City of Palo Alto
City Manager's Report

TO: HONORABLE CITY COUNCIL
ATTN: FINANCE COMMITTEE
FROM: CITY MANAGER
DEPARTMENT: ADMINISTRATIVE SERVICES
DATE: DECEMBER 16, 2008
CMR: 467:08
REPORT TYPE: Discussion Report
SUBJECT: UPDATE TO LONG RANGE FINANCIAL FORECAST

EXECUTIVE SUMMARY
Attached to this report is the City’s updated General Fund Long Range Financial Forecast (LRFF) for fiscal years 2009 through 2019. The LRFF’s primary purpose is to identify key financial issues that will guide the upcoming Fiscal Year (FY) 2010 and 2011 budget process and that affect the City’s long-term financial condition.

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
As newspaper articles state repeatedly, the nation is facing its worst financial and economic crisis since the Great Depression. The National Bureau of Economic Research recently pronounced that the nation has been in a recession since December 2007. Rising unemployment, plummeting home sales and property values, credit tightening, and failing banks and businesses all point to a protracted and perhaps deep recession. In November 2008 alone, approximately 533,000 jobs were cut by employers nationwide, the highest number in 34 years. The national unemployment rate has risen to 6.7 percent.

Similarly, the State of California is mired deeply in financial crisis and economic disarray. Unemployment in the State has risen to 8.2 percent and is likely headed higher. The Governor and Legislature have a $28 billion deficit to solve. States and local jurisdictions throughout the country are struggling with sharply declining revenues and the need to reduce expenditures. Retirement portfolios have experienced steep losses posing potential, future increases in employer contributions. The City of Palo Alto and surrounding jurisdictions are not immune from the economic headwinds. As Stephen Levy, a prominent local economist, stated in the Palo Alto Weekly (October 17, 2008), “The idea that Palo Alto and Silicon Valley are protected from
the worldwide economic meltdown is poorly reasoned. Our local economy’s fate is connected to the fate of the national and world economies and financial markets.” This observation is proving accurate.

City of Palo Alto revenues, as well as those in nearby jurisdictions, are showing definite signs of stress. For example, hotel stays during the first quarter of FY 2009 were nearly 12,000 days below that of the prior year; automobile sales in the first quarter of FY 2009 were 12 percent or $230,000 lower than the prior year period; and documentary transfer taxes have been trending lower since the beginning of the fiscal year. In addition, county wide data shows a sharp slowdown in the rate of property value growth.

These developments and general economic conditions have led staff to lower General Fund revenue targets in the LRFF for this fiscal year and in FY 2010. Compared to the FY 2009 adopted budget, staff believes that total revenues must be adjusted downward by $2.8 million. The consequence of the revenue revisions is that a deficit of $2.6 million is anticipated this year, a deficit of $5.3 million in FY 2010, and consequent deficits could recur through FY 2014. Unless expenditure reductions or new revenues are added, the Budget Stabilization Reserve would fall to 9.7 percent of expenditures by the end of FY 2010, well below the minimum policy level of 15 percent. Staff is in the process of developing a plan to address these shortfalls which it intends to discuss with the Council shortly. Already the City Manager is instituting an aggressive position control process regarding new hires and has instructed departments to come up with budget reductions to close the FY 2009 budget gap.

After recently having reduced the General Fund budget by $20 million and 70 FTE during the dot.com bust, it is expected that upcoming reductions will be difficult. In light of the many challenges the City faces such as growing infrastructure rehabilitation needs; funding, staffing and maintaining new facilities; and rising benefit and labor costs, paring expenditures will require priority setting and a discussion of a Sustainable Budget.

Toward this end, staff has resurrected a report sent to the Finance Committee on a Sustainable Budget for discussion in October 2007 (CMR: 387:07). A copy of this report is attached to the LRFF and a summary of key points is provided below and in the LRFF document.

After the “dot.com” economic downturn, Council was concerned that the City could not continue to fund: the variety and level of services provided, a rising infrastructure backlog, the emerging need for new facilities, and growing employee benefit costs. When combined with the uncertainties of the economic cycle that can swiftly erode revenues, the necessity of creating and maintaining a sustainable budget became more urgent. Examples of expenditure trend data cited in the report supported the need to re-examine the City’s priorities. The report stated that “medical premiums are expected to double by 2015, having grown by 60 percent over the past seven years to $12.2 million.” It showed that as a consequence of eliminating a $20 million structural deficit caused by the dot.com collapse, administrative department expense “dropped in real dollar terms from $17.5 million in 2003 to $13.1 million in 2007.” In turn, this suggested, “that there will be less flexibility in the future to pare expenses in these departments.” As administrative expenses decreased, the services the public and Council view as basic services – police, fire and community services - grew as a percentage of the budget in real dollar terms.
They increased from 58.3 percent in 1997 to 61.5 percent in 2007. Reducing expenditures in these areas has proved difficult in the past, but may need to be considered in the future.

Implementing a sustainable budget raises a series of difficult questions and policy choices. Some of those raised in the 2007 report include:

- What are the City’s core non-discretionary services?
- What are the City’s discretionary services and how will they be prioritized?
- Can these services be delivered in an alternative, cost-efficient manner that is equally or near to equally effective?
- What degree of risk is the City willing to incur as it seeks to control expenses, particularly in the public safety budget?
- 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?
- 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 opportunities does the City have to maintain and expand revenue sources when necessary?
- Can a meaningful dialogue be initiated with City employees and unions on sharing benefit expenses?

In conclusion, the current economic environment is exerting downward pressure on the General Fund’s revenue resources. Although staff believes its revenue forecast is relatively conservative and reasonable, the severity of this recession may present additional challenges in the future. To prepare for this and other contingencies, corrections to this year’s budget and movement toward a sustainable budget for the future is recommended.

**RESOURCE IMPACT**

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

Staff will report on the first series of recommended budget reductions and other adjustments to the Finance Committee in February 2009 at the Midyear review, and continue with the FY 2010 and 2011 proposed budget process.

**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 does not constitute a project under Section 21065 of the California Environmental Quality Act (CEQA).
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City Manager

ATTACHMENTS
Attachment 1: CMR 387:08
Attachment 2: Long Range Financial Forecast.
ATTACHMENT 1

City of Palo Alto
City Manager's Report

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?
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 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.
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.
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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<tbody>
<tr>
<td>From 2004 to 2007</td>
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<tr>
<td>----------------------</td>
</tr>
<tr>
<td>-1.0%</td>
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<tr>
<td>From 2001 to 2007</td>
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<td>-0.8%</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
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).

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