REPORT IN BRIEF

Attached to this report is the City’s updated General Fund Long Range Financial Plan (LRFP) for the years 2004-05 through 2014-15. The report contains a discussion and analysis of the following areas:

- Local, state and national economic conditions
- Actions taken over the last three years to balance the budget
- Methodology and assumptions used to forecast future revenue and expenditure streams; analysis of City revenue and expenditure performance; results of model and action plan to solve budget issues
- Financial challenges lying ahead
- Comparison of City forecasting model with alternative forecasting methods

Because of a sluggish local economy and consequent weak tax and fee revenues, dramatically rising employee benefit expenses, one-time fiscal solutions to prior budget problems, and state takeaways of local revenues, staff’s forecast presents significant financial challenges for the City. Financial conditions have worsened since the 2004-05 budget was developed and the current forecast shows net operating deficits over the next ten years if no action is taken to align resources and costs. For example, staff is projecting a $1.5 million deficit for 2004-05 and a $5.2 million deficit for 2005-06. Just as the City took action since 2001-02 to balance its budgets, staff is developing a strategy for Council consideration to make necessary expense reductions.
**RECOMMENDATION**
Staff recommends that the Finance Committee review and comment on the attached forecast of revenues, expenses, and reserve levels before the full City Council reviews the plan.

**BACKGROUND**
A Long Range Financial Plan (LRFP) is presented to the Finance Committee annually. The LRFP is designed to identify future financial problems and to alert Council and staff to action plans to align revenues and expenses. During the past three years, the City has acted through one-time and permanent revenue and expenditure changes to solve anticipated deficits. In the 2003-05 budget process, for example, the City reduced operating expenses by 5 percent to solve a long-term structural budget deficit. This included the elimination or freezing of nearly 40 full-time General Fund positions; implementation of an unpaid furlough; and capping medical benefits for a majority of employees. Year-end 2003-04 financial results showing a $0.5 million surplus demonstrates that the City was successful in balancing its General Fund operating budget.

The City also has engaged in noteworthy efforts to address long-term structural revenue issues. Two mayoral committees have been formed to address the concerns of local businesses so as to maintain a viable economic base that continues to generate sales and other tax revenues. To forestall the migration of automobile dealerships, signage and other concerns of auto dealers have been explored and partially addressed. On the expense side, the City has made some headway in capping health care and is cautiously optimistic that it can make additional progress in future union negotiations.

**DISCUSSION**
Unfortunately, the City is faced with another round of significant long-term budget issues. The LRFP forecast shows net operating deficits ranging from $1.5 million in 2004-05 to $7.4 million in 2014-15. A perfect storm, if you will, of weak tax and fee revenues, dramatically rising current employee retiree and medical expenses, and state takeaways of local revenues has further eroded the City’s fiscal condition. The duration of the weak economy and the repeated, steep increases from the Public Employees Retirement System (PERS) have far exceeded the best information available at the time the 2004-05 budget was built. These issues are explored in the attached chapters of the Long Range Financial Plan and an explanation for why the forecast for 2004-05 and 2005-06 has changed significantly from that shown in the 2004-05 budget document is provided.

Faced with annual deficits of $1.5 million to $7.4 million over the next ten years, the City of Palo Alto will act, as in years past, to balance its budget. The difference this time is that service level reductions and layoffs will be needed to close the budget gaps. At the current time, staff’s recommended plans to solve the shortfalls are as follows:

**2004-05 Deficit of $1.5 Million**

- Continue to restructure around retirements and vacancies
- Hiring freeze excluding public safety and special Enterprise Fund positions
- Cost reductions and one-time cost savings
2005-06 Deficit of $5.2 Million

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

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

This year’s LRFP update includes chapters on the local, state and national economies; historical efforts to date to align revenues and expenditures; a presentation of the methodology and assumptions used in the forecast; an analysis of revenues, expenditures, and the results of the forecast; a review of future challenges facing the City; and a new chapter comparing the LRFP forecasting methodology to other forecasting methods.

RESOURCE IMPACT
As with any financial forecast, the fiscal impacts shown are estimates. Estimates of future deficits and surpluses as well as the estimated costs of future financial challenges are meant to guide future policy and budget decisions.

POLICY IMPLICATIONS
City Finances and the Long Range Financial Plan are one of the Council’s Top 5 Priorities.

ENVIRONMENTAL REVIEW
This report does not require California Environmental Quality Act (CEQA) review.

ATTACHMENTS
Attachment 1: Long Range Financial Plan (Chapters 1-5)

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