TO: HONORABLE CITY COUNCIL

ATTN: FINANCE COMMITTEE

FROM: CITY MANAGER

DATE: DECEMBER 11, 2007

SUBJECT: UPDATE TO LONG RANGE FINANCIAL FORECAST

RECOMMENDATION
Staff recommends that the Finance Committee review and comment on the attached forecast of revenues, expenses, and reserve levels and forward it to the full Council.

DISCUSSION
Attached to this report is the updated General Fund Long Range Financial Forecast (LRFF) for the years 2007-08 through 2017-18. The LRFF identifies key issues that will guide the upcoming 2008-09 budget process and affect the City’s future financial condition.

This year the LRFF includes a discussion of the City Council Top 4 priority, “Sustainable Budget.” Some of the questions raised in an earlier report (CMR: 387:07) to the Finance Committee include: What are the City’s basic program and spending priorities; can the current level of expenditures continue and if not what costs can be reduced; are there new or additional revenue sources to be obtained; and should the City incur more debt to fund capital improvements?

In addition, this year’s LRFF includes brief, but informative information on the status of the Utility Enterprise Funds. This represents the first, small step toward a more comprehensive, citywide Long Range Financial Forecast.

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
The Long Range Financial Forecast is a tool for Council’s use in making policy decisions regarding the allocation of resources.
ENVIRONMENTAL REVIEW
This report is not a project under the California Environmental Quality Act (CEQA).

PREPARED BY:  

JOSE SACCIO  
Deputy Director

SHARON BOZMAN  
Senior Financial Analyst

DEPARTMENTAL HEAD APPROVAL:  

CARL YEATS  
Director, Administrative Services

CITY MANAGER APPROVAL:  

EMILY HARRISON  
Assistant City Manager

ATTACHMENTS
Attachment 1: Long Range Financial Forecast.
2008-18 Long Range Financial Forecast

is available on the City’s website at:


Booklets were originally part of the Council Packet of December 10, 2007.

Limited paper copies are available:

Administrative Services Department
4th Floor, City Hall
650-329-2692
TO: HONORABLE CITY COUNCIL

ATTN: FINANCE COMMITTEE

FROM: CITY MANAGER DEPARTMENT: ADMINISTRATIVE SERVICES

DATE: OCTOBER 16, 2007 CMR: 387:07

SUBJECT: DISCUSSION OF COUNCIL’S TOP 4 PRIORITY “SUSTAINABLE BUDGET”

RECOMMENDATION
Staff requests that Council review the report and provide comments.

BACKGROUND
In the past decade the City of Palo Alto has faced an array of difficult budget challenges, raising concerns and questions about the City’s long-term ability to support the variety and level of services it currently provides. It is out of these financial trials that the concept of a “sustainable” budget has emerged as a potential medium for solutions. Before reviewing these challenges, a definition of a “sustainable” budget is necessary.

A budget, by definition, is a plan that is designed to keep an entity’s expenditures within its available resources, i.e. spending within your means. By adding the word “sustainable,” the fundamental issue of what services and programs can be supported over a prolonged period of time is raised. In turn, this provokes questions such as:

- What are the City’s basic program and spending priorities now and in the future?
- How long can current expenditure patterns continue and what costs can be reduced or eliminated to achieve a balanced budget?
- Can current services and service levels be provided in a more efficient and cost-effective manner so as to maintain them?
- What revenue sources can be counted upon now and in the future and which are likely to decline?
- To what extent are the City and community able and willing to maintain and grow revenue resources when needed?
ENVIRONMENTAL REVIEW
This report is not a project under the California Environmental Quality Act (CEQA).

PREPARED BY: ____________________________
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ATTACHMENTS
Attachment 1: Long Range Financial Forecast.
A sustainable budget can be considered a spending plan that meets the needs of the present without compromising the ability to provide services to future generations. Such a budget would meet the challenge of funding current operational costs while at the same time funding incurred long-term liabilities.

Over the past 10 years, the City has faced several major financial challenges. These include:

- Financing and rehabilitating the City’s aging infrastructure
- Coping with the revenue shortfalls caused by the recession and dot-com bust of 2001
- Fixing a structural deficit caused by ongoing expenditures, e.g., health care costs that are rising at a greater rate than revenues
- Addressing and funding the retiree medical liability incurred by the City

In addition to these issues, the City has had to contend with State takeaways of revenue; the exodus of key revenue generators such as a hotel and car dealerships; growing competition from the Internet and surrounding big box stores and malls; and legal and regulatory threats to its revenue base.

The City has dealt with at least two major areas of liability that could have jeopardized a sustainable budget: infrastructure rehabilitation and retiree medical obligations.

Historically overlooked due to a recession in the early 1990s and due to a heavy emphasis on services in the operating budget, the City was compelled to ramp up infrastructure spending in the late 1990s. A General Fund Infrastructure Management Plan (IMP) finished in 1997, identified the need to spend $10 million annually for the next ten years to address a growing infrastructure backlog. Without the necessary and ongoing improvements to the streets, sidewalks, parks, buildings, and facilities, the ability of the City to deliver basic services would have been put at risk. Essentially, the City recognized a structural imbalance in its spending patterns and over the next ten years reallocated its resources.

Declaring infrastructure as one of its top priorities for several years, the City made progress in creating and funding a separate “Infrastructure Reserve” (IR) whose purpose was to sustain capital funding over time. It developed a policy whereby year end operating budget savings were channeled into the IR to keep it replenished. This policy helped to significantly increase the amount of spending on IMP infrastructure since 2000 when the funding level was $7.4 million compared to $12.3 million in 2006-07. When faced in recent years with steep increases in construction costs, expanding project scopes, and a draw on the IR for new projects, Council directed staff to identify an additional $3 million for capital spending. This was a “Top 3 Priority” in 2006. This was achieved through a combination of expenditure reductions and revenue enhancements and incorporated in the Adopted Budget for 2007-09. It is expected that the City will need to grow the $3 million each year to keep up with the growth in project construction costs.

Another long-term liability is the unfunded but earned retiree medical benefit. GASB 45 requires that local jurisdictions recognize, and hopefully fund, the costs of retiree medical benefits as they are incurred rather than when the premiums must be paid. Based on investment
of funds in a trust, an actuary has estimated the City's liability at $82.6 million. GASB 45's purpose is to avoid having an operating budget's services and programs suffocated by the growing and sizeable expense of a post employment benefit. The City of Palo has dealt with this major issue by developing a healthy retirement medical reserve and by indentifying funding in its operating budget to meet its annual required contribution. Moreover, the City is near to investing its reserve and contributions in a trust fund whose rate of return mitigates the impact of the overall liability.

In addition to long-term threats, there are short-term and cyclical events that endanger City resources or revenues. These range from the economic cycle to the exodus of major revenue generators, as well as State "takeaways" of revenue sources. Typically, the City deals with these occurrences by reducing expenditures to match lower revenue expectations. During the dot-com downturn, for example, the City's sales and transient occupancy taxes, which totaled $35.2 million in 2001-02, fell by a substantial $11.9 million or 33.8 percent over a two year period. This revenue swing represented a 9.5 percent drop of total budgeted revenues. The downturn, combined with a later realization that expenses such as health care were increasing at a faster rate than revenues, led to a series of painful and prolonged expenditure reductions. Since 2001, the City has pared its expenses by $20 million. This included the elimination of 70 positions.

**DISCUSSION**
The examples above provide evidence that the City has dealt with long-term, sustainable budget issues and that it is in the City's best interests to forecast and address long and short-term dislocations well in advance of their occurrence. To a considerable degree, the City's Long Range Financial Forecast (LRFF) identifies the principal expense and revenue trends and risks facing the City. It includes, for example, mention of increases in medical premiums and health care costs that are growing at a rate faster than inflation; anticipated losses of revenue such as rent when the landfill closes; and the potential impact of a recession. Although the LRFF cites opportunities and efforts underway to maintain and enhance the City's revenue base, it does not recommend strategies or a plan to maintain a viable, sustainable budget over the next decades given what is known today. Before outlining potential steps to develop a sustainable budget, a discussion of some major expense and revenue trends is important.

**Expenditure Trends**
Of all the expense trends facing the City, past and anticipated increases in health care costs are the most disquieting, as depicted in the graph below. As the LRFF states, "Medical premiums are expected to double by 2015, having grown by nearly 60 percent over the past seven years to $12.2 million." In 2006-07, health care costs represented 9.3 percent of the City's budget; by 2015 it is expected to grow to 14.9 percent of total expenses. With health care costs constituting a greater and greater share of national Gross Domestic Product, a similar and unsustainable development is occurring within the City.
The City has taken steps to address this rising cost. Being one of the few remaining jurisdictions to fully fund employee health insurance premiums and retiree medical costs, the City has placed a limit on its contribution to medical premiums for both active and retired employees. In addition, the City has raised its vesting requirement from 5 to 20 years to obtain health care coverage upon retirement. Given expected steep increases in health care costs, however, the City will need to curb expenses further. To achieve a sustainable budget, additional measures to share rising medical expenses with employees are necessary. Other jurisdictions are moving toward employee premium contributions and this practice is common in the private sector.

As the graph below shows, benefits costs in real terms have increased over the past five years. Salaries have fallen over the same period due to the reduction of positions.
In comparison, the public safety departments, Police and Fire, and community services (defined as the Community Services and Library departments) have grown or stayed constant in real dollar terms. In real dollars, the Police Department expenses have grown from $19.7 million in 2003 to $21.4 million in 2007, while the Fire Department expense has risen from $16.8 million to $17.8 million. The provision of community services has remained steady from $19.8 million in 2003 and $19.8 million in 2007.

The table below indicates the rate of change of functional expenditures over the last decade. Expenditures for public safety exhibit the most significant growth, while expenditures for administration show the most significant decline.

<table>
<thead>
<tr>
<th>General Fund Operating Expenditures: Average Annual Growth Rate</th>
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<tr>
<td>From 2004 to 2007</td>
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<tr>
<td>Admin</td>
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<tr>
<td>Public Works</td>
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<td>Public Safety</td>
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<td>CSD and Library</td>
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As a proportion of the City's budget, the public safety and community service functions have grown from 58.3 percent of the total in 1997 to 61.5 percent in 2007. These numbers make sense in light of the reductions made in the administrative departments, but it shows that if the City is to sustain its budget, difficult decisions may be necessary in areas that the public and Council see
Another way to approach expenditure growth is by analyzing expense trends by department. The graph below depicts the change in department expenditures in real dollars over the past five years. It shows that expenses in administrative departments (Administrative Services, Human Resources, City Manager, City Attorney, City Clerk, and City Auditor), or what is commonly termed City overhead, have dropped in real dollar terms from $17.5 million in 2003 to $13.1 million in 2007. This significant drop occurred since most of the cost reductions made over the past five years have been in administrative areas and management positions. This also suggests that there will be less flexibility in the future to pare expenses in these departments.
as “basic” services. This is especially important as the City endeavors to fund a new public safety building and library/community center facilities. In addition to the capital costs expected to be paid from General Obligation bonds, there will be incremental equipment, maintenance, and operating costs associated with these new facilities.

Revenue Trends
The City of Palo Alto is fortunate to have a diverse and well-balanced portfolio of revenue sources. As the following chart shows, no one revenue source exceeds 15 percent. The main sources of total City revenues are: sales tax at 15 percent; property taxes at 15 percent; charges for services (such as the Stanford fire contract) at 15 percent; operating transfers at 12 percent (including Utility equity payments); and rental income at 9 percent. Many jurisdictions rely heavily on a single source of revenue such as property, sales, or business license taxes, exposing them to extreme volatility when economic dislocations occur.

$139.7 Million / Adopted 2007-08

An economic downturn can result in a swift and steep decline in sales and TOT revenues. Events such as the current credit crisis and housing bubble can easily ripple down to the local economy, threatening consumer and business spending essential to the City's revenue base. Long-term threats such as increasing Internet sales (which are not taxed), the aversion to commercial growth and resulting traffic in the community, and retail competition are areas of concern. Legal and regulatory challenges such as telecommunication company objections to the
utilities users tax being paid on national plans could significantly erode over $2.4 million in annual revenue. The City must be agile in maintaining and enhancing its revenue sources just as it must be vigilant in managing its expenses.

Sustainable Budget Suggestions/Options
The City has been proactive in attempting to solve budget problems. City mayors have been active in maintaining and attracting businesses to Palo Alto. Significant efforts have been made to maintain automobile dealerships in Palo Alto; to make Palo Alto a destination point for business travel and tourism; and to work in concert with Stanford University to expand the Stanford University Shopping Center. The City also has engaged the business community in discussions about enhancing revenue sources such as the TOT by adding another 2 percent to the existing tax rate, which will generate additional revenue for the General Fund if approved. There has been very preliminary discussion of a Business Registry Fee and a Business License Tax (Palo Alto is one of the few cities in California that does not have this tax) that could lead to additional revenues either by expanding information on businesses within the City or a new tax. In terms of expenditures, the City typically has taken a conservative approach to issuing debt and to new program spending. General Fund debt is low compared to other jurisdictions.

From a staff perspective, the following complex issues need further analysis, discussion, and action:

- What are the City’s core non-discretionary services?
- Can these services be delivered in an alternative, cost-efficient manner that is equally or near to equally effective?
- What are the City’s discretionary services and how will they be prioritized?
- What framework will the City use to evaluate and fund new programs versus ongoing services?
- What is the optimal balance between infrastructure and operating expenses that will sustain the delivery of services?
- Should the City incur more debt for capital projects so as to spread the cost burden of improvements over current and future users? The City has generally used a conservative, pay-as-you go approach for capital projects.
- How can the City control expenditures growing at greater than inflation rates yet preserve core services?
- What opportunities does the City have to maintain and expand revenue sources when necessary?
- To what extent is the community willing to balance its desire for services and the revenues that support them with its desire to restrict business growth and its associated traffic impacts?
- What degree of risk is the City willing to incur as it seeks to control expenses?
- Can a meaningful dialogue be initiated with City employees and unions on sharing medical premium expenses?

These questions need serious attention to develop a sustainable budget plan.
There are no easy solutions to develop a sustainable budget. The City is in a sound financial position, but it faces numerous challenges. The “easy” reductions have been made in the first half of this decade; the difficult ones can be expected in the second half. Similar to the rebalancing of resources and priorities that the infrastructure effort required, a sustainable budget requires analysis, planning, fiscal discipline, establishing priorities, and a long-term vision.

Next Steps
This report presents initial concepts for consideration by the Finance Committee. Staff is requesting input from the Finance Committee on possible next steps to achieve a sustainable budget plan. With this input staff will further develop the concepts and components of a sustainable budget and include them in the Long Range Financial Forecast (LRFF). The LRFF will be reviewed with the Finance Committee in December and with the full Council in January. Based on this discussion with Council, elements of a sustainable budget can be included in the proposed 2008-09 budget that will be reviewed with the Finance Committee in May 2008.

RESOURCE IMPACT
This report is for informational purposes and does not have a resource impact.

POLICY IMPLICATIONS
This report addresses a Council “Top 4” Priority.

ENVIRONMENTAL REVIEW
Discussion of these general policy issues does not represent a project under California Environmental Quality Act (CEQA).

PREPARED BY:  
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Deputy Director

DEPARTMENT HEAD APPROVAL:  
CARL YEATS  
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CITY MANAGER APPROVAL:  
EMILY HARRISON  
Assistant City Manager
Chairperson Morton called the meeting to order at 7:02 p.m. in the Council Conference Room, 250 Hamilton Avenue, Palo Alto, California.

Present: Beeham, Klein, Morton (chair) arrived at 7:03 p.m., Mossar

Absent: None

1. Oral Communications

None.


**MOTION:** Council Member Beeham moved, seconded by Klein, that the Finance Committee recommend to the City Council to accept the financial statements submitted by Maze & Associates.

**MOTION PASSED** 4-0.

3. Recommendation Regarding Ordinance Closing the 2006-07 Fiscal Year, Including Reappropriation Requests, Closing Completed Capital Improvement Projects, Authorizing Transfers to Reserves and Approval of Comprehensive Annual Financial Report (CAFR)

**MOTION:** Council Member Beeham moved, seconded by Klein, that the Finance Committee forward the ordinance of Attachment A (associated exhibits) to the City Council to approve: the closure of the 2006-07 Fiscal Year, Including authorizing Reappropriation of 2006-07 funds in to the 2007-08 budget requests supported by Exhibits A and B; Closing Completed Capital Improvement Projects listed in Exhibit C; Authorizing Transfers remaining balances to Reserves and those being presented in Exhibits D and E; Approval of Comprehensive Annual Financial Report (CAFR),

12/11/07
MOTION PASSED 4-0.

4. 2006-07 Year End Capital Improvement Program Projects Status Report

   No action taken, Chairperson Morton advised that this report would be passed on to full council.

5. Update To Long Range Financial Forecast

   No action taken, Frank Benest said that he would take this to full Council for review and discussion.

6. Discussion for Future Meeting Schedules and Agendas
   December 18, 2007

ADJOURNMENT: The meeting adjourned at 8:33 p.m.