 million telephone UUT revenue source may erode over time. In addition, since the telecommunications industry was successful in relocating local franchise authority to the State level, it is likely to attempt to do the same for UUT. A State UUT could result in further diminution of the City's telephone UUT revenues.

### State Cable Franchise Legislation

AB2987, the California Cable Franchise bill, was recently signed by the Governor, creating a statewide cable franchising authority. The Forecast assumes that the State's promise, that the City will be made whole, is kept. If, in fact, the new State Franchise Authority

*If the housing market slump becomes more severe, or energy prices do not continue to stabilize, the City's revenues will not meet forecasted figures.*

causes a loss of revenues for the City, this revenue stream would diminish.

The following are downside risks on the expenditure side:

### *Healthcare and Retiree Medical*

The Centers for Medicare and Medicaid Services project national health care expenditures will increase an additional 85 percent from the current $2.16 trillion to $4.0 trillion by 2015. There is little relief in sight for the City's and the nation's health care costs.

The Forecast assumes an average growth rate in health care costs of 7.4 percent per year. It is quite possible that healthcare costs will escalate beyond that rate of growth.

### *Increased Salary Pressures*

If prevailing labor market differentials surface over the next few years, as comparisons are made with benchmark cities, more complex labor negotiations may ensue. Budget-balancing efforts will be weighed against regional wage standards. This could possibly drive salaries and benefits expenditures above those in the Forecast.

### *New Projects and Priorities*

If the City identifies new projects or priorities that are not included in this Forecast, new revenue sources and/or expenditure cuts would have to be identified to fund them.

### *Housing and Population Trends*

In 2006, Palo Alto's population totaled 62,148. For each of the past two years, the population has grown by 1.6 percent, with the number of housing units in the City increasing at 1.4 percent. Within the next few years, the City's population is expected to grow with the construction of new housing units stemming from various developments. These projects include the conversion of the former Hyatt Rickey's site into 181 housing units, a development at 901 San Antonio Road which will create 159 housing units, and a project at 195 Page Mill Road which will yield 84 housing units, among others. While additional housing is recognized as an important need, several hundred new residents from these projects will create additional demands for City services. Moreover, a number of the planned units are designated for seniors. The "greying" of our community may intensify the needs and requests for City services specifically tailored to an older demographic.

The Forecast assumes the maintenance of existing service levels; therefore, an increase in City services would increase the total uses of funds in the Forecast.

## Upside Potential

Possible developments that would positively impact the City's bottom line include:

### *Successful Economic Development Efforts*

In the past few years, the City has been engaged in several efforts to encourage business development. As a result of the Mayor's Committees on Retail and Business Attraction, several key strategies have been implemented:

- The City will be partnering with the Simon Group on efforts to strengthen the Stanford Shopping Center in order to maintain its competitive position in the marketplace.
- Staff has reviewed zoning requirements in several business districts and implemented changes to the zoning code that address challenges to high-volume sales tax generators such as auto dealers.

- Other zoning changes have protected commercial zones from housing development.

In addition, the Business Improvement District (BID) has been a catalyst for businesses in the City's downtown core. Events such as Dine Downtown have been a success in increasing sales to local restaurants. The pilot "Destination Palo Alto" has engaged a variety of partners (City, Chamber of Commerce, BID, Stanford, commercial areas, and neighborhood associations) in prompting visitorship and visitor-related economic activity and revenue.

Business outreach efforts continue, targeted to valued businesses and top sales tax generators. City staff and elected officials have conducted business outreach visits to companies such as Communications and Power Industries, Inc., Varian, and VMware. These visits help the City assess its strengths, weaknesses, and challenges; they will continue to inform decisions regarding business development efforts by the City.

To the extent that these efforts counteract the negative competitive pressures outlined above, City revenues could exceed those forecasted.

### *Refuse Fund Rent*

The Refuse Fund owes the General Fund approximately three years of rent, for land that is intended to be converted to parkland, but has not yet been converted (CMR: 373:06). The Forecast model does not include this prior rent, since a rent policy is currently being discussed with the Finance Committee and has not yet been finalized. It has generally been assumed that the additional rent payments would commence in 2014-15. This is when the rent payments under the current payment plan will cease. However, Council could decide to collect a portion of that rent sooner, as a way to ease the deficits projected to begin in 2010-11.

### *Possible Wave of Retirements*

The City of Palo Alto, like most other government agencies, is facing an approaching "baby boomer" retirement wave. Currently, 38 percent of staff is eligible for retirement and the figure will increase to 56 percent within five years. Given the recent approval of 2.7 percent at 55 for SEIU and ultimately for Management employees, the incentive to retire in the near future will increase significantly in January 2007. This wave of retirements in the next few years will create an opportunity for restructuring and reviewing how services are delivered. This opportunity, however, must be weighed against the significant challenges of managing the loss of expertise and institutional knowledge in the organization and the service needs of the community.

## OPTIONS UNDER CONSIDERATION FOR THE 2007-09 BUDGET AND BEYOND

### INFRASTRUCTURE RESERVE FUNDING

One of Council's top priorities is to restore and maintain the City's General Fund infrastructure. An Infrastructure Reserve (IR) was created to ensure future project funding. When the Infrastructure Management Plan (IMP) was initiated in 1998, it was estimated that the City needed to spend $10.0 million annually both to eliminate an infrastructure backlog and to maintain existing infrastructure in future years. However, the annual expenditures have not been sufficient to cover the growth in infrastructure project costs, which have been impacted by inflation, changes in scope, and steep increases in the cost of construction materials. Moreover, the IR's balance will be depleted without additional funding.

In April 2006, the City Council directed staff to review options to increase IMP funding by $3.0 million per year through a combination of expenditure reductions and revenue enhancements.

## *"Best Bets"*

In two separate discussions, one in May and another in July, the City Council reviewed an expanded list of options for enhancing revenues and decreasing expenses in the General Fund. Building on these discussions, the Finance Committee on October 17 refined the list to the "best bets" and directed staff to pursue them. The following list represents the best bets:

### Revenue Enhancements:

- $250,000 - Review cost recovery level for classes
- $150,000 - Implement roadway impact fee
- $450,000 - Charge for non-emergency sidewalk repair
- $900,000 - Initiate process for ballot measure to increase the transient occupancy tax (TOT)

### Expense Reductions:

- $1,500,000 - Continue restructuring and streamlining efforts and reduce low priority services
- $350,000 - Issue Request For Proposal for outsourcing remainder of park maintenance

### Other:

- $100,000 - Establish "Innovations Fund" (at the level of $100,000 per year for 3 years) to produce new net savings or generate new net revenue

The table below illustrates the impact of incorporating most of the above options into the base model of the Long Range Financial Forecast, and then transferring the resulting surplus into the Infrastructure Reserve.

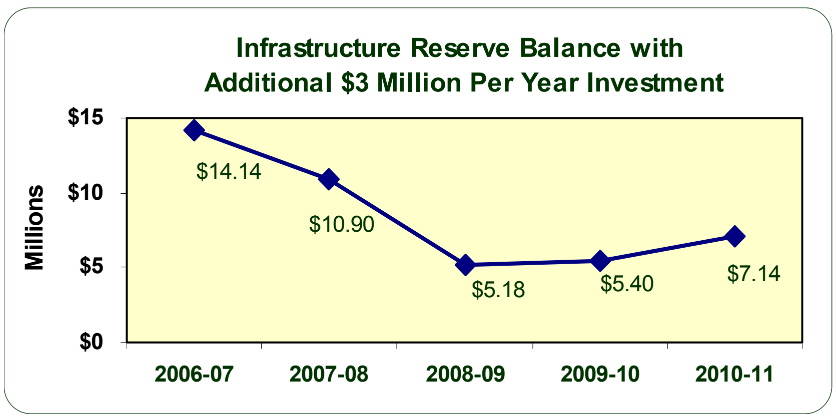
The TOT increase is uncertain, since it requires ballot approval; the Innovations Fund is expected to be cost neutral in the short run. Therefore these two options are not included in the chart below. As a result, $2.7 million in revenue enhancements and cost reductions are reflected, rather than a full $3 million. In addition, a TOT increase becomes critical if any of the other options do not come to full fruition.

**LONG RANGE FINANCIAL FORECAST MODEL 2006 ($000) WITH ADDITIONAL $3 MILLION PER YEAR INFRASTRUCTURE INVESTMENT**

| | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 |
|---|---|---|---|---|---|
| | Projected | | | | |
| **Revenues** | | | | | |
| **TOTAL SOURCE OF FUNDS** | 130,229 | 135,527 | 140,349 | 145,246 | 147,236 |
| Revenue Enhancements | | | | | |
| Cost recovery of classes | | 250 | 250 | 250 | 250 |
| Roadway impact fee | | 150 | 150 | 150 | 150 |
| Non-emergency sidewalk repairs | | 450 | 450 | 450 | 450 |
| **TOTAL SOURCE OF FUNDS** | 130,229 | 136,377 | 141,199 | 146,096 | 148,086 |
| **Expenditures** | | | | | |
| **TOTAL USE OF FUNDS** | 129,124 | 135,197 | 138,564 | 143,379 | 147,938 |
| Expense Reductions | | | | | |
| Restructuring/eliminating services | | (1,500) | (1,500) | (1,500) | (1,500) |
| Outsourcing - park maintenance | | (350) | (350) | (350) | (350) |
| **TOTAL USE OF FUNDS** | 129,124 | 133,347 | 136,714 | 141,529 | 146,088 |
| **Net Operating Surplus/(Deficit)** | 1,106 | 3,030 | 4,485 | 4,567 | 1,998 |
| Additional transfer to Infrastructure Reserve | 0 | (3,000) | (3,000) | (3,000) | (3,000) |
| **Net of Reserve Transfer** | 1,106 | 30 | 1,485 | 1,567 | (1,002) |

The IR Balance table and chart to the right show the improved reserve balance resulting from the additional $3 million annual investment. Note that the balance of the IR was reduced in 2006-07 with the addition of two new projects that were not part of the original IMP: Public Safety Building ($1 million) and Library Service Model Analysis ($400,000).

| Infrastructure Reserve (IR) Balance (in 000s) with Additional $3 Million Per Year Investment | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 |
|---|---|---|---|---|---|
| Sources | $11,397 | $11,399 | $10,580 | $10,235 | $10,273 |
| Uses | (17,398) | (14,639) | (16,300) | (10,013) | (8,531) |
| Surplus (shortfall) of Sources over Uses | (6,001) | (3,240) | (5,720) | 222 | 1,742 |
| Infrastructure Reserve Balance, beginning | 20,138 | 14,137 | 10,897 | 5,177 | 5,399 |
| **Infrastructure Reserve Balance, ending** | **$14,137** | **$10,897** | **$5,177** | **$5,399** | **$7,141** |




### *Next Steps*

In January, at the start of the 2007-09 budget development process, the City Council will consider services to eliminate in order to achieve the $1.5 million savings to complete the additional $3 million for infrastructure.

## CONCLUSION

In conclusion, this year's LRFF incorporates many significant changes and challenges. As the financial forecast's bottom line shows, the City has righted its financial course over the past several years through expense reductions. It continues to balance its budget despite major benefit enhancements and reductions, enhanced infrastructure funding, and an important retiree medical liability. Although deficits are shown in 2010-11 due to a projected recession and the decline in Refuse Fund Rent, the City is in a sound position to deal with its future financial challenges.

## NOTES

**1.** Marni Leff Kottle, "Home prices slip after 4 hot years," San Francisco Chronicle, Oct. 18, 2006, as quoted from DataQuick real estate information services. Figures included single-family houses and condominiums, existing and new.

**2.** California Department of Finance, September newsletter

**3.** Department of Labor, Bureau of Labor Statistics, Sept. 2006

**4.** Carolyn Said, "State's jobless rate slips to 4.8%," San Francisco Chronicle, Aug. 19 2006

**5.** California Department of Finance, Sept. 2006 newsletter

**6.** Market Wire, Aug. 16 2006

**7.** Wikipedia

**8.** George Jahn, "Oil prices slide below $60 per barrel," Associated Press, Nov. 7 2006

**9.** Energy Information Administration, Nov. 6 2006

**10.** Legislative Analyst's Office, "2006-07 Budget: Perspectives and Issues," page 20

**11.** Marni Leff Kottle, "Home prices slip after 4 hot years," San Francisco Chronicle, Oct. 18 2006

**12.** Federal Reserve Board of San Francisco Economic letter, April 28 2006

# APPENDICES A-E

# A DEFINITIONS OF REVENUE AND EXPENDITURE CATEGORIES

## REVENUES:

**Sales Tax** is a tax collected from customers by retailers on sales of tangible personal property and services. In fiscal year 2006-07 it represents 18.7 percent of all General Fund revenues.

**Property Tax** is a tax that the owners of real and personal property pay, equal to one percent of the assessed value of the property. Of the one percent, the City receives 9 percent, or 0.0009 percent of the assessed property value. Note that the bulk of Vehicle License Fees are now remitted to the City via property tax payments from the County.

**Utility Users Tax (UUT)** is a tax based on the usage of telephone, electric, water and gas utilities. The tax rate is 5 percent of the usage, with discounted rates available for very large users.

**Transient Occupancy Tax (TOT)** is a tax levied on short-term (30 days or less) rental of lodging. The current TOT rate is 10 percent of the price of the rental.

**Documentary Transfer Tax** is a tax levied on real property bought or sold in the City at the rate of $3.30 per $1,000 of value. Revenues can vary significantly from year to year since they are sensitive to the volume and value of property sales and due to one-time transactions such as the Stanford Shopping Center lease.

**Other Taxes, Fines, & Penalties** consists of remaining Vehicle License Fees paid directly by the State, parking violations, library fines, administrative citations, and other fines and penalties. Parking violations is the largest component in this category with projected revenues in fiscal year 2006-07 of $1.8 million.

**Service Fees & Permits** are generated from golf course fees and class registration and admission fees in the Community Services Department; permits and plan check and zoning fees in the Planning and Community Environment Department; and paramedic service fees in the Fire Department. Paramedic service fees are the most significant in this area, projected to be $1.6 million in fiscal year 2006-07.

**Joint Service Agreements** are primarily comprised of the Stanford University contract for fire and communication services, which funds 30 percent of the Fire Department's budget--approximately $7 million.

**Reimbursements** refer to payments received by the General Fund (GF) for services rendered to the Enterprise Funds, such as accounting, payroll, purchasing, human resources, and legal advice.

**Transfers Between Funds** are a common way 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 of $14.2 million, which represents a return on the City's original capital investment in the Utility Department's operations more than 100 years ago.

**Other Revenues** are primarily comprised of the rent received for land and facilities used by the Utilities and Public Works Enterprise Funds. They comprise 12 percent of the total sources of GF revenue in fiscal year 2006-07.

## EXPENDITURES

**Salaries & Benefits** consist of salaries (regular, temporary, and overtime) and benefits (health-care, retirement and others). Salaries and Benefits account for approximately 65 percent of fiscal year 2006-07 total expenditures.

**Non-Salary Expenses** include contract services, supplies, general expenses, rents and leases, and allocated charges. They represent 28 percent of the GF budget in fiscal year 2006-07.

**Contract Services** include contracts for Children's Theatre, golf professional services, park maintenance, class instructors, traffic studies, outside legal counsel, auditing, and financial services. In fiscal year 2006-07, contract services represent 8 percent of the GF budgeted expenditures.

**Supplies & Materials** include office supplies, recreational and housekeeping supplies, City employees' uniforms, construction and planting materials, and library circulation. Supplies and materials expense represents 8.7 percent of non-salary expenses in fiscal year 2006-07.

**General Expense** is mainly comprised of the annual Cubberley lease payment to Palo Alto Unified School District (PAUSD) in the amount of $6.2 million. General expense is 25 percent of total non-salary expense in fiscal year 2006-07.

**Rents, Leases & Equipment** consists mainly of land and facility rentals, other rents, and leases. It comprises only 3.1 percent of total non-salary expense in fiscal year 2006-07.

**Allocated Expenses** include printing and mailing, vehicle replacement, technology, and benefits costs incurred by internal service funds, which are allocated to various departments based on a prescribed usage methodology.

**Transfers to Other Funds** are transfers between funds as reimbursement for services, overhead expenses, or other payments. The LRFF includes four main transfer categories: Infrastructure Management Plan (IMP) capital projects, non-IMP capital projects, debt service, and other transfers.

**Debt Service** is the interest and principal payments made to bond holders on the outstanding debt principal balance. The City of Palo Alto's total current outstanding debt principal is $10 million —one of the lowest debt levels of any city in the Bay Area.

**IMP Capital Projects** are a subset of the Infrastructure Management Plan, also known as "CityWorks." It began in fiscal year 1999-2000 as a 10-year, $100 million, plan designed to eliminate the City's backlog of infrastructure rehabilitation projects.

**Non-IMP Capital Projects** include projects for traffic calming, public art, and technology. They are estimated to increase by an average annual rate of 3 percent over the next ten years.

# B APPENDIX B - BASIC FORECAST METHODOLOGY

## REVENUE PROJECTION METHODOLOGY

Consistent with past forecasts, the compound annual rate of growth (CAGR) over the past ten years for economically sensitive revenues is the assumed rate of growth for the next ten years. In utilizing this CAGR methodology for the past ten years, the significant revenue gains during 1999 through 2001 and the steep losses from 2001 through 2003 are balanced. One shortcoming of this methodology is that it does not account for structural changes in revenue receipts, such as the departure or arrival of a major revenue generating business. When this occurs, staff modifies the base revenues prior to developing projections.

This forecast assumes that the City will channel all revenue windfalls into reserves or one-time capital improvements. This assumption ensures that the City will not commit its resources to new or ongoing operating programs or labor commitments in flush times, only to see them cut or under-funded when revenues return to normal levels.

Included in the forecast is a projected economic downturn in approximately five years, or in fiscal year 2010-11. Although projecting a recession is more guesswork than science, it is known that, historically, California has experienced a recession once each decade. Because of this cyclical phenomenon, anticipating a two-year downturn within the next ten years is required for prudent planning and fiscal management. Due to the downturn, a deficit of $0.7 million emerges in the Forecast during fiscal year 2010-11. At this time, staff believes that corrective action is not required. Should a recession fail to materialize, the City will be in a better position than projected.

## EXPENDITURE PROJECTION METHODOLOGY

Similar to revenue projections, expenditure projections are based on a combination of historical trends, assumptions about future growth rates, and other judgments deemed appropriate. Salary projections are based primarily on existing labor agreements. For timelines beyond existing contracts, salary growth is projected using a weighted average of historical trends and regional labor cost increases.

Due to GASB 45, we have budgeted for retiree medical based on our most recent actuarial study and assumptions. Since healthcare and pension costs have risen so rapidly over the past several years, we expect these rates to moderate over the next ten years. The City will continue to explore methods of controlling the growth of these expenses, but such controls are not assumed in the plan.

Operating transfers are primarily generated in relation to capital projects. The five-year capital plan is the basis for the first half of the LRFF's capital transfer projections. The last five years are estimated based on historical spending patterns.

# C APPENDIX C - STATISTICAL ANALYSIS OF FORECAST

## METHODOLOGY

In order to do a "reality check" on the revenue projections reflected in the Long Range Financial Forecast (Forecast), staff performed a quantitative analysis including the following three steps:

### STEP ONE: REGRESSION ANALYSIS ON 3 KEY INDICATORS V. GENERAL FUND REVENUES

Staff identified the following three key macroeconomic indicators that closely correlate with historical City revenues: Gross State Product, number of employed Santa Clara County residents, and State Per-Capita Income.

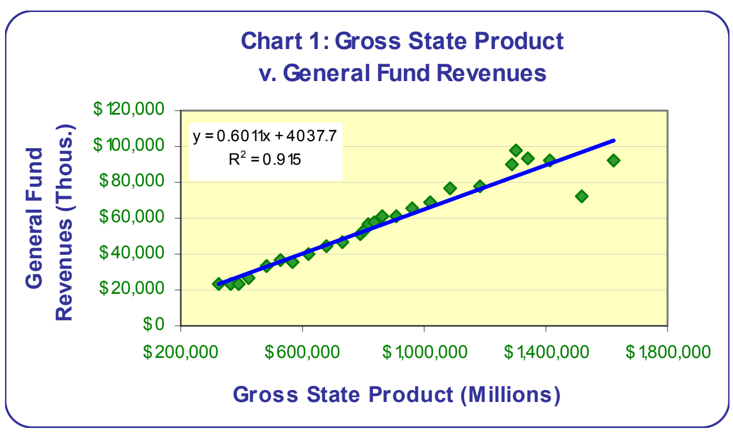
When a regression analysis was performed on each of these indicators relative to General Fund revenues, regression equations were derived. For example, the regression analysis of Gross State Product v. General Fund Revenues yielded the following equation: y=0.6011x + 4037.7, with an $R^2$ of 0.915. Translated, this means: with a 91.5% degree of correlation*, in each of the past 25 years, the City of Palo Alto's General Fund Revenues have been equal to California's Gross State Product divided by 1,000, times 0.6011, plus 4037.7.

(Note: General Fund revenues referenced in this chapter exclude reimbursements and operating transfers.)

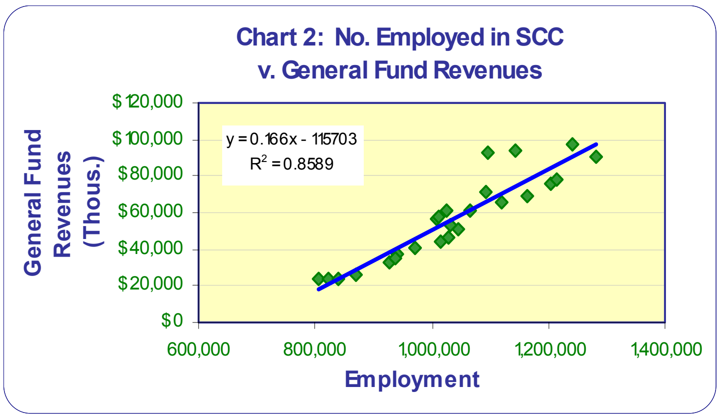
After calculating the correlation equation for each of the three key indicators, staff went on to verify whether, when the key indicators were projected out into the future by various experts, they would validate the projected figures in the Forecast.

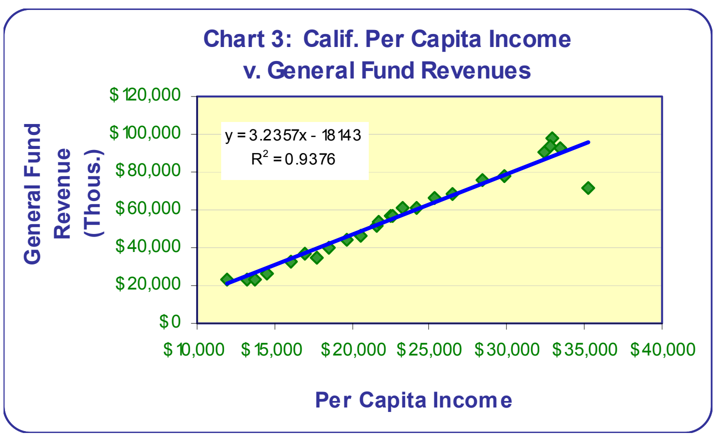
#### *Three Key Economic Indicators*

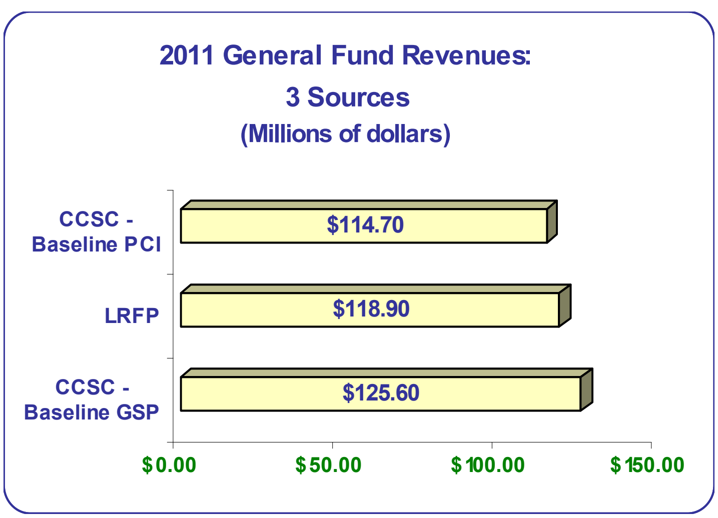
Charts 1, 2, and 3 below indicate the correlation between the three key indicators and General Fund revenues. Chart 1 displays the relationship between Gross State Product and General Fund revenues; Chart 2 illustrates the relationship between the number of employed Santa Clara County residents and General Fund revenues; and Chart 3 shows the relationship between Cal-




* "Correlation" refers to "the degree to which two or more attributes or measurements on the same group of elements show a tendency to vary together." (Dictionary.com)




ifornia Per-Capita income and General Fund revenues:

Of the three key indicators, Per-Capita Income has the highest degree of correlation with

General Fund Revenues, while County employment has the lowest.

## Step Two: Plugging "Expert Projections" into the Regression Equations

Utilizing 2011 “expert projections” for two of the three key indicators, staff inserted the figures into the regression equations above to predict General Fund revenues and then compared the outcomes with the Forecast's projected revenues for 2011.

The Center for Continuing Study of the California Economy (CCSCE) predicted a State Per-Capita Income of $41,044 in 2011. Inserting $41,044 into the regression equation from chart 3 above as “x,” we calculate total General Fund revenue, or “y,” of $114.7 million in 2011. This figure represents a 3.0 percent variance below the Forecast's projection of $118.3 million.

In addition, CCSCE projected a Gross State Product of $1.99 trillion in 2011. Inserting that into the regression equation from chart 1 above, we calculate total General Fund revenue of $125.6 million in 2011 — or a 6.2 percent variance above the Forecast's projection of $118.9 million.

Hence the Forecast's projection of General Fund revenue lies between the results of two independently derived projections, calculated through our regression analysis process.

Staff believes this validates the Long Range Financial Forecast's overall revenue projections.

## Step 3: Use Trend and Weighted Analyses to Project Revenues

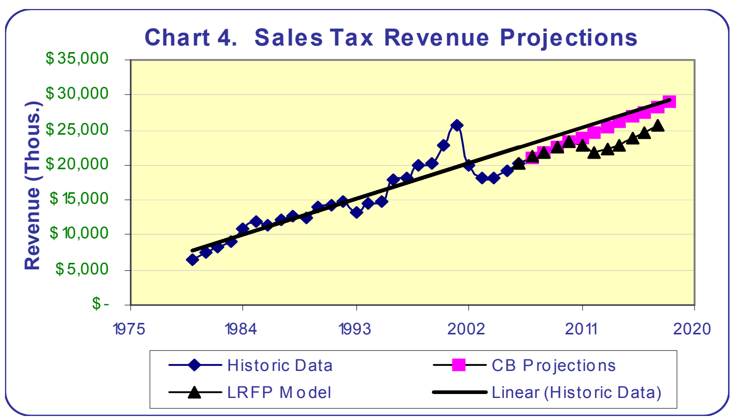
As a final "check" on the Forecast's projections, staff made use of historical revenue data to project future revenues, using two different approaches--a straight trend-line approach and a weighted data approach. In the trend-line approach, data from each year were weighted equally. In the weighted approach, called "Crystal Ball" after the software used to produce the analysis, greater weight was applied to the more recent data and less weight to that of earlier years. Therefore the weighted approach emphasized recent fluctuations in the economy. Neither approach is necessarily more accurate; however the two sets of results provide a framework 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** graphs Sales Tax Revenue projections using three varying methods: trend-line, the weighted "Crystal Ball" method, and the Forecast model.

The linear trend-line in Chart 4 falls consistently above the projections of the other two methods displayed, which accentuates how drastic the changes have been since 2001. Crystal Ball places greater emphasis on the recent declines in sales tax revenues as does the Forecast. Furthermore, the Forecast's projections dive below the Crystal Ball forecast in the later years, due to the Forecast model's assumed recession beginning 2011.

**Chart 5** maps out the three types of projections on Property Tax revenues. The Forecast's projections exceed the linear trend line in the early years — due to soaring home prices and the cessation of ERAF III state takeaways. After 2010 the Forecast falls between the other two projections. This chart illustrates the advantage of utilizing qualitative information in a forecasting model; the recent irregularities due to state budget-balancing measures and trading of revenue sources are impossible for a strictly quantitative model to capture.



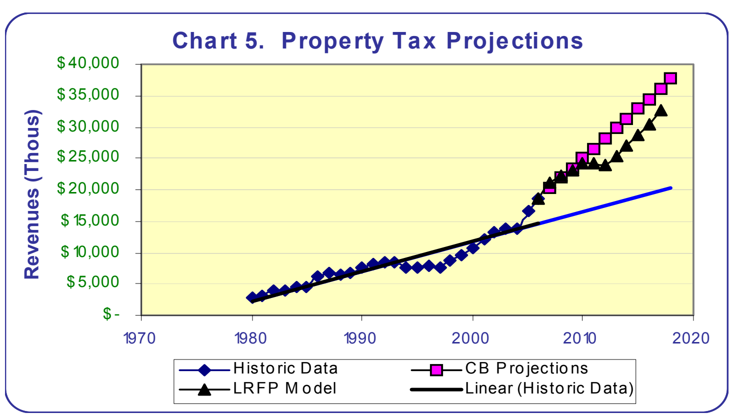



**Chart 6** illustrates that the weighted analysis predicts a slower rebound in TOT revenues than either the trend-line or the Forecast. The Forecast falls between the two, as staff believes that the recent upturn will persist.

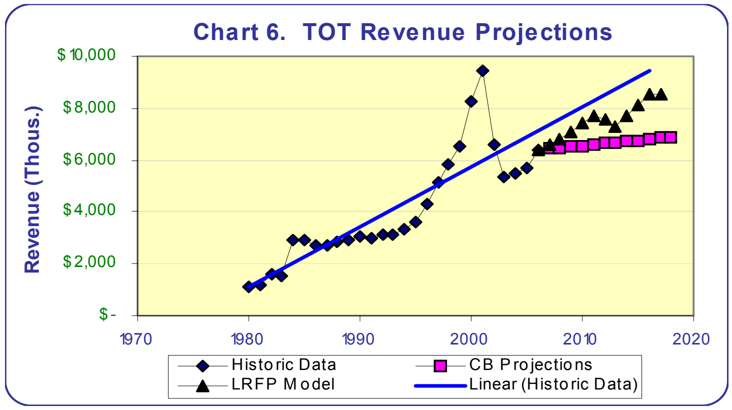
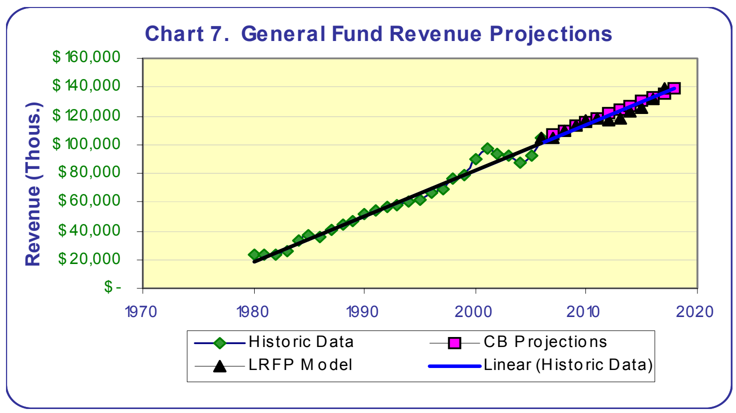



**Chart 7** demonstrates very similar projections using all three methods. Crystal Ball projected total 2016-17 revenue at $136 million — a mere 2 percent lower than the $139 million figure projected in the Forecast, with the trend-line falling tightly in between.




In conclusion, staff employed alternative quantitative forecasting methods to critically review the Forecast's projections, and to validate its assumptions. The alternative calculations of future revenues were well within striking distance of the projections presented in the Long Range Financial Forecast.

# D APPENDIX D - LEGISLATIVE ANALYST OFFICE'S AND OTHER ECONOMIC FORECASTS

The table below summarizes the California Legislative Analyst Office's economic projections, as published in its February 22, 2006 report entitled "2006-07 Budget: Perspectives and Issues":[13]

The Legislative Analyst's Office also compared its projections with other expert projections available at the time of publication. The table at right summarizes projections made by the UCLA Business Forecast Project in December 2005, the 2006-07 Governor's Budget Forecast, and the consensus forecasts published in the Blue Chip Economic Indicators in January and February 2006. To varying degrees, all of the projections call for a slowdown in growth over the next two years, with the UCLA Business Forecast Project anticipating a slightly more significant slowdown than the other California forecasters.[14]

| LAO February Report | 2006 (est'd) | 2007 | 2008 |
|---|---|---|---|
| **National Figures:** | | | |
| Real GDP | 3.30% | 2.90% | 3.00% |
| Unemployment | 4.80% | 4.90% | 5.00% |
| Job Growth | 1.50% | 1.40% | 1.20% |
| Personal Income | 5.70% | 5.50% | 5.90% |
| **CA Figures:** | | | |
| Unemployment* | 5.20% | 5.40% | 5.50% |
| Job Growth | 2.10% | 2.00% | 1.80% |
| Personal Income | 5.70% | 5.50% | 5.90% |

* Note: In February, when these forecasts were published, CA unemployment figures were at 5.0 percent, as compared with 4.8 percent in September 2006.

**Comparisons of Recent Economic Forecasts**

| (% Changes) | Forecast | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| **United States Real GDP:** | | | |
| UCLA December | 3.6 | 2.8 | 2.5 |
| DOF January | 3.6 | 3.2 | 3 |
| Blue Chip Consensus[b] January | 3.6 | 3.4 | 3.1 |
| LAO February | 3.5 | 3.3 | 2.9 |
| **California Payroll Jobs:** | | | |
| UCLA December | 1.6 | 1.1 | 0.8 |
| DOF January | 1.4 | 1.3 | 1.3 |
| Blue Chip Consensus[c] February | 1.6 | 1.5 | 1.2 |
| LAO February | 1.6 | 1.5 | 1.5 |
| **California Personal Income:** | | | |
| UCLA December | 6.2 | 5.2 | 4.5 |
| DOF January | 6 | 5.8 | 5.5 |
| Blue Chip Consensus[c] February | 5.9 | 5.9 | 5.6 |
| LAO February | 6.3 | 5.7 | 5.5 |
| **California Taxable Sales:** | | | |
| UCLA December | 6.9 | 5.1 | 4 |
| DOF January | 5.3 | 4.9 | 5 |
| Blue Chip Consensus[c] February | 5.2 | 5.6 | 5.7 |
| LAO February | 6.5 | 5.3 | 5.4 |

a Acronyms used apply to Legislative Analyst's Office (LAO); University of California, Los Angeles (UCLA); and Department of Finance (DOF).

b Average forecast of about 50 national firms surveyed in January by *Blue Chip Economic Indicators* .

c Average forecast of organizations surveyed in February by *Western Blue Chip Economic Forecast* .

13. Legislative Analyst's Office, "Perspectives on the Economy and Demographics," Feb. 22 2006, page 29
14. Legislative Analyst's Office, "2006-07 Budget: Perspectives and Issues," Feb. 22 2006, page 35

# E APPENDIX E - HISTORICAL TRENDS

## HISTORICAL TRENDS

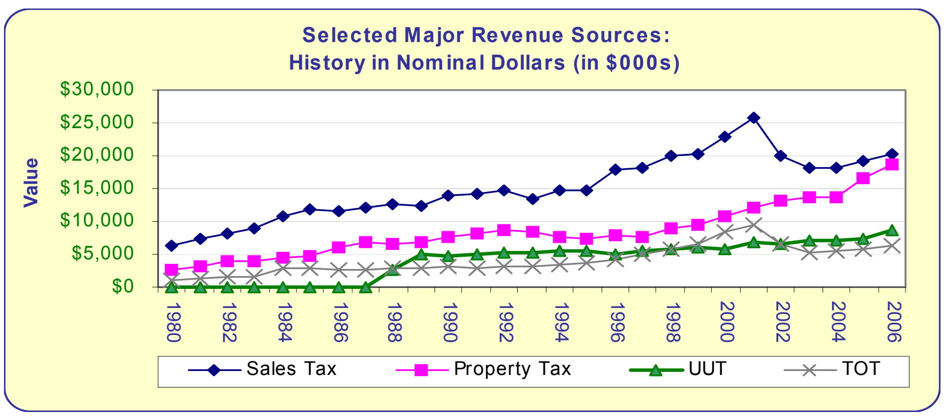
Historical trends help portray the context in which the City operates and are carefully considered in preparing the Long Range Financial Forecast. Please note that the total revenue and expenditure figures in this section may differ from those of other financial documents published by the City due to differences in reporting formats which may result in the exclusion of certain components.

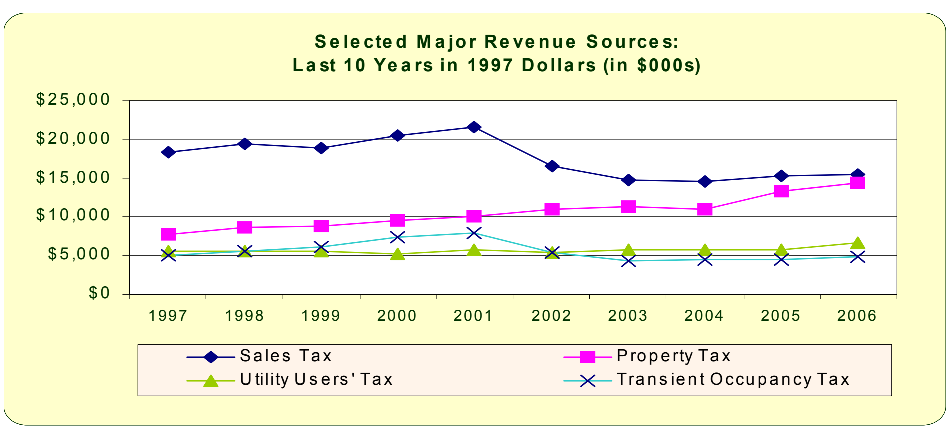
### GENERAL FUND REVENUE SOURCES

The charts on the right show the major sources of General Fund revenues first in nominal dollars (not adjusted for inflation) and then in constant (1997) dollars. Both illustrate that sales tax revenue reached a high in 2001 and has since declined markedly, while property tax revenue has increased steadily over the past ten years. Utility users' tax revenue has remained relatively stable, and transient occupancy tax revenue has followed the swings of the economy during the past ten years.

The second chart shows that, in real dollars, sales tax revenue is lower now than in 1997, while property tax has grown. UUT and TOT have remained relatively unchanged since 1997.

| Selected Major Revenue Sources: Average Annual Growth Rate | | | | |
|---|---|---|---|---|
| | Property Tax | Sales Tax | UUT | TOT |
| **From 2004 to 2006** | 14.00% | 3.20% | 8.00% | 5.30% |
| **From 2001 to 2006** | 7.10% | -6.40% | 3.00% | -9.00% |
| **From 1997 to 2006** | 7.10% | -1.80% | 2.20% | -0.50% |



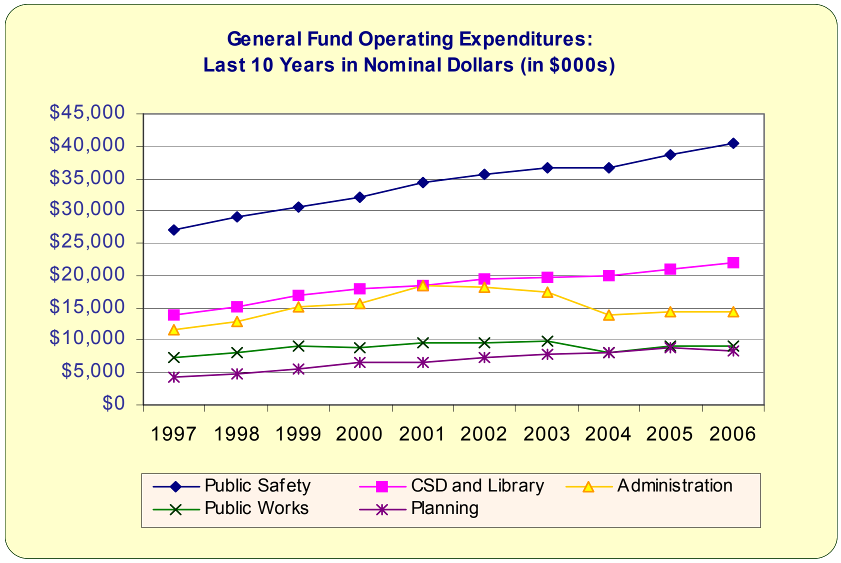
> *Why look at past trends? Understanding where we've been helps us understand where we're headed.*

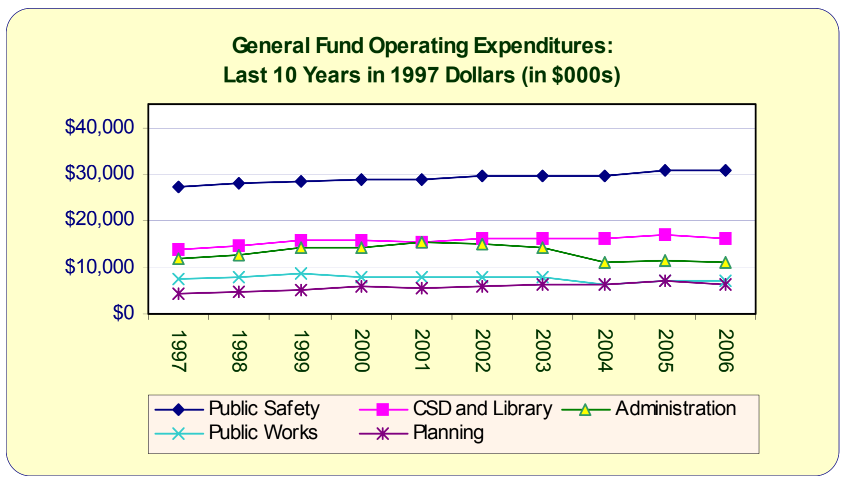
The chart on the previous page summarizes the rate of change of each of the revenue sources over the last ten years.

## General Fund Operating Expenditures

General Fund operating expenditures are also shown in nominal dollars (not adjusted for inflation) and constant (1997) dollars. The largest percentage of total expenditures has been devoted to public safety where expenditures have increased over the last ten years. Also, expenditures for administration reached a peak in 2001 and have since decreased significantly.

In addition, the bottom chart shows the rate of change of functional expenditures over the last ten years.




| General Fund Operating Expenditures: Average Annual Growth Rate | | | | | |
|---|---|---|---|---|---|
| | Public Safety | CSD and Library | Admin | Public Works | Planning |
| From 2004 to 2006 | 2.20% | 0.10% | -0.90% | 3.40% | -0.20% |
| From 2001 to 2006 | 1.50% | 0.70% | -6.80% | -2.80% | 2.90% |
| From 1997 to 2006 | 1.50% | 1.60% | -0.70% | -0.70% | 4.50% |

## Consumer Price Index Trends

Tables for U.S. and Bay Area CPI indices are presented below.

**U.S. Consumer Price Index**

| Fiscal Year | Amount | Percent Change |
|---|---|---|
| 1996 | 156.7 | |
| 1997 | 160.3 | 2.30% |
| 1998 | 163 | 1.70% |
| 1999 | 166.2 | 2.00% |
| 2000 | 172.4 | 3.70% |
| 2001 | 178 | 3.20% |
| 2002 | 179.9 | 1.10% |
| 2003 | 183.7 | 2.10% |
| 2004 | 189.7 | 3.30% |
| 2005 | 194.5 | 2.50% |
| 2006 | 202.9 | 4.30% |

**Bay Area Consumer Price Index**

| Fiscal Year | Amount | Percent Change |
|---|---|---|
| 1996 | 155.2 | |
| 1997 | 160 | 3.10% |
| 1998 | 165.5 | 3.40% |
| 1999 | 171.8 | 3.80% |
| 2000 | 179.1 | 4.20% |
| 2001 | 190.9 | 6.60% |
| 2002 | 193.2 | 1.20% |
| 2003 | 196.3 | 1.60% |
| 2004 | 199 | 1.40% |
| 2005 | 201.2 | 1.10% |
| 2006 | 209.1 | 3.90% |

Source: U.S. Department of Labor
Bureau of Labor Statistics
June of each year

| *Average Annual Growth Rate* | |
|---|---|
| Last 2 Years | 3.40% |
| Last 5 years | 2.70% |
| Last 10 Years | 2.60% |

| *Average Annual Growth Rate* | |
|---|---|
| Last 2 Years | 2.50% |
| Last 5 years | 1.80% |
| Last 10 Years | 3.00% |

Bureau of Labor Statistics
June of each year

## CITY HOUSING UNITS AND POPULATION TRENDS

Tables for Palo Alto Housing Units and Population trends are presented below.

**City of Palo Alto Housing Units**

| Fiscal Year | Amount | Percent Change |
|---|---|---|
| 1996 | 25,541 | |
| 1997 | 25,625 | 0.30% |
| 1998 | 25,701 | 0.30% |
| 1999 | 25,708 | 0.00% |
| 2000 | 25,732 | 0.10% |
| 2001 | 26,048 | 1.20% |
| 2002 | 26,841 | 3.00% |
| 2003 | 26,934 | 0.30% |
| 2004 | 27,019 | 0.30% |
| 2005 | 27,522 | 1.90% |
| 2006 | 27,767 | 0.90% |

| Average Annual Growth Rate | |
|---|---|
| Last 2 Years | 1.40% |
| Last 5 years | 1.30% |
| Last 10 Years | 0.80% |

State of California, Dept. of Finance
Demographic Research Unit

**City of Palo Alto Population**

| Fiscal Year | Amount | Percent Change |
|---|---|---|
| 1996 | 57,000 | |
| 1997 | 57,800 | 1.40% |
| 1998 | 57,900 | 0.20% |
| 1999 | 58,300 | 0.70% |
| 2000 | 58,500 | 0.30% |
| 2001 | 60,200 | 2.90% |
| 2002 | 60,500 | 0.50% |
| 2003 | 60,465 | -0.10% |
| 2004 | 60,246 | -0.40% |
| 2005 | 61,674 | 2.40% |
| 2006 | 62,148 | 0.80% |

| Average Annual Growth Rate | |
|---|---|
| Last 2 Years | 1.60% |
| Last 5 years | 0.60% |
| Last 10 Years | 0.90% |

***What do these charts show? -- Population, housing and inflation trends for the last 15 years. These are considered in making revenue and expenditure forecasts.***

## AMERICANS WITH DISABILITIES ACT STATEMENT

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