Summary Title: Fiscal Years 2017 to 2026 General Fund Long Range Financial Forecast

Title: Fiscal Years 2017 to 2026 General Fund Long Range Financial Forecast
(Continued from March 14, 2016)

From: City Manager

Lead Department: Administrative Services

Recommendation
Staff recommends that the Council review, comment, and accept the Fiscal Year 2017 to 2026 General Fund Long Range Financial Forecast.

Executive Summary
The base Forecast and alternate scenarios provided below differ from those delivered to the Finance Committee (FC) on December 15, 2015 (Attachment A). This is a consequence of several factors:

- updated salary and benefit projections reflecting current estimates of negotiated compensation and benefit packages
- alternative assumption changes requested by the Finance Committee such as using a 3 percent cost increase for salaries in “out” years instead of 2 percent
- revised revenue projections based on updated and currently tracked levels
- most recent retirement assumptions provided by CalPERS
- current valuation numbers provided by the City’s Actuary and prior forecast numbers modified by staff

These modifications are explained in the relevant sections of the report.

The revised, base Fiscal Year (FY) 2017 to 2026 General Fund Long Range Financial Forecast (Forecast) projects a General Fund (GF) deficit of $0.64 million in FY 2017, a $0.20 million deficit in FY 2018, and a $0.08 million surplus in FY 2020. This contrasts with the December 5 Forecast which showed a GF surplus of $0.09 million in FY 2017, a shortfall of $0.63 million in FY 2018,
and a surplus of $0.9 million in FY 2020. The updated projection shows a financial shift downward as the City embarks on the FY 2017 budget process.

The methodology utilized in December remains the same. Revenues have been updated to reflect actual activity in FY 2016 and then are grown by the Compound Annual Growth Rates (CAGR) recommended by the Finance Committee. Base expenditures reflect FY 2016 costs changed for one-time items, midyear adjustments, and through any other actions taken by Council this FY. Out year expenditures are modified according to the assumptions outlined in this report.

The Forecast does not include:

- New staffing and program requests that will be considered in the FY 2017 Proposed Budget process
- One-time expenditures of $3.0 million approved in the FY 2016 Adopted Budget
- Cost implications that may arise in the FY 2017 Proposed Budget process such as: a shortfall in reimbursement from Stanford University for Fire services; support for the Parks Master Plan; and loans to the Palo Alto airport
- A shift of $2.4 to $2.7 million in annual streetlight and traffic signal costs from the Electric to General Fund as a consequence of State propositions

Since the new base Forecast reveals a projected deficit of $0.6 million in FY 2017, the addition of costs without offsets to expenditures or new revenues will intensify the shortfall in FY 2017 and affect out year results.

In addition, there are a number of longer-term financial challenges the GF still confronts. These include, for example:

- Rising pension and health care costs
- Funding long-term pension and retiree healthcare liabilities estimated at $439 million city-wide, of which $293 million is the General Fund share
- Funding Infrastructure Plan projects whose costs are rising above the original $126 million projection

Solid tax revenues and a strong local economy show a rebounding from the Great Recession. The GF has experienced a series of year-end surpluses (primarily due to one-time events) and is projected to end FY 2016 with a $3.1 million surplus. While these results are welcome, rising benefit and other costs diminish a more positive outlook over the next 10 years.

Since the December forecast, which cited upbeat economic indicators, several clouds have been hovering over the local, state, national and world economies making less clear the
direction they will take. These include: a severe drop in world stock markets, a stronger dollar weakening U.S. exports, further evidence of a slowing Chinese economy, sharply declining oil prices, and increased uncertainty about global growth. Economists appear to be evenly divided over the course of the economy with some citing strong employment data and rising wages while others are concerned about weaker corporate profits, lower exports, and looming interest rate hikes. Worried about the economy faltering, the Federal Reserve recently postponed two expected rate increases in 2016.

Staff has added two scenarios requested by the FC to the LRFF that have adverse impacts on the GF’s bottom line (see table below). These include: 1) a poorly performing PERS pension portfolio which Bartel and Associates defines as returns of between 0.2% and 4.1%; and 2) a scenario with 3 percent salary increases for out years. Compared to the base forecast, the PERS scenario shows significant deficits in FYs 2020-22 and declining surpluses thereafter. By using a 3 percent inflator for salaries, and as expected, more and higher deficits occur compared to the base year. The higher salary increase, however, is less onerous than the pension and recession outcomes (see below).

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</thead>
<tbody>
<tr>
<td>CalPERS Poor Investment Return</td>
<td></td>
<td>0</td>
<td>(642)</td>
<td>15</td>
<td>(668)</td>
<td>(1,883)</td>
<td>(2,051)</td>
<td>(1,595)</td>
<td>(46)</td>
<td>2,573</td>
<td>3,638</td>
<td>7,916</td>
</tr>
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<td>Cumulative Net Operating Margin</td>
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<tr>
<td>3 Percent Salary Growth</td>
<td></td>
<td>0</td>
<td>(642)</td>
<td>(199)</td>
<td>(118)</td>
<td>(1,016)</td>
<td>(732)</td>
<td>397</td>
<td>2,935</td>
<td>5,539</td>
<td>6,620</td>
<td>10,966</td>
</tr>
<tr>
<td>Cumulative Net Operating Margin</td>
<td></td>
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<tr>
<td>Base Forecast</td>
<td></td>
<td>-</td>
<td>90</td>
<td>(632)</td>
<td>880</td>
<td>508</td>
<td>1,335</td>
<td>2,836</td>
<td>5,591</td>
<td>8,157</td>
<td>9,739</td>
<td>12,681</td>
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<tr>
<td>Cumulative Net Operating Margin</td>
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</tbody>
</table>

Staff does understand the difficulty of forecasting a recession, but historical trends show that a downturn will occur during the term of this Forecast, especially since the country is nearly seven years into a recovery. By virtue of a recession’s unpredictability, local jurisdictions tend to react late to a downturn, so fiscal discipline and a focus on priorities is a recommended, proactive strategy.

For brevity purposes, staff has omitted much of the detailed background information that can found in the December 5 report (Attachment A). Focus is placed, instead, on the changes recommended by the Finance Committee, revised revenue and expense projections based on recent data, key assumptions, alternate scenarios to the base Forecast, and the financial challenges that lie ahead.
Forecast Discussion

As shown in the table below, the revised, base Fiscal Year (FY) 2017 to 2026 GF Long Range Financial Forecast (Forecast) projects a deficit of $0.64 million in FY 2017, a shortfall of $0.20 million in FY 2018, and surpluses ranging from $0.24 to $12.1 million in the remaining years of the Forecast (with a small exception in FY 2020). The bottom line results through 2021 could easily move downward if additional expenses are added to the base or if revenues underperform. As we move out from FY 2022, surpluses are more significant but are of less predictive value. Over the term of this updated Forecast, a $31.7 million cumulative surplus is projected.

This forecast does assume that the General Fund Budget Stabilization Reserve (BSR) is fully funded at the City Council approved target level of 18.5 percent.

### Fiscal Year 2017-2026 Long Range Financial Base Forecast

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</thead>
<tbody>
<tr>
<td><strong>Total Revenue</strong></td>
<td>$185,672</td>
<td>$193,953</td>
<td>$202,919</td>
<td>$211,814</td>
<td>$225,361</td>
<td>$232,916</td>
<td>$241,044</td>
<td>$249,421</td>
<td>$256,757</td>
<td>$265,564</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4.5%</td>
<td>4.7%</td>
<td>9.2%</td>
<td>7.6%</td>
<td>6.4%</td>
<td>6.7%</td>
<td>7.0%</td>
<td>7.1%</td>
<td>6.5%</td>
<td>6.5%</td>
<td>6.5%</td>
</tr>
<tr>
<td><strong>Total Expenditures</strong></td>
<td>$185,672</td>
<td>$194,594</td>
<td>$203,116</td>
<td>$211,035</td>
<td>$218,469</td>
<td>$225,124</td>
<td>$231,522</td>
<td>$237,091</td>
<td>$242,852</td>
<td>$249,079</td>
<td>$253,506</td>
</tr>
<tr>
<td></td>
<td>4.5%</td>
<td>4.4%</td>
<td>3.9%</td>
<td>3.5%</td>
<td>3.0%</td>
<td>2.8%</td>
<td>2.4%</td>
<td>2.4%</td>
<td>2.6%</td>
<td>1.8%</td>
<td>1.8%</td>
</tr>
<tr>
<td><strong>Net One-Time Surplus/(Shortfall)</strong></td>
<td>$0</td>
<td>($641)</td>
<td>($198)</td>
<td>$779</td>
<td>($76)</td>
<td>$238</td>
<td>$1,365</td>
<td>$3,563</td>
<td>$6,569</td>
<td>$7,678</td>
<td>$12,058</td>
</tr>
<tr>
<td><strong>Cumulative Net Operating Margin (One-Time)</strong></td>
<td>$31,755</td>
<td>$29,114</td>
<td>$19,227</td>
<td>$12,918</td>
<td>$6,351</td>
<td>$2,983</td>
<td>$1,618</td>
<td>$5,055</td>
<td>$7,527</td>
<td>$9,149</td>
<td>$12,058</td>
</tr>
<tr>
<td><strong>Net Operating Margin</strong></td>
<td>$0</td>
<td>($198)</td>
<td>$779</td>
<td>($854)</td>
<td>$313</td>
<td>$1,157</td>
<td>$2,558</td>
<td>$2,616</td>
<td>$1,109</td>
<td>$4,381</td>
<td>$4,381</td>
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<tr>
<td><strong>Cumulative Net Operating Margin</strong></td>
<td>$11,861</td>
<td>$11,663</td>
<td>$12,442</td>
<td>$12,780</td>
<td>$13,133</td>
<td>$14,290</td>
<td>$16,848</td>
<td>$19,464</td>
<td>$20,573</td>
<td>$24,954</td>
<td>$29,335</td>
</tr>
</tbody>
</table>

Assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures.

The table above includes a calculation for the net operating margin which reflects the year over year change of surpluses and shortfalls. With the net operating margin, it is assumed that each shortfall is addressed completely with ongoing solutions in the year it appears, and that each surplus is completely expended with ongoing expenditures. Based on these assumptions, the cumulative net operating margin, or ongoing surplus, during the forecast period is approximately $11.9 million, with the majority of these ongoing surpluses generated in the last five years of the Forecast.

Consistent with the prior year’s forecast, the methodology for calculating changes from FY 2017 to FY 2026 are based on historical trends or using a Compounded Annual Growth Rate (CAGR). This methodology is adjusted somewhat based on staff’s knowledge of known one-time events. By using the historical average growth rate that incorporates the up and down cycles over the past 10 or 20 years, there is no single year in which a downturn is depicted. Instead, past downturns (e.g. dot com bust and Great Recession) have been factored into the CAGR used to forecast future revenue streams. The CAGR approach tends to promote a positive forecast outlook since revenues are growing at a steady pace. For this reason, staff has generated a recession scenario (discussed below) beginning in the first half of Fiscal Year 2019.
For the past several years, the City has generated healthy surpluses which mainly consist of one-time items. In fact, staff is projecting a $3.1 million GF budget surplus for FY 2016. This surplus incorporates City Council authorized budget amendments to date and includes higher tax revenue estimates which are reflected in the 10 year Forecast. In addition, it contains all known expense increases such as pension rates from PERS and salary and benefit increases that have been authorized by Council for current negotiations with the City’s major bargaining units. What the Forecast does not include, however, are the following potential impacts, which can decrease or increase projected bottom line numbers in FY 2017 and beyond. They are:

1. Potential costs in excess of the Council approved $126 million Infrastructure Plan after full design; prevailing wage requirements; construction costs; and operating budget impacts from new facilities. The Public Safety Building and California Avenue Parking Garage are expected to exceed original estimates by up to $30 million.
2. Potential acquisition of the downtown Palo Alto Post Office with associated operating expenses.
3. Parks Master Plan expenditures to be determined in FY 2016.
4. Operating and capital costs related to a new Junior Museum and Zoo facility.
5. Capital costs related to City assets managed by non-profits such as Avenidas Senior Center, the Palo Alto History Museum, and the Ventura Child Care Center.
6. Cubberley Community Center Master Plan expenses in excess of the dedicated Cubberley infrastructure funding as agreed to between the School District and the City.
7. Construction and operating expenditure loans for the Palo Alto Airport.
8. Potential loss in revenue from Stanford University for Fire services if there are no offsetting cost reductions. In FY 2016, a one year extension of the contract was approved at $6.5 million which reflected a $675,000 reduction in revenues as outline in CMR # 6502.
9. The Cadillac Healthcare Federal Excise Tax which was delayed with an expected to impact in calendar year 2020.
10. Future changes to pension plan assumptions by CalPERS.
11. CalPERS City contribution increases. This Forecast assumes CalPERS will meet its annual investment return goal of 7.5%. An alternative Forecast which assumes a poor investment return for the next ten years is provided below at the request of the FC.
12. Higher Transient Occupancy revenues related to two new hotels opening on San Antonio Road.
14. Ongoing labor negotiation changes.
15. Golf Course construction and operating cost updates (previous estimate was based on 2012 costs).
16. Updated retiree medical annual payment and Unfunded liability (Bartel currently updating)

Since the Great Recession, the City Council has approved various strategies to mitigate the rising cost of salaries and benefits. These include:

1. Employees paying their own CalPERS contribution (between 6 percent to 9 percent of salary) except for the members of the Fire Chiefs’ Association
2. Sharing future health plan cost increases
3. Creating a second pension tier that was followed by State implementation of a third tier effective January 1, 2013
4. Reducing professional development expenses
5. Freezing cost of living freezes for four years
6. Terminating the Variable Management Compensation Plan

With the above actions, Council has reduced base costs and curbed the growth trajectory of future costs related to pensions and medical care. The same, proactive stewardship may be needed as the City deals with the potential costs cited above and a recession. A potential solution is to have labor groups share in the cost of the City's or employer pension contribution. Council has directed staff to explore options in the current labor negotiations.

The following sections present analysis and assumptions for the major revenue and expenditure categories in the forecast. Based on new revenue data and input from the FC, staff has revised several projections.

Revenues
City of Palo Alto tax revenues continue to parallel a strong local economy. Robust residential and commercial property values, business driven transient occupancy and daily rates, and the emergence of new hotels have propelled key revenue sources upward since Fiscal Year 2013. Economic drivers such as low unemployment, strong incomes, vibrant business activity, and demand for Palo Alto property should continue to buttress revenue in the near future.

The tables below highlight annual revenue projections and year over year percentage increase assumptions in the Forecast. Compared to FY 2016 Adopted Budget total sources of revenue are expected to increase by 4.1 percent or $7.8 million in FY 2017. Principal contributors to this growth come from property and transient occupancy taxes.
Fiscal Year 2017-2026 Long Range Revenue Forecast

### Total Source of Funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Source of Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$145,672</td>
</tr>
<tr>
<td>2017</td>
<td>$150,231</td>
</tr>
<tr>
<td>2018</td>
<td>$159,953</td>
</tr>
<tr>
<td>2019</td>
<td>$202,919</td>
</tr>
<tr>
<td>2020</td>
<td>$214,814</td>
</tr>
<tr>
<td>2021</td>
<td>$218,383</td>
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<tr>
<td>2022</td>
<td>$225,361</td>
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<tr>
<td>2023</td>
<td>$232,016</td>
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<tr>
<td>2024</td>
<td>$240,404</td>
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<tr>
<td>2025</td>
<td>$249,421</td>
</tr>
<tr>
<td>2026</td>
<td>$256,767</td>
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### CAGR 10 Years

<table>
<thead>
<tr>
<th>2016-2026</th>
<th>2.5%</th>
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</thead>
<tbody>
<tr>
<td>2017-2026</td>
<td>2.0%</td>
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<tr>
<td>2018-2026</td>
<td>4.4%</td>
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<tr>
<td>2019-2026</td>
<td>4.4%</td>
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<tr>
<td>2020-2026</td>
<td>3.1%</td>
</tr>
<tr>
<td>2021-2026</td>
<td>3.2%</td>
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<tr>
<td>2022-2026</td>
<td>3.4%</td>
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<tr>
<td>2023-2026</td>
<td>3.5%</td>
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<tr>
<td>2024-2026</td>
<td>3.5%</td>
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<tr>
<td>2025-2026</td>
<td>2.9%</td>
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<tr>
<td>2026-2026</td>
<td>3.4%</td>
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</table>

### Revenue & Other Sources

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Adopted</th>
<th>Projected</th>
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</thead>
<tbody>
<tr>
<td>2016-2026</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales Taxes</td>
<td>$27,630</td>
<td>$25,780</td>
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<tr>
<td>Property Taxes</td>
<td>35,067</td>
<td>35,074</td>
</tr>
<tr>
<td>Transient Occupancy Tax - General Purpose</td>
<td>13,366</td>
<td>15,317</td>
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<tr>
<td>Transient Occupancy Tax - Infrastructure</td>
<td>5,025</td>
<td>9,232</td>
</tr>
<tr>
<td>Documentary Transfer Tax</td>
<td>6,685</td>
<td>7,050</td>
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<tr>
<td>Utility Users Tax</td>
<td>11,389</td>
<td>10,495</td>
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<tr>
<td>Other Taxes and Fines</td>
<td>2,180</td>
<td>2,180</td>
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<tr>
<td><strong>Total Non-Tax Revenue</strong></td>
<td>$51,405</td>
<td>$57,080</td>
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<td><strong>Revenue &amp; Other Sources</strong></td>
<td>$125,597</td>
<td>$140,668</td>
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### Charges for Services

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<thead>
<tr>
<th>Fiscal Year</th>
<th>Adopted</th>
<th>Projected</th>
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</thead>
<tbody>
<tr>
<td>2016-2026</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stanford Fire &amp; Dispatch Services</td>
<td>7,823</td>
<td>6,983</td>
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<tr>
<td>Permits and Licenses</td>
<td>8,211</td>
<td>8,670</td>
</tr>
<tr>
<td>Return on Investments</td>
<td>824</td>
<td>840</td>
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<tr>
<td>Rental Income</td>
<td>15,296</td>
<td>15,015</td>
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<tr>
<td>From Other Agencies</td>
<td>373</td>
<td>373</td>
</tr>
<tr>
<td>Charges to Other Funds</td>
<td>11,930</td>
<td>11,930</td>
</tr>
<tr>
<td><strong>Total Source of Funds</strong></td>
<td>$145,672</td>
<td>$150,231</td>
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</table>

### Operating Transfers-In

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Adopted</th>
<th>Projected</th>
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</thead>
<tbody>
<tr>
<td>2016-2026</td>
<td></td>
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</tr>
<tr>
<td>BSR Contribution (One-Time)</td>
<td>18,589</td>
<td>18,589</td>
</tr>
<tr>
<td><strong>Total Source of Funds</strong></td>
<td>$145,672</td>
<td>$150,231</td>
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</tbody>
</table>

### BSR Operating Loss Reserve Liquidation

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Adopted</th>
<th>Projected</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016-2026</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Source of Funds</strong></td>
<td>$145,672</td>
<td>$150,231</td>
</tr>
</tbody>
</table>

City of Palo Alto
The graph below depicts historical performance and base model projections for the five major General Fund tax revenues. It includes 10 years of actual revenue history; projections for FY 2016 based on actual year-to-date data; and projections for FY 2017 through FY 2026.

Per 2013 Finance Committee discussions and recommendations, staff has used historical, CAGR data to forecast revenues. The rates utilized are shown at end of table above and discussed in the tax revenue categories. In addition, analysis of other major revenue sources is presented.

**Sales Tax**
Sales taxes have risen from a low of $17.9 million in FY 2010 to a projected level of $28.4 million in FY 2016. Staff has factored into the forecast weakening receipts over the past several years from a few key generators as well as a drop-off in one-time use tax receipts from the Stanford Hospital construction projects. The latter change was discussed during the December 5 Finance Committee meeting.

Staff remains concerned about the ongoing movement of tangible good purchases from brick and mortar stores to online vendors. This poses an important long-term threat. Evidence of this erosion was reported in a December 1, CNBC article, “According to the Adobe's Digital Index, total online sales on Cyber Monday rose 16 percent compared to last year, to $3.07 billion.” The article goes on to say that in-store data “showed sales were down an estimated 10.4 percent over Black Friday weekend” compared to the prior year.

As reported to Council, there was a one-time tax windfall from one vendor in FY 2014 and a Government Accounting Standards Board tax accrual adjustment in FY 2015. In each year, sales
tax was reported at $29 million. As shown below, the FY 2016 and FY 2017 projections return to a more realistic level in 2017. Restaurant and auto sales are trending higher, while department store and electronic firm sales are trending lower. The State will terminate its “triple flip” program this Fiscal Year so the City will receive more timely payments.

<table>
<thead>
<tr>
<th>TABLE 1: SALES TAX REVENUE BY FISCAL YEAR (MILLIONS)</th>
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</thead>
<tbody>
<tr>
<td>Fiscal Year</td>
</tr>
<tr>
<td>Revenue</td>
</tr>
</tbody>
</table>

The CAGR applied to the period FY 2016 through FY 2025 is 2.5 percent which is in line with historical growth rates.

**Property Tax**

As the table below shows, since FY 2012 property taxes have risen substantially. Staff projects this source to grow at a 6.0 growth rate next ten years which is in line with historical trends. Recent and large purchases along Page Mill Road and in the Stanford Research Park as well as an acquisition of Epiphany Hotel ($71.6 million) evidence a compelling commercial real estate market. Other contributing factors include: single family home sales that have exceeded asking prices and the unleashing of latent property values from the sale of long held homes that were “shielded” from assessed value appreciation by Proposition 13.

<table>
<thead>
<tr>
<th>TABLE 2: PROPERTY TAX REVENUE BY FISCAL YEAR (MILLIONS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal Year</td>
</tr>
<tr>
<td>Revenue</td>
</tr>
</tbody>
</table>

The City’s property tax estimate for FY 2016 is based on quarterly information from the Santa Clara County Assessor’s Office. Projections beyond FY 2016 are based on a 5.7 percent growth rate consistent with the CAGR derived from historical data. Of note are the recent one-time payments of excess ERAF funds to the City amounting to some $0.9 million in FY 2015 and an estimated $0.9 million FY 2016. These are anticipated to end when property value increases are less heated.

In FY 2015, the Administrative Services Department contracted with a firm to produce detailed reports on property taxes. The consultant’s reports have provided key insights into Palo Alto’s real estate market that supports property taxes growing at around 5-6 percent per year, including:

**Transient Occupancy Tax (TOT)**

Transient Occupancy Taxes continue to perform exceptionally well. Average daily room rates and occupancy levels continue to demonstrate considerable strength since FY 2011. Generally, occupancy levels between 80 and 85 percent indicate full occupancy. Current, average room
rates have reached an elevated level. A vibrant business environment has led to a surge in hotel bookings from San Francisco down through the Peninsula to San Jose.

**TABLE 3: TRANSIENT OCCUPANCY TAX BY FISCAL YEAR (MILLIONS)**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016*</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Purpose Revenue</td>
<td>$9.7</td>
<td>$10.8</td>
<td>$12.3</td>
<td>$13.4</td>
<td>$14.3</td>
<td>$15.1</td>
</tr>
<tr>
<td>Infrastructure Revenue</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>$3.3</td>
<td>$7.7**</td>
<td>$8.0**</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$9.7</td>
<td>$10.8</td>
<td>$12.3</td>
<td>$16.7</td>
<td>$22.0</td>
<td>$23.1</td>
</tr>
<tr>
<td>Average Daily Room Rate</td>
<td>$165</td>
<td>$182</td>
<td>$208</td>
<td>$208</td>
<td>$250</td>
<td>N/A</td>
</tr>
<tr>
<td>Average Occupancy (percent)</td>
<td>79%</td>
<td>80%</td>
<td>79%</td>
<td>79%</td>
<td>75%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

* Projected revenue based on trend and FY 2016 year-to-date data. Average Daily Room and Occupancy rates are year-to-date through January 2016.

**These revenue figures are lower than in the December 5 forecast due to a miscalculation. The new and lower numbers are reflected in the forecast.

This forecast includes estimated revenues for the Epiphany, the two new Hilton hotels, and the Westin Annex expected to open sometime this Fiscal Year. Revenues from the two new hotels planned for San Antonio Road are not incorporated.

Receipts from the 2.0 percent TOT increase and from new hotels dedicated to infrastructure are shown as a combined line item in the table above. The CAGR applied to the period FY 2016 through FY 2026 is 3.0 percent which is lower than the 4.5 percent used in prior forecast. Staff believes that the current, elevated occupancy and room rates have resulted in a revenue base that will be difficult to grow by 4.5 percent in out years.

*Documentary Transfer Tax (DTT)*

After two solid years of unusually strong performance, the Documentary Transfer Tax will likely regress toward more normal levels in FY 2016. Although mid-January 2016 receipts are running 8.1 percent above the prior year, it is unlikely remaining revenue streams will equal the sizable, one-time transactions in the second half of last FY. During that period, there were $1.4 and $3.6 million receipts, primarily due to Hudson Pacific purchases of office space along the Page Mill corridor. Such acquisitions are unlikely to be duplicated in FY 2016.

Based on current activity, staff expects $7.1 million in FY 2016 with a mild uptick in FY 2017 to $7.5 million.

**TABLE 4: DOCUMENTARY TRANSFER TAX BY FISCAL YEAR (MILLIONS)**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$4.8</td>
<td>$6.8</td>
<td>$8.1</td>
<td>$10.1</td>
<td>$7.1</td>
<td>$7.5</td>
</tr>
</tbody>
</table>
The CAGR applied to the period FY 2016 through FY 2026 is 5.9 percent, again, in line with prior year CAGR trends.

**Utility Users Tax (UUT)**

The Utility Users Tax forecast includes a 5 percent tax on water, gas and electric usage and a 4.75 percent tax on telephone activity. In FY 2015, the step down tax for large users of utilities was eliminated.

Receipts anticipated from the UUT are based on the Utilities’ five-year revenue and rate projections. These estimates can change as the department presents its proposed rate plan to the Finance Committee and City Council during the budget process. With the drought and heightened water conservation efforts as well as lower gas prices and consumption, the utilities UUT is expected to decline from FY 2015 to FY 2016. Revenues in FY 2015 registered at $7.6 million and these are expected to drop to $7.1 million in FY 2016. Upward movement in revenues to $7.8 million is anticipated in FY 2017 with proposed rate increases.

Telephone receipts have been increasing marginally since FY 2014 and are expected to continue the same trend despite the drop of 0.25 percent in the telephone UUT. Starting January 1, 2016, the City will be collecting new UUT revenue on pre-paid wireless cards and phone plans. This effort is being implemented via a State program. With no actual data, a modest revenue guesstimate has been included in the Forecast. Telephone revenue is expected at $3.4 million in FY 2016 and to move slightly higher in 2017.

Total UUT revenues are projected at $10.5 and $11.2 million in FY 2016 and FY 2017, respectively.

**Other Taxes & Fines**

Based upon a review of historical collection patterns, budgeted revenue estimates will need to be reduced as part of the FY 2017 Proposed Operating Budget. As such, this forecast assumes a reduction of 7.2 percent, primarily attributable to lower parking violations and library fines. In the remaining years of the forecast, revenues are anticipated to increase between 2.7 and 4.9 percent.

**Charges for Services**

For FY 2017, total revenues in this category (excluding Stanford Fire & Dispatch Services) will decrease by 4.9 percent or $0.9 million compared to the FY 2016 Adopted Budget of $17.6 million. Factored into the revenue projection are one-time adjustments approved as part of the FY 2016 Adopted Budget. In addition, major components of this category are Golf Course receipts, Development Services fees, and outlined below are payments from Stanford University for fire and dispatch services of which a number of these areas present financial issues.
Golf Course revenues are decreased by approximately $0.6 million from the FY 2016 Adopted budget due to an anticipated closure for renovation beginning in FY2017 and returning to full operational status by FY2019. This significant change from a reduction in revenues to sizeable increases is a direct reflection of the anticipated opening of the golf course with growth of 9.0 percent in FY2018 and 12.5 percent in FY2019. These declines and subsequent increases in revenues are offset by changes in contract services expenses associated with operating the Golf Course. Since the State Water Board has not issued a required permit, it is unknown when construction on the course will begin, however, at the time of the printing of this report it is anticipated July 2016. As more information is refined, the anticipated revenue and expenditure implications will be factored into the development of the FY 2017 Proposed Operating Budget. Additional significant changes from the FY 2016 Adopted Budget reflect the technical correction of removing $0.3 million in estimated revenue for Fire Department plan check permits. As part of the FY 2015 Budget when the Development Services Department was created, these revenues were inadvertently budgeted both as part of the Development Services Department as well as the Fire Department. This change to eliminate the double budgeting of these revenues was also reflected in the FY 2016 Mid-Year Budget Review.

Stanford Fire and Dispatch Service Charges
On October 8, 2013, the City received a Notice of Termination letter from Stanford with the intention to terminate the contract with the City no sooner than one year and no later than two years from the date of the notice. During the termination period as well as in the past few months, the City continued to negotiate with Stanford to settle on a service level and cost. As outlined in CMR #6505 Stanford Fire Agreement 3rd Amendment, the Third Amendment provides for continuation of fire services for one year at a fixed fee of $6.5 million, while allowing the time needed to facilitate negotiation of financial terms for a new long term agreement. This Forecast assumes a Stanford payment at $8.3 million for Office of Emergency Services and fire services (excluding both Capital and vehicle reimbursements) and $0.7 million for Public Safety Dispatch Services a net reimbursement of $9.0 million. The $8.3 million reimbursement assumes the previous contract calculation, of 30.3% of the operating budget. Stanford and the City are in a mediation process to determine appropriate reimbursement for City fire services. Depending on the outcome of mediation significant adjustments to the assumed reimbursement level of fire services in the General Fund may be necessary.

Permits and Licenses
Revenue from permits and licenses has experienced consistent growth over the past several years. This results from increased development activity in the City. Based on year-to-date estimates, FY 2016 revenues are projected to reach the Adopted Budget revenue estimate of $8.2 million. In FY 2017, revenues in this category are expected to increase 5.6 percent. This is consistent with projected increases in salary and benefits which are a major component of the fees and cost recovery. Remaining years in the forecast assume 2.6 percent cost growth annually, consistent with the modeled growth in personnel costs. As stated in the FY 2016 Adopted Budget, the Planning and Community Environment and Development Services
departments are reviewing their cost recovery levels. Upon completion of this analysis, staff will evaluate changes in fees and then recommend adjustments to Council.

Rental Income
The largest source of rental income comes from the City’s Enterprise Funds and the Cubberley Community Center. Compared to the FY 2016 Adopted Budget, rental income will decrease from $15.3 million to 15.0 million in FY 2017. The decrease includes a projected loss of $500,000 in rental income due to Foothill College’s departure from Cubberley, however, at the time of the printing of this report, it is anticipated that the departure timeline will be slightly accelerated compared to these assumptions. Staff will pursue and recommend replacement tenants to offset this significant loss. The Forecast does assume that by Fiscal Year 2018 Cubberley will have new, paying tenants that increase income by $200,000. The Forecast’s out years assume 2.6 percent growth for all rental properties except for Refuse Fund rent which has been set by Council until FY 2021 to cover closing costs.

Charges to Other Funds
Approximately 86 percent of this category is General Fund administrative cost plan charges to the Enterprise and Internal Service Funds. Internal support departments such as ASD, HR, and Council Appointees provide services to these funds. The charges for Fiscal Year 2017 are determined based on actual services provided in Fiscal Year 2015. The FY 2017 projected amount is $11.5 million, a decrease of 3.2 percent, from the FY 2016 Adopted Budget. This is attributable to internal support departments providing more support to General Fund departments in Fiscal Year 2015. The forecast includes increases ranging between 2.6 to 4.9 percent each year based primarily on assumed increases in salary and benefit costs.

Operating Transfers In
Operating Transfers principally consist of equity transfers from the Electric and Gas funds. In accordance with a methodology approved by Council in June 2009, the equity transfer is calculated by applying a rate of return to the capital asset base of the Electric and Gas funds. Using the Utility Department’s projections from the Electric and Gas Five Year Financial Forecasts, the equity transfer from the Electric and Gas funds are projected to increase from $17.3 million in FY 2016 to $18.8 million in FY 2017 (8.4 percent); and then increase annually by 2.3 percent over the forecast period. The higher increase in FY 2017 reflects updated Gas Fund capital asset data while the subsequent years reflect the average annual adjustment in the equity transfer since 2009. Overall Operating Transfers are estimated to increase to $20.1 million in FY 2017, an increase of $1.5 million from the 2016 Adopted Budget level of $18.6 million.

Expenditures
In developing the FY 2017 Forecast expenditure budget, expenditure categories have been adjusted by removing FY 2016 Adopted Budget one-time expenditures and updating major cost elements such as salary and benefits costs. The tables below display the General Fund expense
Salary and Benefits

The table above depicts the salaries and benefits costs for the next ten years. Over the Forecast period, the salaries and benefits cost gradually increase as a percentage of the total expenditure budget. In FY 2017, salaries and benefits costs represent 61.3 percent of the total use of funds budget while in FY 2026, the same costs represent 62.4 percent of the budget. During the same period, benefit costs as a percentage of total salaries and benefits costs increase from 40.4 percent in FY 2017 to 43.6 percent in FY 2026. This is compared to the FY2016 Adopted Budget which reflects benefits of 50.3 percent of total salaries and benefits. Over the Forecast period (from FY2017 to FY2026), salaries and benefits are projected to grow approximately an average of 3.5 percent annually. This compounded growth is less than that estimated in the prior year Forecast due to lower estimated City pension contributions in the out-years of the Forecast. The reason for this change is discussed in more detail below. The following sections describe the assumed increases in salary and benefits costs and depict the reasons for the faster increasing benefits versus salaries costs.

Fiscal Year 2017-2026 Long Range Expenditure Forecast

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</thead>
<tbody>
<tr>
<td>Total Use of Funds</td>
<td>N/A</td>
<td>1.9%</td>
<td>2.8%</td>
<td>4.4%</td>
<td>3.9%</td>
<td>3.5%</td>
<td>3.0%</td>
<td>2.8%</td>
<td>2.4%</td>
<td>2.4%</td>
<td>2.6%</td>
<td>1.8%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Expenditures &amp; Other Uses</td>
<td>N/A</td>
<td>0.6%</td>
<td>27.5%</td>
<td>3.8%</td>
<td>3.0%</td>
<td>2.8%</td>
<td>2.6%</td>
<td>2.3%</td>
<td>2.2%</td>
<td>2.2%</td>
<td>2.3%</td>
<td>2.2%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Transfer to Infrastructure - TOT</td>
<td>N/A</td>
<td>0.6%</td>
<td>27.5%</td>
<td>3.8%</td>
<td>3.0%</td>
<td>2.8%</td>
<td>2.6%</td>
<td>2.3%</td>
<td>2.2%</td>
<td>2.2%</td>
<td>2.3%</td>
<td>2.2%</td>
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</tr>
<tr>
<td>Total Non Sal/Ben Before Transfers</td>
<td>50,314</td>
<td>50,314</td>
<td>49,027</td>
<td>51,236</td>
<td>52,689</td>
<td>53,613</td>
<td>55,099</td>
<td>56,442</td>
<td>57,884</td>
<td>59,395</td>
<td>60,946</td>
<td>62,539</td>
<td></td>
</tr>
<tr>
<td>Operating Transfers-Out</td>
<td>18,634</td>
<td>18,634</td>
<td>18,634</td>
<td>18,634</td>
<td>18,634</td>
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<td></td>
</tr>
<tr>
<td>Benefits</td>
<td>N/A</td>
<td>-6%</td>
<td>-13%</td>
<td>5.6%</td>
<td>7.0%</td>
<td>6.7%</td>
<td>4.3%</td>
<td>3.9%</td>
<td>2.8%</td>
<td>2.5%</td>
<td>3.0%</td>
<td>0.2%</td>
<td></td>
</tr>
<tr>
<td>Benefits</td>
<td>N/A</td>
<td>-6%</td>
<td>-13%</td>
<td>5.6%</td>
<td>7.0%</td>
<td>6.7%</td>
<td>4.3%</td>
<td>3.9%</td>
<td>2.8%</td>
<td>2.5%</td>
<td>3.0%</td>
<td>0.2%</td>
<td></td>
</tr>
</tbody>
</table>

City of Palo Alto
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Salary
The City is currently in negotiations with all of its major labor units. The base Forecast includes projected costs for salary and benefits increases reflecting the current status of negotiations and by 2 percent in the out years. The Forecast also assumes step increases consistent with applicable MOUs and merit increases for Management and Professional employees. As requested by the Finance Committee a scenario with 3 percent growth in the out years can be found later in this report.

Benefits
Pension
The Forecast includes pension rates from CalPERS as of the June 30, 2014 valuation for the City’s Miscellaneous and Safety plan and as updated by Bartel Associates (Bartel), the City’s actuary. Staff asked Bartel to update the pension rates based on the latest available information from CalPERS based on the actuarial valuations as of June 30, 2014 which became available at the start of the year. CalPERS releases the latest valuation, staff updated the pension costs for the Fiscal Year 2017 through FY 2022 budget and in the out years of the forecast period used Bartels assumed rate of growth on CalPERS rates. In the December 2015 Forecast, staff relied on the figures from Bartel based on the latest information at that time. Once

As shown in the table below, the FY 2017 pension contribution rates for the Miscellaneous and Safety plans, increased from the current year. For the Miscellaneous Plan, the projected pension contribution rate increase is 1.2 percentage points from the FY 2016 rate of 27.7 percent to a FY 2017 rate of 28.9 percent reflecting growth of approximately 4%. For the Safety Plan, the projected pension contribution rate increase is 3.5 percentage points, from the FY 2016 rate of 41.9 percent to a FY 2017 rate of 45.4 percent. The table below shows the pension contribution rates from FY 2018 through FY 2026.

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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Miscellaneous</td>
<td>27.7%</td>
<td>28.9%</td>
<td>31.0%</td>
<td>33.1%</td>
<td>35.2%</td>
<td>35.9%</td>
<td>36.4%</td>
<td>36.2%</td>
<td>36.0%</td>
<td>35.8%</td>
<td>32.6%</td>
</tr>
<tr>
<td>Safety</td>
<td>41.9%</td>
<td>45.4%</td>
<td>48.8%</td>
<td>52.1%</td>
<td>55.5%</td>
<td>56.4%</td>
<td>57.3%</td>
<td>56.9%</td>
<td>56.5%</td>
<td>56.0%</td>
<td>55.7%</td>
</tr>
</tbody>
</table>

The City pension contribution rates assumed in this Forecast are substantially lower for the last few years of the Forecast period than assumed in the prior year Forecast due to a change in methodology for projecting the rates. Last year, staff used a linear extrapolation of rate increases provided by CalPERS during the first four years (CalPERS only provides rates for five fiscal years). This year, staff asked Bartel and Associates to provide a projection of the City Contribution rates as presented to the Finance Committee in November. To illustrate the impact of this change in methodology, the last Forecast assumed for FY 2025 a 42.6% City contribution rate for Miscellaneous employees and a 64.3% City contribution rate for Safety
employees. The lower City contribution rates for this Forecast resulted in lower overall projected benefits costs.

The CalPERS Board recently approved a “de-risking” policy of its investment portfolio in order to reduce the assumed investment return of 7.5 percent to 6.5 percent over a 20 year period. With this policy, CalPERS will only reduce the investment return assumption in years with investment returns higher than 11.5 percent in intervals and with annual caps. The Board, however, is scheduled to revisit this policy in February 2018. Whenever the assumed investment return is lowered, it typically results in higher City contribution rates and costs.

Retiree Healthcare

This Forecast includes the Annual Required Contribution (ARC) per the May 2014 actuarial valuation based on information as of June 30, 2013, (accepted by the City Council on June 9, 2014) for the City’s retiree healthcare plan and as updated by Bartel. Bartel’s update to the last actuarial valuation assumes the latest CalPERS mortality rate assumptions, incorporates the investment gain for the Retiree Healthcare Trust Fund as of June 30, 2015, and assumes a lowering of the assumed investment return assumption from 7.61% to 7.25%. Currently, Bartel is preparing the Retiree Healthcare valuation as of June 30, 2015. Staff will incorporate the findings of the valuation as part of the FY 2017 Proposed Budget as appropriate.

The table below details Bartel’s estimate for the City’s annual Retiree Healthcare contribution by the General Fund and all other funds for the next ten years.

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>General Fund</td>
<td>$10.0</td>
<td>$10.9</td>
<td>$11.2</td>
<td>$11.6</td>
<td>$12.0</td>
<td>$12.4</td>
<td>$12.8</td>
<td>$13.2</td>
<td>$13.6</td>
<td>$14.0</td>
<td>$14.5</td>
</tr>
<tr>
<td>Non-General Funds</td>
<td>$4.8</td>
<td>$5.2</td>
<td>$5.4</td>
<td>$5.6</td>
<td>$5.8</td>
<td>$5.9</td>
<td>$6.1</td>
<td>$6.3</td>
<td>$6.6</td>
<td>$6.8</td>
<td>$7.0</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$14.8</td>
<td>$16.1</td>
<td>$16.6</td>
<td>$17.2</td>
<td>$17.8</td>
<td>$18.3</td>
<td>$18.9</td>
<td>$19.5</td>
<td>$20.2</td>
<td>$20.8</td>
<td>$21.5</td>
</tr>
</tbody>
</table>

On June 9, 2014, City Council accepted the Retiree Healthcare Plan GASB 45 Actuarial Valuation as of June 30, 2013 and approved full funding of the Annual Required Contribution (ARC) for Retiree Healthcare for FY 2015 and FY 2016. As documented in the report (CMR #4891), which recommended approval of full payment of the ARC, the primary reason for the increased ARC was the inclusion of a new actuarial standard regarding the implied subsidy of healthcare premiums of active employees in relationship to healthcare premiums for retirees. The implied subsidy for FY 2015 was $1.9 million for all funds.

In preparing the FY 2015 CAFR, staff worked closely with the City’s actuary, the managers of the City’s trust fund for Retiree Healthcare, and the City’s external auditor concerning the implied subsidy in the Retiree Healthcare Fund. After many discussions, staff realized that the implied subsidy budgeted in the Retiree Healthcare Fund should have been budgeted as a contribution from the City’s healthcare premiums for active employees. However, the FY 2015 budget had fully funded the City’s healthcare premiums of approximately $17.4 million for active...
employees. Therefore, the cost of healthcare premiums related to the implied subsidy in the amount of $1.9 million was inadvertently budgeted in two places.

For FY 2015, the savings of healthcare premiums related to the implicit subsidy remained in the General Benefits Fund for future use. For FY 2016, staff brought forward recommendations in the FY 2016 Midyear Budget Review report to correct departmental budgets regarding the implied subsidy. Starting with this Forecast and the FY 2017 Budget, staff correctly budgeted for the implied subsidy for active employees healthcare premiums.

**Healthcare**

Consistent with the previous Forecast and as a result of the last labor agreement between the City and the Service Employees International Union (SEIU), the City’s contribution amount towards medical costs for SEIU employees is based on a flat contribution from the City with the employee contributing towards the remaining medical plan premium. This flat contribution towards medical costs also is used for the Management and Professional employees.

All other labor groups eligible for medical benefits will remain on the 90/10 contribution structure until new agreements are reached. This Forecast assumes an annual health care cost inflator of 8 percent for the labor groups on the 90/10 medical benefit structure, and a 4 percent annual health care cost inflator for the labor groups on the flat rate contribution structure. Consistent with the previous Forecast and with historical trends, the 2017-2026 LRFF assumes a 4 percent increase for dental and vision costs for the out-years.

**Contract Services**

The FY 2016 Adopted Budget included $17.4 million to fund contract services of which approximately $2.4 million was for one-time items. These items include: $0.3 million for trash receptacles on University Avenue; $0.3 million for the Fry’s Master Plan; and $0.3 million for the continuation of services at the Palo Alto Animal Shelter as well as the Shelter’s transitioning its operations to a non-profit.

In addition, the FY 2016 Adopted Budget assumed the Golf Course would be closed during the second half of the fiscal year. Due to continued delays, however, in securing the required permits to begin the Golf Course Reconfiguration Project (detailed in CMR #6335), this Forecast assumes the project will begin in early FY 2017. As a result, contractual expenses related to the Golf Course are anticipated to be reduced by approximately $0.5 million from the FY 2016 Adopted Budget level. This reduction in Golf Course expenses is offset by a reduction in Charges for Services of approximately $0.6 million. In FY 2018, upon the assumed completion of the Golf Course Project, contractual expenses will increase by approximately $0.9 million along with estimated revenues. As noted in the discussion of General Fund revenues, staff is currently undergoing an revised analysis of the impacts of the July 2016 anticipated closure date and will provide updated adjustments as appropriate as part of the FY 2017 Proposed Budget process.
As discussed with the Finance Committee in October, staff continues to look for implementing alternative service delivery models such as partnering with a non-profit agency to provide animal services or identifying a partner for the City’s swim program. For the FY 2017 Forecast Budget year, $0.1 million has been added for the maintenance of the Magical Bridge playground and parkland maintenance. In the out-years of the Forecast, a 2.6 percent growth factor for contract services is assumed. This is aligned to the 20 year historical average of the San Francisco Metropolitan Statistical Area Consumer Price Index – All Urban Consumers of 2.6.

General Expense
This category includes costs for travel and meetings, telephone and non-City utilities, contingency accounts, subsidies and grants provided through the Human Services Resource Allocation Process (HSRAP), and bank card service charges. These costs remain flat over the near future at 4.7 million. Except for the Cubberley lease, annual increases of between 2.5 and 2.6 percent.

On January 1, 2015, the City and Palo Alto Unified School District (PAUSD) agreed to an extension of the Cubberley Lease for five years. As part of the lease agreement, the City Council approved creation of a fund for Cubberley infrastructure improvements. The lease called for $1.9 million to be transferred to the Cubberley Property Infrastructure Fund. Therefore, the $1.9 million is classified as an Operating Transfer Out (discussed below).

The FY 2017 Forecast Budget includes $5.8 million for Cubberley Lease payments. In accordance with the lease agreement, a 3.0 percent annual CPI increase for the lease payments to the PAUSD is projected. Although the lease agreement is five years, for planning purposes this Forecast assumes the agreement will continue through FY 2026.

Rents & Leases
Rent and Lease expenses for FY 2017 are estimated to increase by $38,000 from the FY 2016 adopted level of $1.5 million. The largest expense in this category is $1.1 million for the Development Services Center (DSC). From FY 2018 forwards, this expense is expected to increase by 2.6 percent per year. The continued availability of the current space for the DSC will be revisited in the next year and, depending upon the potential acquisition of the downtown post office, the lease cost could change.

Facilities & Equipment
Facilities and Equipment expenses for FY 2017 are projected to decrease by 20.1 percent, or $0.1 million, as compared to the FY 2016 Adopted Budget, due to the elimination of one-time funding. One-time items funded during FY 2016 include the purchase of 30 AEDs ($50,000), community center furniture replacement ($25,000), and the build out of office space at the Development Center ($20,000). After eliminating one-time items, projected expenses in this category will remain fairly consistent at $0.5 million in FY 2018 and beyond. Consistent with
the 20-year CPI for the San Francisco San Jose Metropolitan Statistical Area, the forecast assumes a 2.6 percent annual increase starting in FY 2018.

Allocated Charges
Allocated Charges represent expense allocations by the City’s enterprise and internal services funds for services provided to General Fund departments. For FY 2017, these charges are estimated at $18.1 million including utilities usage (24.2 percent or $4.4 million), liability insurance (7.5 percent or $1.4 million), technology costs (33.9 percent, or $6.1 million), vehicle equipment and replacement costs (27.7 percent or $5.0 million), and other costs (6.7 percent, or $1.2 million). The FY 2017 charges of the forecast updates the revenue and expense for these cost plans based on the most current cost data available at the time of Forecast development. Growth of 2.6 percent is anticipated in the out-years.

Operating Transfers Out
Operating Transfers Out includes transfers from the General Fund to the Debt Service Fund, Technology Fund, and Airport Fund. Fiscal Year 2016 year-end projected transfers out total $1.8 million, and are expected to remain at that level for FY 2017. In FY 2018, the transfer level is anticipated to increase by approximately $0.3 million which is attributable to debt service payments for the Golf Course Reconfiguration project estimated at $0.5 million annually. This is offset by elimination of a one-time transfer to the Airport Fund of $0.3 million. Once Golf Course construction and net operation costs are updated these numbers will change. Based on the most current information, it is anticipated that as part of the FY17 Budget, a one-time recommendation to increase the General Fund loan to the Airport Fund will be recommended.

Transfer for Capital and Infrastructure Plan Projects
In FY 2016, the adopted General Fund transfer to the Capital Improvement Fund is $19.0 million. This includes a GF base transfer of $14.0 million and an estimated $7.7 million transfer resulting from TOT revenues generated by the two percentage point TOT increase (started January 1, 2015) and revenue from new hotels. This transfer is consistent with City Council direction to dedicate these TOT revenues to the City’s $126 million Infrastructure Plan.

In the out-years of the forecast, the TOT-associated transfer is anticipated to increase at a CAGR of 3.6 percent. These additional increases will help to somewhat to offset rising costs of Infrastructure Plan projects. In addition, the base transfer to the Capital Improvement Fund is anticipated to increase by 2.6 percent each year. Finally, this category includes the $1.9 million transfer to the Cubberley Property Infrastructure Fund. This transfer remains flat in all out-years of this Forecast.

As in past years, the chief contributors to increased expense are salaries and benefits. In addition, higher costs are a consequence of transfers out related to the Infrastructure Plan which are, in turn, supported by newer TOT revenues.
Alternative Fiscal Year 2017-2026 Long Range Financial Forecast Scenarios

At the request of the Finance Committee, staff has generated a Forecast scenario with a poor CalPERS pension investment return and a scenario with salary growth of 3 percent in the out years of the forecast. In addition, staff is providing the third scenario with a projected recession beginning in FY 2019. The likelihood of a recession during the next ten years is strong.

**Scenario 1: CalPERS Poor Investment Return**

As discussed with the City Council in September 2015 and the Finance Committee in November 2015 and December 2015, the actuarial firm, Bartel Associates, provided the City with a continuous, poor CalPERS investment performance scenario. Weak portfolio performance, which Bartel defines as returns between 0.2% and 4.1%, results in significantly higher employer contribution rates. The table below shows the Bartel projected City pension contribution rates by plan based on modest returns of 7.0%.

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</tr>
</thead>
<tbody>
<tr>
<td>Miscellaneous</td>
<td>27.7%</td>
<td>28.9%</td>
<td>30.7%</td>
<td>34.8%</td>
<td>37.3%</td>
<td>38.3%</td>
<td>39.5%</td>
<td>40.3%</td>
<td>40.0%</td>
<td>39.7%</td>
<td>36.7%</td>
</tr>
<tr>
<td>Safety</td>
<td>41.9%</td>
<td>45.4%</td>
<td>48.4%</td>
<td>55.2%</td>
<td>59.2%</td>
<td>61.3%</td>
<td>63.5%</td>
<td>64.9%</td>
<td>64.4%</td>
<td>63.9%</td>
<td>63.4%</td>
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</tbody>
</table>

These higher annual pension rates would increase expenditures by a total of $24.5 million over the Forecast period compared to the base model. General Fund deficits and surpluses would move in a more negative direction. For example, in FY 2019 a $0.8 million surplus would transform into a deficit of $0.7 million, a $1.5 million negative swing.

Fiscal Year 2017-2026 Long Range Revenue Forecast – CalPERS Poor Investment Return Alternate Model

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</tr>
</thead>
<tbody>
<tr>
<td>Total Expenditures</td>
<td>$185,672</td>
<td>$193,953</td>
<td>$202,919</td>
<td>$211,814</td>
<td>$218,393</td>
<td>$225,361</td>
<td>$232,916</td>
<td>$241,044</td>
<td>$249,421</td>
<td>$256,757</td>
<td>$265,564</td>
</tr>
</tbody>
</table>

| Net One-Time Surplus/Shortfall | $0 | ($642) | $15 | ($668) | ($1,883) | ($2,051) | ($1,595) | ($46) | $2,573 | $3,638 | $7,916 |

| Cumulative Net Operating Margin (One-Time) | $7,256 |

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</thead>
<tbody>
<tr>
<td>Cumulative Net Operating Margin</td>
<td>$7,916</td>
<td></td>
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</table>

Assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures.

During the Forecast period, the net operating margin fluctuates between positive $4.3 million and negative $1.2 million. This scenario keeps base model revenues constant since they reflect staff’s best estimates and Finance Committee direction on growth trends.
**Scenario 2: 3% Salary Growth Alternate Forecast**

At the December 2015 Finance Committee, staff was asked to model 3 percent increases in salary growth beginning in FY 2019 compared to the 2 percent base case. This 1 percent increase results in additional costs of $8.0 million. Pension rates from the base Forecast were applied against salaries inflated by 3 percent.

**Fiscal Year 2017-2026 Long Range Revenue Forecast – 3 Percent salary growth**

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<tbody>
<tr>
<td><strong>Total Revenue</strong></td>
<td>$185,672</td>
<td>$193,953</td>
<td>$202,919</td>
<td>$211,814</td>
<td>$218,393</td>
<td>$225,361</td>
<td>$232,916</td>
<td>$241,044</td>
<td>$249,421</td>
<td>$256,757</td>
<td>$265,564</td>
</tr>
<tr>
<td><strong>Total Expenditures</strong></td>
<td>$185,672</td>
<td>$194,595</td>
<td>$203,117</td>
<td>$211,931</td>
<td>$219,409</td>
<td>$226,294</td>
<td>$232,519</td>
<td>$238,109</td>
<td>$243,882</td>
<td>$250,137</td>
<td>$254,568</td>
</tr>
<tr>
<td><strong>Net One-Time Surplus/(Shortfall)</strong></td>
<td>$0</td>
<td>($642)</td>
<td>($199)</td>
<td>($118)</td>
<td>($1,016)</td>
<td>($732)</td>
<td>$397</td>
<td>$2,935</td>
<td>$5,539</td>
<td>$6,620</td>
<td>$10,996</td>
</tr>
<tr>
<td><strong>Cumulative Net Operating Margin (One-Time)</strong></td>
<td>$23,780</td>
<td></td>
<td></td>
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Net Operating Margin

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<tbody>
<tr>
<td><strong>Cumulative Net Operating Margin</strong></td>
<td>$10,996</td>
<td></td>
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</tbody>
</table>

Assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures.

In this scenario, deficits occur through FY2021 with much lower surpluses beginning in FY 2022. As with Alternative Scenario 1, this model holds base model revenues constant.

**Fiscal Year 2019 Recession Alternate Forecast**

As described previously, the assumptions included in this Forecast are based on a historical analysis of increases using the Compounded Annual Growth Rate (CAGR) with adjustments based on knowledge of one-time and future events. The adjusted CAGR model factors in the impact of prior recessions, but does not make assumptions about when a recession may occur. Typically, the average business cycle lasts six years and the period between the last two recessions was about ten years. Below, an alternative Forecast model is presented which assumes a recession beginning in FY 2019 and shows its impacts. This model adjusts projected tax revenues and decreases the rate of growth for certain non-salary expenditures which would be expected when the next downturn occurs. The model is presented for information purposes and does not purport to accurately forecast a recession.

Assuming onset of a recession in FY 2019 (see table below), a significant annual deficit of $10.2 million would occur in FY 2019. This scenario only demonstrates the decline in revenues with no actions to reduce expenditures. Naturally, the Council and City management would take action, as in the past, to address a recession’s impacts.
The recessionary model assumes a reduction in major tax revenues although they are anticipated to decline at a lower rate than those in the Dot.Com bubble and Great Recession.

Conclusion

For ease of comparison the Table below shows the bottom line results for the two scenarios requested by the FC and staff’s base scenario (modified based on FC input).

Comparison of Bottom Lines for Base, Poor PERS Performance and 3 Percent Salary Scenarios for Fiscal Year 2017-2026 LRFF

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<tbody>
<tr>
<td>CalPERS Poor Investment Return</td>
<td>0</td>
<td>(642)</td>
<td>15</td>
<td>(668)</td>
<td>(1,883)</td>
<td>(2,051)</td>
<td>(1,595)</td>
<td>(46)</td>
<td>2,573</td>
<td>3,638</td>
<td>7,916</td>
</tr>
<tr>
<td>Cumulative Net Operating Margin</td>
<td></td>
<td>-642</td>
<td>24</td>
<td>(906)</td>
<td>(1,254)</td>
<td>(1,712)</td>
<td>(1,208)</td>
<td>(1,175)</td>
<td>2,706</td>
<td>3,599</td>
<td>8,573</td>
</tr>
<tr>
<td>3 Percent Salary Growth</td>
<td>0</td>
<td>(642)</td>
<td>(199)</td>
<td>(118)</td>
<td>(1,016)</td>
<td>(732)</td>
<td>397</td>
<td>2,935</td>
<td>5,539</td>
<td>6,620</td>
<td>10,966</td>
</tr>
<tr>
<td>Cumulative Net Operating Margin</td>
<td></td>
<td>-642</td>
<td>-41</td>
<td>(918)</td>
<td>(934)</td>
<td>(405)</td>
<td>340</td>
<td>1,922</td>
<td>5,457</td>
<td>6,349</td>
<td>23,750</td>
</tr>
<tr>
<td>Base Forecast</td>
<td></td>
<td>0</td>
<td>90</td>
<td>(632)</td>
<td>880</td>
<td>508</td>
<td>1,335</td>
<td>2,836</td>
<td>5,591</td>
<td>8,157</td>
<td>9,739</td>
</tr>
<tr>
<td>Cumulative Net Operating Margin</td>
<td></td>
<td>-642</td>
<td>-352</td>
<td>(994)</td>
<td>(844)</td>
<td>(103)</td>
<td>1,064</td>
<td>2,129</td>
<td>5,692</td>
<td>6,525</td>
<td>12,681</td>
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</table>

The base Long Range Forecast, which includes a 2 percent increase in salaries in out years, projects a GF deficit of $0.64 million in FY 2017 and a tiny deficit of $0.20 million in FY 2018 and again in FY 2020 of $0.1 million. Otherwise, there are positive bottom lines through FY 2026, albeit with rather marginal surpluses in Fiscal Years 2019 and FY 2021. Staff recommends preempting the FY 2017 shortfalls during the FY 2017 budget process with one-time solutions and while it works on options and recommendations that will mitigate any ongoing deficits.

The Alternative Forecast Models demonstrate the City’s acute vulnerability to poor pension portfolio performance by CalPERS and to a lesser extent with 3 percent salary increases in out years. Having healthy reserves, a separate pension trust plan, and exerting fiscal discipline in the FY 2017 Budget process would help to offset some of the negative impacts revealed in the table above. Moreover, they would allow the City flexibility and time to plan for further, potential budget adjustments.

To address the anticipated higher pension costs, staff will bring forth a recommendation as part of the Fiscal Year 2017 budget to establish a 115 Supplemental Pension Trust Fund with one-
time sources. The funds in the pension trust fund can be used in the future to alleviate rising pension costs for one or more fiscal years.

Although revenue receipts have improved considerably since the Great Recession, the City continues to face numerous funding challenges such as:

- Infrastructure rehabilitation costs exceeding original estimates
- Rising benefits costs; and unfunded long-term pension and retiree healthcare liabilities
- Funding a plethora of initiatives related to potential acquisition of the downtown Palo Alto Post Office; non-profits such as the History Museum/Roth Building and Avenidas Senior Center; the Cubberley Community Master Plan; and the Parks Master Plan
- retaining and attracting a talented workforce that is responsive to the City Council priorities and community expectations

Staff will explore options to reduce the unfunded liabilities with ongoing contributions once funding gaps are addressed in the General Fund. As the City addresses the short and long-term issues in this report, it needs to continue reviewing its operations and service delivery options. Over the last few years, the City has outsourced services to the private sector and has entered into negotiations with the non-profit sector for public-private partnerships. Staff is engaged in finding a partner to effectively and efficiently operate Animal Services and is exploring different service delivery options for the City’s aquatic operations. City staff will review cost recovery levels for services provided to the residents and businesses. During 2016, staff will continue to bring forward recommendations to increase fees for the Planning and Community Environment Departments as well as other departments to align the fees with the cost recovery goals set by the City Council approved User Fee Cost Recovery Level Policy.

Based on a recent analysis of incoming 2 percent and new hotel revenue levels and their growth trends, staff believes that by FY 2019 the City can expect $8.5 million in receipts. At this level, and compared to the original Infrastructure Plan analysis, there will be sufficient revenues to cover up to $30 million in extra COPs for the Public Safety Building and the California Avenue Garage. Should other Infrastructure Plan projects face higher costs, the picture becomes less clear and likely will require constraining other expenses or pushing projects further into the future. Should one or both of the alternative forecast scenarios occur, the City will face weighty challenges which counsel further disciplined spending and advanced planning. Palo Alto has demonstrated over the years being fiscally responsible in addressing deficits with permanent solutions which it is prudent to continue.

During the next two months, staff will continue to monitor revenue sources as well as update revenues and expenditures based on newly available information. This updated information will be reflected in the FY 2017 Proposed Budget released to the City Council in late April 2016.
Executive Summary
The Fiscal Year (FY) 2017 to 2026 General Fund Long Range Financial Forecast (LRFF), which marks the beginning of the FY 2017 budget planning process, projects a slight General Fund surplus of $0.1 million in FY 2017, a shortfall of $0.6 million in FY 2018, and surpluses in the remaining years of the Forecast. Although economic indicators and rebounding tax revenues reveal that the City of Palo Alto has reached a turning point from the Great Recession, this Forecast reflects financial obligations and rising benefits costs that diminish the positive outlook over the next 10 years. Despite improving revenue receipts as projected forward, the City continues to face challenges related to the funding of infrastructure, the desire to retain and attract a talented workforce to be responsive to the City Council and the community, rising benefits costs, and unfunded long-term pension and retiree healthcare liabilities in the amount of $439 million. Additionally, as an alternative Forecast Model shows, the City needs to prepare for the next recession. While the base model captures the past 20 years of compounded revenue annual growth rates, which includes economic booms and recessions, staff included the alternative model for further discussion. While recessions are difficult to predict, history shows that one will be experienced during the term of this Forecast.

In June 2014, the City Council approved the Infrastructure Plan in the amount of $125.8 million. Since approval of the plan, the City was able to dedicate additional funding to close the initial funding gap of $7.5 million and fund the related public art expenditure of $1.1 million, and a small Infrastructure Plan Reserve of $0.8 million. However, as discussed during the Council Infrastructure Plan Study Session on December 9, the projects identified in the Infrastructure
Plan are estimated to cost substantially more due to updated designs, rising construction costs, and the State imposed requirement to pay prevailing wages. Some of these higher costs will be funded through higher than previously estimated Transient Occupancy Tax receipts dedicated to the Infrastructure Plan. Over the ten years of the Forecast, the additional funding for Infrastructure is estimated at $68 million.

Since the Great Recession, the City Council has approved various strategies to mitigate the rising cost of salaries and benefits. These strategies include: (1) employees paying their own CalPERS contribution (between 6 percent to 9 percent of salary) except for the members of the Fire Chiefs’ Association; (2) sharing future health plan cost increases; (3) creating a second pension tier (and the state implemented a third tier effective January 1, 2013); (4) reducing professional development expenses; (5) cost of living freezes for four years; and (6) terminating the Variable Management Compensation Plan. Continuing with previous actions to curtail the growth of benefits costs, in 2014, as part of approving the agreement with SEIU and the compensation plan for Management and Professional employees, the City Council approved the cost sharing of future health plan costs. Currently, the City is in negotiation with all of its bargaining groups. It is the City’s desire to retain and attract a talented workforce.

Therefore, this Forecast includes salary and benefits adjustments based upon projected cost of living increases and market changes. This Forecast provides a long-term view of the City's General Fund to provide a strategic focus for addressing future funding needs in the FY 2017 Proposed Budget and beyond. This Forecast assumes FY 2016 service level remain the same. As in past years, the Forecast has been updated based on current information compiled from various sources, in addition to utilizing available tools to project revenues and expenditures. This document facilitates City Council members’ and staff’s understanding of the long-term impacts of past decisions and identifies issues that must be addressed in the near and long-term. The Forecast is not a prediction or a commitment of resources; rather, it is a reasonable snapshot of the City’s future financial condition based on various assumptions and currently available data.

A continuously improving economic climate is noted by the majority of national, state, regional, and local economic indicators. This Forecast assumes a continued, gradual growth of the national economy with positive impacts to the local economy, which is reflective in the estimates of economically sensitive revenue estimates. It is important to note that consistent with previous forecasts, the methodology for calculating changes for out-years of the Forecast (FY 2017 to FY 2026) are based on a historical analysis of increases using the Compounded Annual Growth Rate (CAGR) with adjustments factored in for known items. By using the historical average growth rate that incorporates the up and down cycles over the past 10 or 20 years, there is no single year in which a downturn is depicted. Instead, past downturns (e.g. dot com bust and Great Recession) have been factored into the compound growth rate used to forecast future revenue streams. Staff performed a reasonableness test of the results and made appropriate changes to the CAGR analysis.
As shown in the table below, the FY 2017 Forecast Budget anticipates a slight General Fund surplus of approximately $0.1 million for FY 2017, a shortfall of $0.6 million in FY 2018, and surpluses in the remaining years of the Forecast. During the forecast period, surpluses range between $0.1 million and $12.6 million with an approximate cumulative one-time surplus of $41.0 million. Assuming that the General Fund Budget Stabilization Reserve (BSR) is fully funded at the City Council approved target level of 18.5 percent of General Fund operating expenditures, $13.1 million would have to be set aside to maintain the target level. With these funds set aside, the one-time resources projected in this Forecast would decrease by $13.1 million from $41.0 million to $27.9 million. It is important to note that the majority of these surpluses are predicted in the last five years of the Forecast. The further we look into the future, the less reliable these predictions are.

**Fiscal Year 2017-2026 Long Range Financial Forecast**

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<tbody>
<tr>
<td>Total Revenue</td>
<td>$186,672</td>
<td>$195,446</td>
<td>$205,340</td>
<td>$214,610</td>
<td>$221,467</td>
<td>$228,733</td>
<td>$236,667</td>
<td>$245,072</td>
<td>$253,803</td>
<td>$261,510</td>
<td>$279,723</td>
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<tr>
<td>Total Expenditures</td>
<td>$180,572</td>
<td>$195,335</td>
<td>$205,196</td>
<td>$214,320</td>
<td>$221,170</td>
<td>$228,430</td>
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<td>$245,380</td>
<td>$253,805</td>
<td>$261,645</td>
<td>$279,570</td>
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<tr>
<td>Net One-Time Surplus/Shortfall</td>
<td>$0</td>
<td>$90</td>
<td>$(632)</td>
<td>$(880)</td>
<td>$(508)</td>
<td>$1,315</td>
<td>$2,836</td>
<td>$5,091</td>
<td>$8,157</td>
<td>$(7,739)</td>
<td>$12,081</td>
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<tr>
<td>Cumulative Net Operating Margin (One-Time)</td>
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<td>$41,185</td>
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<tr>
<th></th>
<th>Net Operating Margin</th>
<th>Cumulative Net Operating Margin</th>
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<tr>
<td></td>
<td>$0</td>
<td>$(632)</td>
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<tr>
<td></td>
<td>$(880)</td>
<td>$(508)</td>
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<td></td>
<td>$(827)</td>
<td>$(504)</td>
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<td></td>
<td>$(2,755)</td>
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<tr>
<td></td>
<td>$(1,582)</td>
<td>$(2,049)</td>
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</tbody>
</table>

Assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures.

The table includes a calculation for the net operating margin which reflects the year over year change of surpluses and shortfalls. With the net operating margin, it is assumed that each shortfall is addressed completely with ongoing solutions in the year it appears, and that each surplus is completely expended with ongoing expenditures. Based on these assumptions, the cumulative net operating margin, or ongoing surplus, during the forecast period is approximately $12.0 million, with the majority of these ongoing surpluses generated in the last five years of the Forecast.

Although this Forecast presents overall a positive fiscal outlook for the City’s General Fund, it is important to note that it does not include the following potential impacts, which can increase or decrease the projected annual surpluses to the FY 2017 Projected Budget and the out-years of the Forecast: (1) ongoing labor negotiations; (2) funding of the Council approved Infrastructure Plan after completion of full design, increased construction costs, and prevailing wage requirements; (3) operating budget impact of Infrastructure Plan projects; (4) cost impact related to the Parks Master Plan; (5) additional costs related to the future Junior Museum and Zoo facility; (6) potential acquisition of the downtown Palo Alto Post Office; (7) one-time costs related to City assets managed by non-profits such as Avenidas Senior Center, the Palo Alto History Museum, the Ventura Child Care Center, the Junior Museum and Zoo, or the Scout Building; (8) Cubberley Community Center Master Plan; (9) construction loans for the Palo Alto Airport; (10) potential termination of the Fire Services Contract with Stanford University; (11) Cadillac Healthcare Federal Excise Tax expected to impact in calendar year 2018; (12) future changes to pension plan assumptions by CalPERS; (13) Transient Occupancy Tax increases.
related to two new hotels on San Antonio Road; (14) Tax revenue alignment with updated Comprehensive Plan; and (15) changes in the local, regional, and national economy.

At this time, staff projects a $6.5 million General Fund budget surplus for FY 2016. This surplus assumes City Council authorized budget amendments to date and includes higher tax revenue estimates as indicated in this Forecast ($5.5 million) and expenditure savings related to the Retiree Healthcare Implied Subsidy ($1.0 million) as discussed further in the Salary and Benefits section of this report. The majority of the excess revenue is related to the Transient Occupancy Tax of which $4.2 million will be recommended for transfer to the Capital Improvement Fund for the Infrastructure Plan as part of the Fiscal Year 2016 Midyear Budget Review report. This amount does not assume any other recommendations to adjust revenues and expenditure that staff intends to bring forward for City Council consideration as part of the FY 2016 Midyear Budget Review. During the next few months, staff will continue to monitor revenues and expenditures based on available information and include these updates in the FY 2017 Proposed Budget scheduled for release late April 2016.

Officially, the Great Recession ended in June 2009. According to the National Bureau of Economic Research, the average duration of a business cycle from 1945 to 2009 lasted about six years and the period between the last two recessions was about ten years. Therefore, staff has provided an alternative Forecast model which assumes a recession in the first half of Fiscal Year 2019. As can be seen from this model, the City needs to start preparing for the next recession. As discussed this fall with the City Council and Finance Committee, during a recessionary period, the City is expected to receive less revenue and pension cost expenses increase. The Budget Stabilization Reserve has been used in the past in small parts to buffer revenue decreases. To address the anticipated higher pension costs, staff will bring forth a recommendation as part of the Fiscal Year 2017 budget to establish a 115 Supplemental Pension Trust Fund with one-time sources. The funds in the pension trust fund can be used in the future to mitigate rising pension costs for one or more fiscal years.

**Economic Outlook**

In preparing the FY 2017 to 2026 General Fund Long Range Financial Forecast, key economic indicators and measures available through various publications and reports were reviewed. Overall, the economic outlook for 2017 calls for continued measured optimism even as global economic conditions continue to produce uneven economic growth across regions and sectors.

**International**

As a world renowned hub of technological innovation, and at the heart of the Silicon Valley, Palo Alto is connected to the global economy in immeasurable ways. According to the October 2015 World Economic Outlook (WEO), “global growth for 2015 is projected at 3.1 percent, 0.3 percentage point lower than in 2014, and 0.2 percentage point below the forecasts in the July 2015 World Economic Outlook Update.”
Slower global activity is taming inflation in 2015. The continued moderate growth is a combination of advanced economies anticipating continued growth contrasted with anticipated declines in emerging markets for the fifth year. With declining commodity prices, depreciating emerging market currencies, and increasing financial market volatility, downside risks to the outlook have risen, particularly for emerging markets and developing economies. Modest increases are anticipated in advanced economies as a result of the strengthening of the euro and a return of positive growth in Japan assisted by declining oil prices and monetary policies.ii

Looking forward, “Global activity is projected to gather some pace in 2016. In advanced economies, the modest recovery that started in 2014 is projected to strengthen further. In emerging market and developing economies, the outlook is projected to improve: in particular, growth in countries in economic distress in 2015 (including Brazil, Russia, and some countries in Latin America and in the Middle East), while remaining weak or negative, is projected to be higher next year, more than offsetting the expected gradual slowdown in China.”iii

**United States**

In November 2015, the Bureau of Economic Analysis revised their Q3 2015 Gross Domestic Product (GDP) second estimate to 2.1% compared to the 3.9% increase during Q2. The increase in Q3 is primarily reflective of “positive contribution from personal consumption expenditures, nonresidential fixed investment, state and local government spending, residential fixed investment, and exports that were partially offset by a negative contribution from private inventory investment.”iv

Overall, Q1 2014 continues to be the worst first quarter showing since Q1 2009, amidst the Great Recession period, which has been attributed to the sharp decline in output and productivity to unusually cold weather in much of the US in early 2014. According to the UCLA Anderson Forecast, the federal funds rate is forecasted to be about 1.5 percent by the end of 2016 and approximately 3.25 percent at the end of 2017. This combined with the continued job growth and anticipated wage growth will drive consumption levels upward in 2016 leading to the first year of greater than 3.0% in real GDP since 2005.v The chart below provides a quarterly view of GDP growth from 2009 to present.
As noted briefly above, the UCLA Anderson Forecast cites several factors attributing to their favorable outlook for 2016. As of December, UCLA Anderson Senior Economist David Shulman cites, that “employment remains healthy, with the economy generating jobs at a 200,000-a-month clip that will bring it further declines in the unemployment rate to 4.6 percent.” As a result of the continuing decline in unemployment, reaching nearly full employment levels, and the continued upward pressure on wage increases, it is anticipated that the likelihood of inflation reaching its 2.0 percent target will be achieved. National Unemployment levels continue to decline, and are holding steady at October 2015 levels of 5.0 percent in November 2015. This is 13.8 percent below November 2014 levels of 5.8 percent. With the higher wages and a slight rebound in oil prices and housing costs resulting in inflation reaching 2.0 percent, UCLA Anderson Forecast anticipated that the Fed will begin to normalize the Federal Funds rate and gradually begin to tighten.

California
California’s economy continues to be a bright spot in the nation’s economic outlook with job growth continuing to outpace national levels. According to the Bureau of Labor Statistics (BLS), California’s unemployment rate dropped from 7.2 percent in October 2014 to a preliminary estimate of 5.8 percent in October 2015, a 19.4 percent decline. The current UCLA Forecast echoes this and forecasts continued steady gains in employment through 2017 with an unemployment rate of 4.9 percent by the end of the forecast period.

In addition, UCLA Anderson Forecast senior economist Jerry Nickelsburg reviewed economic indicators that differentiate the state of California from the U.S. average forecast such as trade through California’s ports, travel through international airports, state government finances, and residential construction and employment. Overall, continued steady growth through 2017 is anticipated in these sectors with some notable historical highs in port activity in September.
2015 as well as record levels of travel, continued residential construction, and steady growth in employment of 2.6 percent for 2016 and 1.4 percent for 2017. California’s payroll will grow more, at about the same rate and personal income growth is estimated to be 4.3 percent in 2015 and forecast to be 3.4 percent in 2016 and 3.2 percent in 2017.\(^x\)

According to the Zillow Home Value Index, the median home value in California for October 2015 is $449,500. California home values have gone up 5.8 percent over the past year (October 2014 to October 2015) and Zillow predicts they will rise 2.8 percent within the next year. The median price of homes sold is $418,250.\(^{xi}\)

**Palo Alto and the Bay Area**

Palo Alto’s traditional economic indicators of growth and prosperity, which are highlighted below, continue to be strong. The unemployment rate in the San Jose, Sunnyvale, Santa Clara Metropolitan Statistical Area (MSA), ticked up slightly in the preliminary October 2015 estimate to 4.0 percent, up from 3.7 percent in September 2015, but down from the October 2014 rate of 5.0 percent.\(^{xii}\)

The employment picture, though returning to normalcy nationally, is showing different influential factors. Of particular focus in the UCLA Anderson Forecast and significant to the Silicon Valley in particular is the office-using employment which includes the three leadings sectors – information, financial services, and professional and businesses services. These positions are significant as they have the highest average annual salaries for their employees ranging from $70,070 to $105,000 annually. This is compared to other employment sectors such as manufacturing, education and health, trades, and leisure and hospitality which range from $34,490 to $61,000 annually. Therefore, growth in these lucrative sectors is critical to the prosperity of cities as they bring significant purchasing power.

Finally, home values in Palo Alto continue to reach new highs. According to the Zillow Palo Alto Real Estate Market Summary, the average price per square foot for Palo Alto was $1,468, an increase of 12.6 percent compared to the same period last year. The median sales price for homes for August 2015 to November 2015 was $2.5 million, a 22.5 percent increase from the same period a year ago. Over the last five years, sales have appreciated a staggering 154.2 percent in Palo Alto. The number of sales has increased 1.2 percent and the average list price for homes was $3.1 million, according to Trulia.\(^{xiii}\)

**Fiscal Year 2017-2026 General Fund Long Range Financial Forecast**

The FY 2017-2026 General Fund LRFF projects a slight General Fund surplus of $0.1 million for FY 2017, a shortfall of $0.6 million in FY 2018, and surpluses in the remaining years of the Forecast. During the forecast period, surpluses range between $0.1 million and $12.6 million with an approximate cumulative one-time surplus of $41.0 million. Assuming that the General Fund Budget Stabilization Reserve (BSR) is fully funded at the City Council approved target level of 18.5 percent of General Fund operating expenditures, $13.1 million would have to be set aside to maintain the target level. With these funds set aside, the one-time resources projected
in this Forecast would decrease by $13.1 million from $41.0 million to $27.9 million. It is important to note that the majority of these surpluses are predicted in the last five years of the Forecast. The further we look into the future, the less reliable these predictions are.

The operating margin reflects the variance between the projected General Fund revenues and expenditures for each year of the forecast or the annual surplus or deficit. With the operating margin, the year over year change in surpluses and deficits, it is assumed that each shortfall is addressed completely with ongoing solutions in the year it appears and that each surplus is completely expended with ongoing expenditures. During the Forecast period, the net operating margin fluctuates between negative $0.6 million and positive $2.9 million. Although this Forecast projects healthy revenue growth, the revenue growth is barely keeping pace with the projected expenditure growth during the first five years of the Forecast. In the second half of the Forecast, revenues substantially outpace expenditures resulting in significant surpluses ranging from $2 to $12 million annually. This is primarily due to tapering off of City pension rate increases as discussed further in the salary and benefits section of this report.

Fiscal Year 2017-2026 Base Long Range Financial Forecast

<table>
<thead>
<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
<td>$185,672</td>
<td>$195,446</td>
<td>$205,360</td>
<td>$214,650</td>
<td>$221,467</td>
<td>$228,733</td>
<td>$236,607</td>
<td>$245,072</td>
<td>$253,403</td>
<td>$261,519</td>
<td>$270,723</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>$185,672</td>
<td>$195,355</td>
<td>$205,992</td>
<td>$213,710</td>
<td>$220,959</td>
<td>$227,398</td>
<td>$233,771</td>
<td>$239,481</td>
<td>$245,645</td>
<td>$251,779</td>
<td>$258,041</td>
</tr>
<tr>
<td>Net Operating Margin</td>
<td>$0</td>
<td>$(90)</td>
<td>$(880)</td>
<td>$(908)</td>
<td>$(1,335)</td>
<td>$(2,306)</td>
<td>$(5,591)</td>
<td>$(6,127)</td>
<td>$(9,739)</td>
<td>$(12,682)</td>
<td>$(14,185)</td>
</tr>
<tr>
<td>Cumulative Net Operating Margin</td>
<td>$0</td>
<td>$(90)</td>
<td>$(880)</td>
<td>$(908)</td>
<td>$(1,335)</td>
<td>$(2,306)</td>
<td>$(5,591)</td>
<td>$(6,127)</td>
<td>$(9,739)</td>
<td>$(12,682)</td>
<td>$(14,185)</td>
</tr>
</tbody>
</table>

 Assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures.

The graph below provides a representation of the operating and net operating margin of the base model as described above.
It should be noted that this Forecast, as outlined in the following sections of this report, does not include the following potential impacts to the FY 2017 Projected Budget and the out-years of the Forecast:

(1) Labor negotiations: The City is currently in negotiations with the Palo Alto Police Officers Association (PAPOA), the International Fire Fighters Association (IAFF), the Service Employees International Union, the Police Management Association, and the Fire Chiefs Association. Any agreements reached between the City’s bargaining units and approved for the Management and Professional Personnel Compensation Plan and the City will be incorporated into future budgets and forecasts, as applicable.

(2) Infrastructure Plan capital budget impacts: In June 2014, the Infrastructure Plan was approved by the City Council and contains $125.8 million in projects recommended by the Infrastructure Committee; however, the Plan’s construction and design costs were based on data from 2012. As construction costs have increased and the City is required to pay prevailing wages, the Plan is not sufficiently funded. However, the higher than anticipated revenues for Transient Occupancy Taxes related to new hotels and the 2% voter approved tax increase will partially offset the higher construction costs.

(3) Infrastructure Plan operating budget impacts: In June 2014, the City Council approved the Infrastructure Plan which includes $125.8 million in projects recommended by the Infrastructure Committee. This Forecast does not assume ongoing operating impacts as a result of the Infrastructure Plan, but future forecasts will include operating cost impacts as the specific projects are designed.
(4) Parks Master Plan: the Parks Master Plan will be finalized in 2016 and future forecasts will include associated cost impacts as necessary.

(5) Junior Museum and Zoo: In November 2014, the City Council directed staff to negotiate a capital lease with the Friends of the Junior Museum and Zoo for the reconstruction of the Junior Museum and Zoo. This Forecast does not assume any additional operating costs related to the renovated building.

(6) Acquisition of the downtown Palo Alto Post Office: The City may acquire the downtown Palo Alto Post Office with the plan to relocate staff from leased facilities. The acquisition would be financed through issuance of debt with the annual debt service paid through lease cost savings. If the Palo Alto Post Office is acquired, it would require substantial improvements while the City pays the annual debt service, and during that time the City will also have to continue paying for leasing existing facilities. Staff is reviewing potential strategies, which would reduce the impact to the General Fund in the short-term.

(7) City owned assets operated by non-profit organizations: This Forecast does not include any additional capital investments for the Avenidas Senior Center, the Palo Alto History Museum, the Ventura Child Care Center, the Junior Museum and Zoo, or the Scout Building.

(8) Cubberley Community Center Master Plan: The FY 2016 Adopted Capital Budget included funding for the Cubberley Community Center Master Plan. Costs in excess of the dedicated Cubberley infrastructure funding as agreed to between the Palo Alto Unified School District and the City are not assumed in this Forecast.

(9) Loans to the Airport Fund for capital improvement projects: Staff intends to apply for Federal Aviation Administration (FAA) reimbursable grants during the Forecast period. If approved, the FAA reimburses 90% of capital improvement costs. Since some of these capital improvements may bridge fiscal years, the General Fund may have to provide loans crossing fiscal years until the Airport Fund receives the FAA reimbursements.

(10) Fire Services Contract with Stanford University: On October 8, 2013, the City received a Notice of Termination letter from Stanford with the intent to terminate the contract with the City no sooner than one year and no later than two years from the date of the notice. During the termination period as well as the last two months, the City continued to negotiate with Stanford to settle on a service level and cost. This Forecast assumes the continuation of the contract for $6.5 million.
(11) Cadillac Healthcare Federal Excise Tax: Beginning 2018, a 40 percent excise tax will be imposed on the value of health insurance benefits that exceed a certain threshold. CalPERS may be able to design healthcare premiums to stay below the threshold and discussions are in the preliminary stage. Congress is also discussing possibly delaying or modifying this tax. If the tax is applicable, the City may have to pay the tax.

(12) CalPERS City contribution increases: Currently, CalPERS assumes an annual investment return of 7.5%. This Forecast assumes that CalPERS will meet the annual investment return. However, staff provided an alternative Forecast which assumes a poor investment return for the next ten years. Further, the CalPERS Board approved a gradual de-risking strategy, which is intended to reduce the assumed investment return to 6.5% over the next 20 years when CalPERS earns an investment on its portfolio in excess of 11.5%. In the event that the de-risking strategy does not result in a reduction of the expected rate of return, the CalPERS board will revisit this assumption as part of their process starting in November 2017 with formal action to take place in February 2018.

(13) Transient Occupancy Tax increases related to two hotels on San Antonio Road: The City is in the process of reviewing plans for two Marriott hotels with a potential location at San Antonio Road. This Forecast does not assume any potential Transient Occupancy Tax increases from these two hotels.

(14) Tax revenue alignment with updated Comprehensive Plan: The City is currently in the process of updating its Comprehensive Plan including the potential fiscal impact of various land use scenarios. The fiscal impact of various land use scenarios will be brought forward for City Council discussion in 2016.

(15) Changes in the local, regional, and national economy: This Forecast assumes a steadily growing local economy. Any changes may have positive or negative impacts on economically sensitive revenues such as Sales Tax and the Transient Occupancy Tax.

At this time, staff projects a $6.5 million General Fund budget surplus for FY 2016. This surplus assumes City Council authorized budget amendments to date and includes higher tax revenue estimates as indicated in this Forecast ($5.5 million) and expenditure savings related to the Retiree Healthcare Implied Subsidy ($1.0) as discussed further in the Salary and Benefits section of this report. The majority of the excess revenue is related to the Transient Occupancy Tax of which $4.2 million will be recommended for transfer to the Capital Improvement Fund for the Infrastructure Plan as part of the Fiscal Year 2016 Midyear Budget Review report. This amount does not assume any other recommendations to adjust revenues and expenditure that staff intends to bring forward for City Council consideration as part of the FY 2016 Midyear Budget Review.
Since the Great Recession, the City Council has approved various strategies to reduce the costs of salaries and benefits. These strategies include: (1) employees paying their own CalPERS contribution (between 6 percent to 9 percent of salary) except for the members of the Fire Chiefs’ Association; (2) sharing the cost of health plan costs at 90/10; (3) creating a second pension tier (and the state implemented a third tier effective January 1, 2013); (4) reducing professional development expenses; (5) cost of living freezes for four years; and (6) terminating the Variable Management Compensation Plan. Continuing with previous actions to curtail the growth of benefits costs, in 2014, as part of approving the agreement with SEIU and the compensation plan for Management and Professional employees, the City Council approved the cost sharing of future health plan costs. However, in comparison to market studies to comparable agencies, the salaries of our employees, primarily safety employees, have fallen behind. Currently, the City is in negotiation with all of its bargaining groups. It is the City’s desire to retain and attract a talented workforce. Therefore, this Forecast includes salary and benefits increases to adjust employees’ salaries to the average of the market over the next few years. Due to these adjustments, for Fiscal Year 2018 only, revenue growth is outpaced by a salary and benefits growth resulting in a shortfall of about $0.6 million. Looking forward to the next fiscal year, in Fiscal Year 2019, this Forecast predicts a surplus of $0.9 million. Therefore, the projected Fiscal Year 2018 shortfall can be bridged with one-time funding.

The next section of the report discusses the analysis and assumptions of major revenue and expenditure categories. Consistent with the 2016-2025 LRFF, the methodology for calculating changes for out-years of the Forecast (FY 2018 to FY 2026) are based on a historical analysis of increases using the Compounded Annual Growth Rate (CAGR) with adjustments factored in for known items. Staff performed a reasonableness test of the results. Typically, the average business cycle lasts six years and the period between the last two recessions was about ten years. Therefore, this report includes an alternative Forecast model with a recession assumed in Fiscal Year 2019.

**Revenues**

City of Palo Alto tax revenues continue to parallel the strong local economy. Robust residential and commercial property values, business driven transient occupancy and daily rates, and the emergence of new hotels have propelled key revenue sources upward since Fiscal Year 2013. The fundamental economic drivers of low unemployment, strong incomes in Silicon Valley, vibrant business activity, and the demand for Palo Alto property will continue to buttress revenue in the near future.
The tables above (also available in Attachment A) highlight the annual revenue estimates and year over year increases for this Forecast. Compared to FY 2016 projected, FY 2017 revenues are estimated to increase by $5.0 million, or approximately 2.6 percent. Based on the economic analysis presented in the previous section of this report, revenue estimates, which are primarily linked to the performance of the regional and local economy, are reflective of increased consumer spending, continued rise in home prices, and the opening of hotels. The upward trend of the City’s tax revenues is expected to continue over the next 10 years. These tax revenues have significantly improved since the beginning of the Great Recession. The table above illustrates the steady growth projected for the General Fund’s revenue streams, by percentage, from FY 2017 through FY 2026.

During the 2013 Finance Committee discussions, it was recommended that staff consider use of a historical annual growth rate derived for each tax revenue source to project future revenue streams. This methodology was used in the final forecast presented for FY 2015 to 2025 and
has been used in this forecast as well. The Compound Annual Growth Rates (CAGR) utilized in this Forecast is cited in each revenue section and reflected in the revenue section table.

The graph above depicts a historical and the base model projected view of the five major General Fund tax revenues. It includes 10 years of actual revenue history; the projections for FY 2016 based on actual data available for the first five months of the fiscal year; as well as the projections for FY 2017 and the subsequent years of the Forecast. Revenue forecasts are based on current data and application of the Compound Annual Growth Rate (CAGR) methodology. The following section is a detailed discussion of General Fund Tax revenue and other major revenue sources by category.

**Sales Tax**
Sales taxes have risen from a low of $17.9 million in FY 2010 to a projected level of $27.9 million in FY 2016. They are expected to grow by a compound annual growth rate of around 2.6 percent through FY 2026. Staff has factored into the forecast weakening receipts over the past several years from a few key generators. In addition, the ongoing movement of tangible good purchases from brick and mortar stores to online vendors continues and poses a long-term threat. Evidence of this was reported in a December 1, CNBC article, “According to the Adobe's Digital Index, total online sales on Cyber Monday rose 16 percent compared to last year, to $3.07 billion.” The article goes on to say that in-store data “showed sales were down an estimated 10.4 percent over Black Friday weekend” compared to the prior year.

As reported to Council, there was a one-time tax windfall from one vendor in FY 2014 and a Government Accounting Standards Board tax accrual adjustment in FY 2015. In each year, sales tax was reported at $29 million. As shown below, the FY 2016 and FY 2017 projections return to a more realistic level in 2017.
Restaurant and auto sales are trending higher, while department store and electronic firm sales are trending lower. The State will terminate its “triple flip” program this January so the City will receive more timely payments and slightly higher interest earnings due to better cash flow. The CAGR applied to the period FY 2016 through FY 2025 is 2.6 percent which is in line with historical growth rates.

Property Tax
As the table below indicates, since FY 2012 property taxes have risen substantially. Staff projects this source to grow at 5.9 percent over the next ten years which is in line with historical trends. The recent purchases of the Tibco Site in the Stanford Research Park ($330 million) and the Epiphany Hotel ($71.6 million) evidence a compelling commercial real estate market. Other contributing factors include: single family home sales that have exceeded asking prices and the unleashing of latent property values from the sale of long held homes that were “shielded” from assessed value appreciation by Proposition 13.

Table 1: Sales Tax Revenue by Fiscal Year (Millions)

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$22.1</td>
<td>$25.6</td>
<td>$29.4</td>
<td>$29.7</td>
<td>$27.9</td>
<td>$28.5</td>
</tr>
</tbody>
</table>

The City’s property tax estimate for FY 2016 is based on information received from quarterly meetings with the Santa Clara County Assessor’s Office. The estimate includes appeals on record with the Assessor’s Office, additions to the roll, and movements in assessed values. Projections beyond FY 2016 are based on historical growth rates. The CAGR used in this 10 year forecast equals 5.9 percent, slightly higher than the 5.4 percent in last year’s forecast. This higher growth rate is justified by the factors cited above.

Table 2: Property Tax Revenue by Fiscal Year (Millions)

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$26.5</td>
<td>$28.7</td>
<td>$30.6</td>
<td>$34.1</td>
<td>$35.1</td>
<td>$37.5</td>
</tr>
</tbody>
</table>

As requested by the City Council, staff contacts the Palo Alto Unified School District (PAUSD) regarding their assumptions in property tax growth. Typically, the initial growth assumptions used by PAUSD in developing their budget are lower than the City’s. As the budget year progresses, however, PAUSD will align their property tax revenue with actual increases that tend to be closer to the City’s projections. PAUSD’s growth rate assumption for FY 2016 was 5.34 percent.

In FY 2015, the Administrative Services Department contracted with a firm to produce detailed reports on property taxes. The consultant’s reports have provided key insights into Palo Alto’s real estate market that supports property taxes growing at around 6 percent per year, including:
• There are 8,010 residential properties in Palo Alto under $600,000 in Assessed Value (AV). These properties, over a seven year period ending in FY 2015, turned over at an average rate of 582 annually.

• On average, 3.1 percent of the above residential parcels annually changed ownership and the average AV increased by 171 percent. For example, a property with an AV of $1,000,000 is expected to sell in today’s market at $1,710,000 which is somewhat conservative given current sale prices.

• Per the 2015-2016 Assessor’s Roll, average Assessed Value of residential properties in Palo Alto equal $1,080,000.

**Transient Occupancy Tax (TOT)**

As the table below shows, Transient Occupancy Taxes continue to perform exceptionally well. As summarized in the table below, average daily room rates and occupancy levels continue to demonstrate considerable strength since FY 2011. Generally, occupancy levels between 80 and 85 percent indicate full occupancy. Demand for Palo Alto rooms is strong, leading to construction and planned construction of five new hotels. A vibrant business and tourist environment has led to a surge in hotel bookings from San Francisco down through the Peninsula to San Jose.

**Table 3: Transient Occupancy Tax by Fiscal Year (Millions)**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016*</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Purpose Revenue (millions)</td>
<td>$9.7</td>
<td>$10.8</td>
<td>$12.3</td>
<td>$13.4</td>
<td>$15.3</td>
<td>$16.1</td>
</tr>
<tr>
<td>Infrastructure Revenue (millions)</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>$3.3*</td>
<td>$9.2</td>
<td>$9.7</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$9.7</td>
<td>$10.8</td>
<td>$12.3</td>
<td>$16.7</td>
<td>$24.5</td>
<td>$25.8</td>
</tr>
<tr>
<td>Average Daily Room Rate</td>
<td>$165</td>
<td>$182</td>
<td>$208</td>
<td>$208</td>
<td>$253</td>
<td>N/A</td>
</tr>
<tr>
<td>Average Occupancy (percent)</td>
<td>79%</td>
<td>80%</td>
<td>79%</td>
<td>79%</td>
<td>80%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

* This $3.3 million is currently retained in the Budget Stabilization Reserve to support Infrastructure Plan projects, as recommended for approval by the Finance Committee as part of closing the Fiscal Year 2015 budget.

** Projected revenue based on trend and Fiscal Year 2016 year to date data. Average Daily Room Rate and Occupancy are year-to-date through October 2015.

This forecast includes estimated revenues for all of the new hotels that have come on-line, the Epiphany and the two new Hilton hotels as well as the Westin Annex which is expected to open this year. Plans for a hotel on the Ming’s restaurant site have been terminated. The new hotels planned for San Antonio Road are not included in the LRFF. Revenues from the 2.0 percent TOT increase effective January 1, 2015 and from the new hotels that are dedicated to infrastructure are isolated in the LRFF. The CAGR applied to the period FY 2016 through FY 2026 is 4.8 percent which is in line with historical growth rates.
Documentary Transfer Tax (DTT)

After two solid years of unusually strong performance, the Documentary Transfer Tax will likely approach more normal levels in FY 2016. Through November 2015, transactions and receipts are down 24 percent and 35 percent, respectively, compared to the same prior year period. As mentioned above, there were sizable, one-time transactions (Hudson Pacific purchases of office space) along the Page Mill corridor last FY that are unlikely to be duplicated in FY 2016. Based on current activity, staff expects $7.1 million in FY 2016 with a mild uptick in FY 2017 to $7.4 million.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$4.8</td>
<td>$6.8</td>
<td>$8.1</td>
<td>$10.1</td>
<td>$7.1</td>
<td>$7.4</td>
</tr>
</tbody>
</table>

The CAGR applied to the period FY 2016 through FY 2026 is 5.8 percent, again, in line with prior year CAGR trends.

Utility Users Tax (UUT)

The Utility Users Tax forecast includes a 5 percent tax on water, gas and electric usage and a 4.75 percent tax on telephone activity. In FY 2015, the step down tax for large users of utilities was eliminated.

Receipts anticipated from the UUT are based on the Utilities Department’s five-year revenue and rate projections. These estimates could change as the department discusses its proposed rate plan with the Utilities Advisory Commission and the City Council during the annual budget process. With the drought and heightened water conservation efforts as well as lower gas prices and consumption, the utilities UUT is expected to decline from FY 2015 to FY 2016. Revenues in FY 2015 registered at $7.6 million and these are expected to drop to $7.1 million in FY 2016. Upward movement in revenues is anticipated in FY 2017 with increasing rates. Telephone receipts have been increasing marginally since FY 2014 and are expected to do so despite the drop of 0.25 percent in the UUT rate for this category.

Other Taxes & Fines

Based upon a review of historical collection patterns, it is anticipated that the budgeted revenue estimate for this category will need to be reduced as part of the FY 2017 Proposed Operating Budget. As such, this forecast assumes a reduction of 7.2 percent, primarily attributable to lower parking violations and library fines. In the remaining years of the forecast, revenues are anticipated to increase between 2.7 and 4.9 percent.

Charges for Services

For FY 2017, total revenues in this category will increase 1.7 percent or $296,000 from the FY 2016 Adopted Budget. Revenues collected primarily reflect the costs to provide services to the community and therefore, are significantly impacted by personal service costs. The slight increase reflects an increase in estimated receipts to maintain cost recovery levels in FY 2017.
partially offset by any one-time revenue adjustments approved as part of the FY 2016 Adopted Budget and adjustments reflective of the Golf Course closure in Fiscal Year 2017. The golf course revenues are decreased by $542,000 from the FY 2016 Adopted budget due to the anticipated closure. This decline in revenues is partially offset by a reduction in contract services associated with operating the Golf Course. As discussed in City Manager Report (CMR) #6335, to be heard by the City Council on December 14th, 2015, the Golf Course is now anticipated to remain open through the end of FY 2016 and construction is now anticipated to begin in the summer of 2016 and continue through FY 2018.

Ongoing, this Forecast assumes an increase in charges for services revenue by approximately 3.1 percent to account for general salary and benefit increase included in the Forecast. These figures do not include Charges for Services revenue for Stanford Fire & Dispatch which is explained in further detail below.

**Stanford Fire & Dispatch Services**
The City has two separate agreements with Stanford University to provide fire response services and emergency dispatch services. As part of these agreements, Stanford is charged 30.3 percent of the Fire Department’s net cost and 16 percent of the Police Department’s Communication and Dispatch Division to reimburse the City for Stanford’s proportional share of these services. The term of the fire response service contract between the City and Stanford is through September 30, 2026; however, at Stanford’s request, the two parties have been in negotiations over the past two years to restructure the contract. On October 8, 2013, the City received a Notice of Termination letter from Stanford with the intention to terminate the contract with the City no sooner than one year and no later than two years from the date of the notice. During the termination period as well as the last two months, the City continued to negotiate with Stanford to settle on a service level and cost. Based on outcome of these negotiations, this Forecast assumes the continuation of the Fire Services contract for $6.5 million and dispatch contract for $741,000 with Stanford University escalated by the increased salary and benefits costs.

**Permits and Licenses**
Revenue from permits and licenses has experienced consistent growth over the past several years, primarily due to increased development activity around Palo Alto. Based on year-to-date estimates, FY 2016 revenues are projected to reach the Adopted Budget revenue estimate of $8.2 million. Revenues collected primarily reflect the costs to provide services to the community and therefore, are significantly impacted by personal service costs. In FY 2017, revenues in this category are expected to increase 5.6 percent, consistent with the projected increased personal service costs. From the FY 2016 projected level with ongoing annual increases of 2.6 percent through the forecast. As discussed in the FY 2016 Adopted Budget, the Planning and Community Environment and Development Services departments are reviewing the cost recovery model for these departments. Upon completion of this analysis, the staff will evaluate changes in planning and development fees and bring forward recommended adjustments as appropriate as part of the annual budget process.
Return on Investment
Interest earnings continue to be depressed as a consequence of the Federal Reserve’s loose monetary and interest policies. Expectations for earnings from investments are around $0.9 million which is a 1.9 percent increase from FY 2015 yearend projections.

Rental Income
The largest source of rental income comes from the City’s Enterprise Funds and the Cubberley Community Center. Compared to the FY 2016 Adopted Budget, rental income will decrease from $15.3 million to 15.0 million. The decrease includes a projected loss of $500,000 in rental income at Cubberley due to Foothill College moving out. As part of the development of the Fiscal Year 2017 budget, staff will pursue replacement tenants to offset the rental loss figure related to Foothill College. The forecast does assume that by Fiscal Year 2018, Cubberley will have new tenants on board resulting in a rental income revenue increase of $200,000. The forecast out years also assume a 2.6 percent growth for all rental properties, except for the Refuse Fund rent which is assumed until FY 2021 as approved by the City Council to account for the closing costs related to the Middlefield Well landfill site.

Revenue from Other Agencies
Included in this category is funding from Community Services Outreach theatre programs, reimbursements from the Palo Alto Unified School District (PAUSD) for School Resource Officers, and state and federal grants, if received. Many of these revenue streams are difficult to predict and are dedicated often to specific purposes. In this category revenues over the past five fiscal years have remained well below $0.5 million. This forecast assumes $0.4 million for FY 2017 with a growth rate of approximately 1.3 percent in subsequent years due to the unpredictability of this funding source.

Charges to Other Funds
Approximately 86 percent of this category is General Fund administrative cost plan charges to the Enterprise and Internal Service Funds. Internal support departments such as ASD, HR, and Council Appointees provide services to enterprise and internal service funds. The costs for these services are recuperated through the administrative cost plan charges. The charges for Fiscal Year 2017 are determined based on actual services provided in Fiscal Year 2015. The FY 2017 projected amount is $11.5 million, a decrease of 3.2 percent, from the FY 2016 Adopted Budget. The decrease in cost plan charges to the Enterprise and Internal Service funds is attributable to internal support departments providing more support to General Fund departments in Fiscal Year 2015. The forecast includes increases ranging between 2.6 to 4.9 percent each year based primarily on assumed increases in salary and benefit costs. In addition to the General Fund administrative cost plan, this revenue category includes several other allocations, most notably Public Works administration charged to Public Works Enterprise Funds and public safety communication services provided to the Utility Department.
Other Revenues

Major revenue sources in this category are reimbursements for the Shuttle program (e.g. City of East Palo Alto), Animal Services charges to Los Altos and Los Altos Hills, reimbursements from PAUSD for its share of Cubberley and athletic field maintenance, donations from non-profits to City libraries, and miscellaneous revenues. Revenues for this category are estimated to decline by 16.4 percent in FY 2017, mostly due to the elimination of $0.3 million in one-time revenue in approved in the FY 2016 Adopted Budget. The FY 2017 projected revenue for this category is $1.3 million, with a 2.6 percent to 2.8 percent annual increase forecasted for through FY 2026.

Operating Transfers In

Operating Transfers include the equity transfer from the Electric and Gas funds as well as transfers from the University Ave Parking Permit Fund. In accordance with a methodology approved by Council in June 2009, the equity transfer is calculated by applying a rate of return to the capital asset base of the Electric and Gas funds. This rate of return is based on PG&E's rate of return on equity as approved by the California Public Utilities Commission (CPUC). Using the Utility Department's projections from the Electric and Gas Five Year Financial Forecasts, as approved by the City Council in spring 2015, the equity transfer from the Electric and Gas funds are projected to increase from $17.3 million in FY 2016 to $18.8 million in FY 2017 (8.4 percent), and then increase annually by 2.3 percent over the rest of the forecast period. The higher increase in FY 2017 reflects updated Gas Fund capital asset data while the subsequent years reflect the average annual adjustment in the equity transfer since 2009. Overall Operating Transfers are estimated to increase to $20.1 million in FY 2017, an increase of $1.5 million from the 2016 Adopted Budget level of $18.6 million.

Expenditures

As part of developing the FY 2017 Forecast expenditure budget, the General Fund expenditure categories have been adjusted by removing FY 2016 Adopted Budget one-time expenditures and updating major cost elements such as salary and benefits costs. The tables below display the General Fund expense forecast. Compared to FY 2016 Adopted Budget, FY 2017 expenditures are estimated to increase by $9.7 million, or 5.2 percent primarily due to increased salary and benefits, an increased transfer to infrastructure, and allocated charges costs from Enterprise Funds and Internal Service Funds.
Fiscal Year 2017-2026 Long Range Expenditure Forecast

### Salary and Benefits

The table above (also available as an attachment) depicts the salaries and benefits costs for the next ten years. Over the Forecast period, the salaries and benefits cost gradually increase in comparison to the total expenditure budget. In FY 2017, salaries and benefits costs represent 60.6 percent of the expenditure budget; in FY 2026, the salaries and benefits cost represent 61.8 percent of the budget. In the same period, though, the benefits cost as a percentage of total salaries and benefits costs increase from 50.6 percent in FY 2017 to 53.7 percent in FY 2026. Over the Forecast period, salaries compounded growth is 28.0 percent versus a compounded growth in benefits costs of 42.4 percent. This compounded growth is less than estimated in the previous Forecast primarily due to lower estimated City pension contributions in the out-years of the Forecast as described in more detail below. The following sections describe the assumed increases in salary and benefits costs and depict the reasons for the faster increasing benefits versus salaries costs.

### Salary

Consistent with the City’s change in salary budget methodology that was implemented as of recent budgets, positions are budgeted at actual rate of pay including benefits as of fall 2015. Then, by position, salary costs are updated in accordance with applicable Memoranda of Understanding (MOU) between the City and its labor groups and the Management and Professional Personnel and Council Appointees Compensation Plan. It is important to note that the City is currently in negotiations with the Palo Alto Police Officers Association (PAPOA), the...
International Fire Fighters Association (IAFF), the Service Employees International Union, the Police Management Association, and the Fire Chiefs Association. This Forecast includes salary and benefits increases based on projected increases in the cost of living and market based adjustments. The Forecast also assumes step increases consistent with applicable MOUs and merit increases for Management and Professional employees.

**Benefits**

**Pension**

The forecast includes the pension rates from CalPERS as of the June 30, 2013 valuation for the City’s Miscellaneous and Safety plans, as updated by Bartel Associates (Bartel), the City’s actuary. Staff asked Bartel to update the pension rates based on the latest available information from CalPERS since CalPERS advised cities that the actuarial valuations as of June 30, 2014 will become available in December and project the rate for the ten-year period of the Forecast. In the last Forecast, staff relied on the CalPERS projections and extended those for the out years of the Forecast. Once CalPERS releases the latest valuation, staff will update the pension costs for the Fiscal Year 2017 budget as necessary.

As shown in the table below, the FY 2017 pension contribution rates for the Miscellaneous and Safety plans, as calculated by Bartel increased from the current year. For the Miscellaneous Plan, the projected pension contribution rate increase is 1.8 percentage points from the FY 2016 rate of 27.7 percent to a FY 2017 rate of 29.5 percent. For the Safety Plan, the projected pension contribution rate increase is 2.7 percentage points, from the FY 2016 rate of 41.9 percent to a FY 2017 rate of 44.6 percent. The table below shows the pension contribution rates from FY 2018 through FY 2026.

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<tbody>
<tr>
<td>Miscellaneous</td>
<td>27.7%</td>
<td>29.5%</td>
<td>31.3%</td>
<td>33.1%</td>
<td>34.9%</td>
<td>35.3%</td>
<td>35.6%</td>
<td>35.4%</td>
<td>35.2%</td>
<td>35.0%</td>
<td>31.9%</td>
</tr>
<tr>
<td>Safety</td>
<td>41.9%</td>
<td>44.6%</td>
<td>47.9%</td>
<td>50.8%</td>
<td>53.6%</td>
<td>54.1%</td>
<td>54.6%</td>
<td>54.1%</td>
<td>53.7%</td>
<td>53.2%</td>
<td>52.8%</td>
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The City pension contribution rates assumed in this Forecast are substantially lower for the last few years of the Forecast period than assumed in the last Forecast due to a change in methodology for projecting the rates. Last year, staff used a linear extrapolation of rate increases provided by CalPERS during the first four years (CalPERS only provides rates for five fiscal years). This year, staff asked Bartel and Associates to provide projection of the City Contribution rates as presented to the Finance Committee in November. To exemplify the impact of this change in methodology, the last Forecast assumed for FY 2025 a 42.6% City contribution rate for Miscellaneous employees and a 64.3 % City contribution rate for Safety employees. The lower City contribution rates for this Forecast resulted in lower overall benefits costs.

It is important to note, however, that the CalPERS Board approved a de-risking policy of its investment portfolio in order to reduce the assumed investment return of 7.5% to 6.5% over a
20 year period. With this policy CalPERS will only reduce the investment return assumption in years with investment returns higher than 11.5%. However, the Board is scheduled to revisit this policy in February 2018. If the Board decides to reduce the assumed investment return regardless of the actual earnings at this time, the City’s contribution rate would most likely increase for FY 2021.

Retiree Healthcare

This Forecast includes the Annual Required Contribution (ARC) per the May 2014 actuarial valuation based on information as of June 30, 2013, (accepted by the City Council on June 9, 2014) for the City’s retiree healthcare plan as updated by Bartel. Bartel’s update to the last actuarial valuation assumes the latest CalPERS mortality rate assumptions, incorporates the investment gain for the Retiree Healthcare Trust Fund as of June 30, 2015, and assumes a lowering of the assumed investment return assumption from 7.61% to 7.25%. Currently, Bartel is preparing the Retiree Healthcare valuation as of June 30, 2015. Staff will incorporate the findings of the valuation as part of the FY 2017 budget. As this Forecast predicts surpluses in the out-years, staff intends to revisit the investment earning assumptions for further reductions in coming years.

The table below details Bartel’s estimate for the City’s annual Retiree Healthcare contribution by the General Fund, non-general funds, and all funds for the next ten years.

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<tbody>
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<td>General Fund</td>
<td>$10.0</td>
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<td>$13.6</td>
<td>$14.0</td>
<td>$14.5</td>
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<tr>
<td>Non-General Funds</td>
<td>$4.8</td>
<td>$5.2</td>
<td>$5.4</td>
<td>$5.6</td>
<td>$5.8</td>
<td>$5.9</td>
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<td>$6.3</td>
<td>$6.6</td>
<td>$6.8</td>
<td>$7.0</td>
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<tr>
<td>TOTAL</td>
<td>$14.8</td>
<td>$16.1</td>
<td>$16.6</td>
<td>$17.2</td>
<td>$17.8</td>
<td>$18.3</td>
<td>$18.9</td>
<td>$19.5</td>
<td>$20.2</td>
<td>$20.8</td>
<td>$21.5</td>
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On June 9, 2014, City Council accepted the Retiree Healthcare Plan GASB 45 Actuarial Valuation as of June 30, 2013 and approved full funding of the Annual Required Contribution (ARC) for Retiree Healthcare for FY 2015 and FY 2016. As documented in the report (CMR #4891) which recommended approval of full payment of the ARC, the primary reason for the increased ARC for Retiree Healthcare was the inclusion of a new actuarial standard regarding the implied subsidy of healthcare premiums of active employees in relationship to healthcare premiums for retirees. CalPERS blends active employees with pre-Medicare retirees and charges them the same medical premium; however, younger employees on average consume less healthcare services and therefore are subsidizing older employees and retirees. The implied subsidy is the difference between average retiree claims and retiree premiums charged by CalPERS.

Consistent with City Council direction, as recommended by staff, the City budgeted for full payment of the ARC for FY 2015 and FY 2016, including the implied subsidy. The implied subsidy for FY 2015 was $1.9 million for all funds. As part of preparing for the FY 2015 CAFR, staff worked closely with the City’s actuary, the managers of the City’s trust fund for Retiree
Healthcare, and the City’s external auditor about the implied subsidy in the Retiree Healthcare Fund. After many discussions, staff realized that the implied subsidy budgeted in the Retiree Healthcare Fund should have been budgeted as a contribution from the City’s healthcare premiums for active employees. However, the FY 2015 budget had fully funded the City’s healthcare premiums of approximately $17.4 million for active employees. Therefore, the cost of healthcare premiums related to the implied subsidy in the amount of $1.9 million was budgeted twice. For FY 2015, the savings of healthcare premiums related to the implicit subsidy remained in the General Benefits Fund for future use. For FY 2016, staff will bring forward recommendations as part of the FY 2016 Midyear Budget Review report to correct departmental budgets regarding the implied subsidy. Starting with this Forecast and the FY 2017 Budget, staff correctly budgeted for the implied subsidy for active employees healthcare premiums. This means that for all funds approximately $2.2 million of the active employees healthcare premiums are included in the Retiree Healthcare ARC.

Healthcare

Consistent with the previous Forecast and as a result of the most recent labor agreement between the City and the Service Employees International Union (SEIU), the City’s contribution amount towards medical costs for SEIU employees is based on a flat contribution from the City with the employee contributing towards the remaining medical plan premium. This flat contribution towards medical costs is also used for the Management and Professional employees. All other labor groups eligible for medical benefits will remain on the 90/10 contribution structure until new labor agreements are reached with the City and the affected bargaining groups. This Forecast assumes an annual health care cost inflator of 8 percent for the labor groups on the 90/10 medical benefit structure, and a 4 percent annual health care cost inflator for the labor groups on the flat rate contribution structure. Consistent with the previous Forecast and with historical trends, the 2017-2026 LRFF assumes a 4 percent increase for dental and vision costs for the out-years.

Contract Services

The FY 2016 Adopted Budget included $17.4 million to fund contract services of which approximately $2.4 million was for one-time items that include $0.3 million for trash receptacles on University Avenue, $0.3 million for the Fry’s Master Plan, and $0.3 million for the continuation of services at the Palo Alto Animal Shelter and transition operations to a non-profit. This $2.4 million has been removed from the forecast for FY 2017 and beyond. In addition, the FY 2016 Adopted Budget assumed that the Golf Course would be closed during the second half of the fiscal year; however, due to continued delays in securing the required permits to begin the Golf Course Reconfiguration Project, as detailed in CMR #6335 to be heard by City Council on December 14, 2015, this Forecast assumes that the project will begin in early FY 2017. As a result, contractual expenses related to the Golf Course are anticipated to be reduced by approximately $0.6 million from the FY 2016 Adopted Budget level. This reduction in Golf Course expenses is partially offset by a reduction in revenue collections in Charges for Services. In FY 2018, upon the assumed completion of the Golf Course Project, contractual expenses will increase by approximately $0.9 million.
As discussed with the Finance Committee in October, staff continues to look for implementing alternative service delivery models such as partnering with a non-profit agency to provide animal services or identifying a partner for the City’s swim program. For the FY 2017 Forecast Budget year, $0.1 million has been added for the maintenance of the Magical Bridge playground and parkland maintenance. In the out-years of the Forecast, a 2.6 percent growth factor for contract services is assumed. This is aligned to the 20 year historical average of the San Francisco Metropolitan Statistical Area Consumer Price Index – All Urban Consumers of 2.6 percent.

**Supplies & Materials**

The category for Supplies and Materials decreases from $3.7 million in FY 2016 to $3.6 million in FY 2017 due to the elimination of one-time items funded in the FY 2016 Adopted Budget. For the out-years of the Forecast, it is assumed that costs will increase based on the 2.6 percent annual CPI increase.

**General Expense**

This category includes costs for travel and meetings, telephone and non-city utilities, contingency accounts, subsidies and grants provided through the Human Services Resource Allocation Process (HSRAP), and bank card service charges. The FY 2017 Forecast for this category remains flat as compared to FY 2016 at $4.7 million. For the remaining years of the forecast, this category assumes annual increases between 2.5 and 2.6 percent. These figures do not include General Expenses for the Cubberley Lease which is explained in further detail below.

**Cubberley Lease**

In Fiscal Year 2015, the City and Palo Alto Unified School District (PAUSD) agreed to an extension of the Cubberley Lease by five years starting January 1, 2015. As part of the lease agreement, the City Council approved creation of a fund for Cubberley infrastructure improvements. Based on the new lease, $1.9 million will be transferred to the Cubberley Property Infrastructure Fund for future infrastructure improvements. Therefore, the $1.9 million is classified as an Operating Transfer Out which is discussed in further detail below. With the Cubberley infrastructure funds set aside, the FY 2017 Forecast Budget includes $5.8 million for Cubberley Lease payments. In accordance with the lease agreement, the Forecast assumes a 3.0 percent annual CPI increase for the lease payments to the Palo Alto Unified School District (PAUSD) for the Cubberley facility. Also, the lease agreement period is five years; however, for planning purposes in this Forecast, it is assumed that the agreement will continue during the entire Forecast period.

**Rents & Leases**

Rent and Lease expenses for FY 2017 are estimated to increase by $38,000 from the FY 2016 adopted level of $1.5 million. The largest expense in this category is $1.1 million for the
Development Services Center. From FY 2018 forwards, this expense is expected to increase by 2.6 percent per year.

Facilities & Equipment
Facilities and Equipment expenses for FY 2017 are projected to decrease by 20.1 percent, or $0.1 million, as compared to the FY 2016 Adopted Budget, due to the elimination of one-time funding included in FY 2016. One-time items funded during FY 2016 include the purchase of 30 AEDs ($50,000), community center furniture replacement ($25,000), and the build out of office space at the Development Center ($20,000). After the elimination of one-time funding, projected expenses in this category of $0.5 million will remain fairly consistent in FY 2018 and beyond. Consistent with the 20-year CPI for the San Francisco San Jose Metropolitan Statistical Area, the forecast assumes a 2.6 percent annual increase starting in FY 2018.

Allocated Charges
Allocated Charges represent expense allocations by the City’s enterprise and internal services funds for services and products they provide to General Fund departments. In FY 2017, these charges are estimated at $18.1 million including utilities usage (24.2 percent or $4.4 million), liability insurance (7.5 percent or $1.4 million), technology costs (33.9 percent, or $6.1 million), vehicle equipment and replacement costs (27.7 percent or $5.0 million), and other costs (6.7 percent, or $1.2 million). The FY 2017 charges of the forecast updates the revenue and expense for these cost plans based on the most current information available at the time of Forecast development. Growth of 2.6 percent is anticipated in the out-years, which is based on the average annual expense growth over the forecast period.

Operating Transfers Out
Operating Transfers Out includes transfers from the General Fund to the Debt Service Fund, Technology Fund, and Airport Fund. Fiscal Year 2016 year-end projected transfers out total $1.8 million, and are expected to remain at that level for FY 2017. In FY 2018, the transfer level is anticipated to increase by approximately $0.3 million, primarily attributable to debt service payments for the Golf Course Reconfiguration project ($0.5 million), partially offset by the elimination of a transfer to the Airport Fund ($0.3 million).

Transfer to Infrastructure
In FY 2016, the adopted General Fund transfer to the Capital Improvement Fund is $19.0 million, which includes the base transfer of $14.0 million and $5.0 million from additional Transient Occupancy Tax (TOT) proceeds generated through a two percentage point TOT increase as well as through the addition of new hotels. Incremental TOT increases from the rate increase and new hotels are dedicated to the Capital Improvement Fund to support the Infrastructure Plan, consistent with City Council direction. The transfers to the Capital Improvement Fund are anticipated to increase significantly as compared to the FY 2016 Adopted Budget, as the revenue generated from these new sources has outpaced initial
projections. In FY 2016, an additional $4.2 million is anticipated to be transferred to the Capital Improvement Fund. In the out-years of the forecast, the TOT-associated transfer is anticipated to increase between 4.1 and 5.2 percent annually. These additional increases will help in offsetting the rising costs of Infrastructure Plan projects and ensuring the projects in the plan will remain fully funded. Additionally, the base transfer to the Capital Improvement Fund is anticipated to increase by 2.6 percent each year. Finally, this category includes the $1.9 million transfer to the Cubberley Property Infrastructure Fund, described earlier in this document. This transfer remains flat in all out-years of this Forecast.

**Alternative Fiscal Year 2017-2026 Long Range Financial Forecast**

In order to provide potential alternative perspectives, staff analyzed two other long range alternatives including one with a low pension investment return and another with a projected recession beginning in FY 2019.

**CalPERS Poor Investment Return**

As discussed with the City Council in September 2015 and the Finance Committee in November 2015, Bartel Associates provided the City with a continuous poor CalPERS investment performance scenario. A continuous poor CalPERS investment scenario which Bartel defines as investment returns between 0.2% and 4.1% will result in exceedingly high pension rates. The table below shows the Bartel projected City pension contribution rates by plan based on continuous poor investment results.

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</tr>
</thead>
<tbody>
<tr>
<td>Miscellaneous</td>
<td>27.7%</td>
<td>29.5%</td>
<td>31.3%</td>
<td>33.8%</td>
<td>36.9%</td>
<td>39.1%</td>
<td>41.6%</td>
<td>43.8%</td>
<td>45.6%</td>
<td>47.0%</td>
<td>45.4%</td>
</tr>
<tr>
<td>Safety</td>
<td>41.9%</td>
<td>44.6%</td>
<td>47.9%</td>
<td>52.0%</td>
<td>57.0%</td>
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<td>64.1%</td>
<td>67.6%</td>
<td>70.2%</td>
<td>72.2%</td>
<td>73.9%</td>
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Based on these higher annual pension rates, pension costs would increase by a total of $34.0 million over the Forecast period, compared to the base model. The General Fund annual surplus in FY 2018, the first year impacted by the higher rates, would be reduced from $1.1 million in the base model to $0.7 million, a 36 percent reduction. This trend would continue through FY 2026 as the projected General Fund surplus of $3.4 million in FY 2026 would become a General Fund deficit of $5.4 million. During the Forecast period, the net operating margin fluctuates between positive $0.6 million and negative $5.4 million. This model does not project any additional revenue growth compared to the base model, which is the main reason expenditures begin to outpace revenue in FY 2021 and this gap continues to grow through FY 2026.
**Fiscal Year 2017-2026 Long Range Revenue Forecast – CalPERS Poor Investment Return**

**Alternate Model**

As described previously, the assumptions included in this Forecast, consistent with previous forecasts, are based on a historical analysis of increases using the Compounded Annual Growth Rate (CAGR) with adjustments factored in for reasonableness. The adjusted CAGR model factors in the impact of prior recessions but does not make assumptions about when a recession may occur. Typically, the average business cycle lasts six years and the period between the last two recessions was about ten years. Below, an alternative Forecast model is presented for informational purposes showing the projected impact of a recession beginning in FY 2019. This recessionary model adjusts the projected tax revenues and decreases the rate of growth for certain non-salary expenditures, which would be expected when the next downturn occurs.

Assuming an onset of a recession at the beginning of FY 2019, as can be seen in the table below, a significant annual deficit of $9.7 million would exist in FY 2019. Assuming the FY 2019 deficit is not solved with ongoing expenditure reductions the annual deficit would grow to between $10.6 and $21.7 between FYs 2020 and 2024. However, as shortfalls are addressed primarily due to expenditure reductions, the subsequent ongoing deficits are reduced as shown in the net operating margin analysis. By addressing the net operating margin shortfalls over three years, the City will return to surpluses starting with FY 2022.

<table>
<thead>
<tr>
<th>Fiscal Year 2019 Recession Alternate Forecast</th>
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### Fiscal Year 2019 Forecast – Recession

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenue</th>
<th>Total Expenditures</th>
<th>Net One-Time Surplus/Shortfall</th>
<th>Cumulative Net Operating Margin (One-Time)</th>
<th>Cumulative Net Operating Margin</th>
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<tbody>
<tr>
<td>2019</td>
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<td>$185,672</td>
<td>0</td>
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<tr>
<td>2020</td>
<td>$185,446</td>
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</tr>
<tr>
<td>2021</td>
<td>$204,135</td>
<td>$222,456</td>
<td>($10,039)</td>
<td>($141,028)</td>
<td>($141,028)</td>
</tr>
<tr>
<td>2022</td>
<td>$202,263</td>
<td>$214,875</td>
<td>($10,289)</td>
<td>($151,317)</td>
<td>($151,317)</td>
</tr>
<tr>
<td>2023</td>
<td>$205,725</td>
<td>$227,705</td>
<td>($13,980)</td>
<td>($265,297)</td>
<td>($265,297)</td>
</tr>
<tr>
<td>2024</td>
<td>$207,725</td>
<td>$231,680</td>
<td>($13,955)</td>
<td>($399,252)</td>
<td>($399,252)</td>
</tr>
<tr>
<td>2025</td>
<td>$214,875</td>
<td>$239,184</td>
<td>($8,309)</td>
<td>($488,561)</td>
<td>($488,561)</td>
</tr>
<tr>
<td>2026</td>
<td>$224,764</td>
<td>$245,680</td>
<td>($10,916)</td>
<td>($599,477)</td>
<td>($599,477)</td>
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</tbody>
</table>

### Fiscal Year 2020 Forecast – Recession

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenue</th>
<th>Total Expenditures</th>
<th>Net One-Time Surplus/Shortfall</th>
<th>Cumulative Net Operating Margin (One-Time)</th>
<th>Cumulative Net Operating Margin</th>
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</thead>
<tbody>
<tr>
<td>2020</td>
<td>$185,446</td>
<td>$204,295</td>
<td>0</td>
<td>$0</td>
<td>$0</td>
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<tr>
<td>2021</td>
<td>$204,135</td>
<td>$222,456</td>
<td>$91</td>
<td>($499)</td>
<td>($499)</td>
</tr>
<tr>
<td>2022</td>
<td>$202,263</td>
<td>$214,875</td>
<td>($10,039)</td>
<td>($141,028)</td>
<td>($141,028)</td>
</tr>
<tr>
<td>2023</td>
<td>$205,725</td>
<td>$227,705</td>
<td>($10,289)</td>
<td>($151,317)</td>
<td>($151,317)</td>
</tr>
<tr>
<td>2024</td>
<td>$207,725</td>
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</tr>
<tr>
<td>2025</td>
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<td>$239,184</td>
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</tr>
<tr>
<td>2026</td>
<td>$224,764</td>
<td>$245,680</td>
<td>($10,916)</td>
<td>($599,477)</td>
<td>($599,477)</td>
</tr>
</tbody>
</table>

Assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures.

The recessionary model assumes a reduction in major tax revenues, though they are anticipated to decline at a lower rate than those in the Dot.Com bubble and Great Recession. The economically sensitive revenue sources follow somewhat different patterns in reacting to a recession. Acting like a harbinger, historical data indicates that Documentary Transfer Taxes decline just prior to the onset of a downturn.
Sales Tax and TOT decline dramatically, as was the case during the Dot.Com bubble and Great Recession, in the year a recession is declared. A recession’s impact on Property Taxes, however, lags behind the other categories by approximately 2 years as it takes considerable time for the County Assessor to reflect residential and commercially assessed valuations downward. Staff’s assumptions for economically sensitive revenues in this alternative scenario are as follows:

- **Documentary Transfer Tax:** declines by 8.5% or $0.6 million in FY 2018 followed by another decline of 22.4% or $1.5 million in FY 2019.
- **Sales Tax:** declines 11.8% or $3.5 million in FY 2019 and by another 5.0% or $1.3 million in FY 2020.
- **Transient Occupancy Tax:** declines by 11.5% or $3.1 million in FY 2019 and dips further in FY 2020 by 4.6% or $1.1 million
- **Property Tax:** Palo Alto has been fortunate in past recessions with property taxes plateauing rather than declining. Beginning in FY 2019, staff expects revenues to level off at $43.0 million and stay at this level through FY 2021.

**Conclusion**

The Long Range Forecast projects a slight General Fund surplus of $0.1 million for FY 2017 and, except for a budget shortfall in FY 2018, reflects a generally positive outlook over the next 10 years. Economic indicators demonstrate that the local business environment is rebounding; however, substantial financial obligations and added uncertainties may diminish the General Fund surplus over the next 10 years.

Despite improving revenue receipts as projected forward, the City continues to face challenges related to the funding of infrastructure, the desire to retain and attract a talented workforce, being responsive to the City Council priorities and the community expectations, rising benefits costs, and unfunded long-term pension and retiree healthcare liabilities in the amount of $439 million. Additionally, as an Alternative Forecast Model shows, the City needs to be prepared for the next recession. Having healthy reserves and a potential separate pension trust plan to offset a recession impact will be critical in order to have a future budget that allows staff and the City Council at least a year to plan for permanent budget adjustments.

While the City is addressing these short and long-term issues, the City needs to continue reviewing its operations and service delivery options. Over the last few years, the City has outsourced services to the private sector and entered into negotiations with the non-profit sector for public-private partnerships. Staff is engaged in finding a partner to effectively and efficiently operate Animal Services and is exploring different service delivery options for the City’s aquatic operations. While the City further explores alternative service delivery models with the goal to reduce staff levels and related benefit costs, the City will also review cost recovery levels of services currently provided to the community. In early 2016, staff will bring forward recommendations to increase fees for the Planning and Community Environment Departments as well as other departments to align the fees with the cost recovery goals set by the City Council approved User Fee Cost Recovery Level Policy.
This 10-year Forecast assumes an additional $68 million to be dedicated towards the completion of infrastructure needs. Although these additional funds are substantial, they may not be sufficient to build the projects due to escalating construction costs or within existing timelines. Therefore, as prior infrastructure plans have not completely materialized to completion, it will be important to focus on maintaining the current plan as a top priority and not be tempted to increase ongoing operational expenses that surface unless they are deemed absolutely necessary in order to complete the plan.

The City is currently updating its Comprehensive Plan. Staff is in the final stages of assessing the fiscal impacts of the various planning scenarios that will be used to analyze policy choices that will have to be made as part of the Comprehensive Plan Update. Once the City Council approves the Comprehensive Plan update with its inherent policy choices, revenue assumptions for future Forecasts will be aligned with the new Comprehensive Plan.

During the next two months, staff will continue to monitor revenue sources as well as update revenues and expenditures, as applicable, based on newly available information. This updated information will be reflected in the FY 2017 Proposed Budget, which is scheduled to be released to the City Council late April 2016. While facing some significant unfunded financial challenges, the City is in a good position to plan accordingly and based on the diversified revenue sources it can continue to address the necessary infrastructure needs, but decisions must be prioritized and focused.

**Attachments:**
- Attachment A: Revenues (PDF)
- Attachment B: Expenditures (PDF)

**Endotes**

i International Monetary Fund (IMF), *World Economic Outlook: Executive Summary*, October 2015, Page XV

ii International Monetary Fund (IMF), *World Economic Outlook: Executive Summary*, October 2015

iii International Monetary Fund (IMF), *World Economic Outlook: Chapter 1 Recent Developments and Prospects*, October 2015, Page 1


v UCLA Anderson Forecast, December 2015

vi UCLA Anderson Forecast, December 2015


viii UCLA Anderson Forecast, December 2015

ix Bureau of Economic Analysis (BEA), *Local Area Unemployment Statistics*, December 2015

x UCLA Anderson Forecast, *Job growth, wage increases to push real GDP growth past 3% for first time since ’05*, December 2, 2015.
xi Zillow, California Home Prices & Values, Zillow Home Value Index, Accessed December 2015
### Fiscal Year 2017-2026 Base Long Range Financial Forecast - Revenues

<table>
<thead>
<tr>
<th>Revenue &amp; Other Sources</th>
<th>Adopted 2026</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
<th>2025</th>
<th>2026</th>
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</thead>
<tbody>
<tr>
<td>Sales Taxes</td>
<td>$27,630</td>
<td>$26,850</td>
<td>$28,474</td>
<td>$29,402</td>
<td>$30,017</td>
<td>$30,775</td>
<td>$31,559</td>
<td>$32,348</td>
<td>$33,180</td>
<td>$34,052</td>
<td>$34,975</td>
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<tr>
<td>Property Taxes</td>
<td>35,067</td>
<td>35,074</td>
<td>37,453</td>
<td>39,917</td>
<td>42,516</td>
<td>45,172</td>
<td>47,863</td>
<td>50,523</td>
<td>53,266</td>
<td>56,079</td>
<td>58,951</td>
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<tr>
<td>Transient Occupancy Tax- General Purpose</td>
<td>13,766</td>
<td>15,317</td>
<td>16,115</td>
<td>16,772</td>
<td>17,470</td>
<td>18,209</td>
<td>18,990</td>
<td>19,797</td>
<td>20,626</td>
<td>21,482</td>
<td>22,371</td>
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<tr>
<td>Transient Occupancy Tax- Infrastructure</td>
<td>5,025</td>
<td>9,232</td>
<td>7,113</td>
<td>10,109</td>
<td>10,530</td>
<td>10,975</td>
<td>11,446</td>
<td>11,933</td>
<td>12,433</td>
<td>12,949</td>
<td>13,483</td>
</tr>
<tr>
<td>Documentary Transfer Tax</td>
<td>6,852</td>
<td>7,050</td>
<td>7,432</td>
<td>7,865</td>
<td>8,340</td>
<td>8,875</td>
<td>9,453</td>
<td>10,000</td>
<td>10,564</td>
<td>11,146</td>
<td>11,744</td>
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<tr>
<td>Utility Users Tax</td>
<td>11,189</td>
<td>10,495</td>
<td>11,209</td>
<td>11,811</td>
<td>12,147</td>
<td>12,423</td>
<td>12,581</td>
<td>12,782</td>
<td>13,097</td>
<td>13,531</td>
<td>13,986</td>
</tr>
<tr>
<td>Other Taxes and Fines</td>
<td>2,180</td>
<td>2,180</td>
<td>2,022</td>
<td>2,122</td>
<td>2,242</td>
<td>2,304</td>
<td>2,367</td>
<td>2,433</td>
<td>2,500</td>
<td>2,568</td>
<td>2,639</td>
</tr>
</tbody>
</table>

**Subtotal: Taxes**

101,709 | 107,198 | 112,418 | 117,998 | 123,201 | 128,671 | 134,196 | 139,750 | 145,599 | 151,739 | 158,078 | 164,553 |

| Charges for Services                     | 17,576       | 17,576 | 17,872 | 19,416 | 21,729 | 22,999 | 23,090 | 23,803 | 24,538 | 25,298 | 26,084 | 26,896 |
| Stanford Fire & Dispatch Services        | 7,823        | 7,148 | 7,316 | 8,229 | 8,533 | 8,850 | 9,178 | 9,518 | 9,871 | 10,237 | 10,615 | 11,009 |
| Permits and Licenses                     | 8,211        | 8,211 | 8,670 | 8,866 | 9,128 | 9,365 | 9,609 | 9,859 | 10,116 | 10,379 | 10,649 | 10,926 |
| Return on Investments                    | 824          | 824   | 840   | 857   | 876   | 917   | 940   | 964   | 990   | 1,019  | 1,050  | 1,082  |
| Rental Income                           | 15,296       | 15,296 | 15,015 | 15,631 | 15,885 | 15,033 | 14,510 | 14,879 | 15,257 | 15,646 | 15,971 | 15,951 |
| From Other Agencies                     | 373          | 373   | 333   | 337   | 341   | 345   | 349   | 354   | 358   | 363    | 367    | 372    |
| Charges to Other Funds                   | 11,930       | 11,930 | 11,550 | 12,123 | 12,593 | 13,153 | 13,685 | 13,863 | 14,282 | 14,618 | 15,001 | 15,388 |
| Other Revenue                           | 1,609        | 1,609 | 1,344 | 1,382 | 1,420 | 1,456 | 1,494 | 1,532 | 1,571 | 1,611  | 1,652  | 1,694  |
| **Total Non-Tax Revenue**                | 63,642       | 62,967 | 62,933 | 66,870 | 70,514 | 71,497 | 72,833 | 74,747 | 76,557 | 79,140 | 80,109 | 82,430 |

| Operating Transfers-In                  | 18,589       | 18,589 | 20,088 | 20,491 | 20,895 | 21,299 | 21,704 | 22,110 | 22,517 | 22,924 | 23,332 | 23,740 |
| BSR Contribution (One-Time)             | 1,732        | 1,732   | 1,732  | 1,732  | 1,732  | 1,732  | 1,732  | 1,732  | 1,732  | 1,732  | 1,732  | 1,732  |
| Golf Operating Loss Reserve Liquidation | N/A          | N/A    | N/A    | N/A    | N/A    | N/A    | N/A    | N/A    | N/A    | N/A    | N/A    | N/A    |

**Total Source of Funds**

$185,672 | $190,486 | $195,446 | $205,360 | $214,610 | $221,467 | $228,733 | $236,607 | $245,072 | $253,803 | $261,519 | $270,723
# Fiscal Year 2017-2026 Base Long Range Financial Forecast – Expenditures

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>56,015</td>
<td>55,677</td>
<td>58,567</td>
<td>61,102</td>
<td>62,875</td>
<td>64,590</td>
<td>66,191</td>
<td>67,686</td>
<td>69,192</td>
<td>70,712</td>
<td>72,251</td>
<td>73,809</td>
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<td>Benefits</td>
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<td>56,296</td>
<td>59,885</td>
<td>64,772</td>
<td>68,470</td>
<td>72,207</td>
<td>74,766</td>
<td>77,302</td>
<td>79,360</td>
<td>81,530</td>
<td>83,581</td>
<td>85,672</td>
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<td>17,362</td>
<td>14,474</td>
<td>15,739</td>
<td>16,252</td>
<td>16,653</td>
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<td>17,497</td>
<td>17,937</td>
<td>18,387</td>
<td>18,850</td>
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<td>3,664</td>
<td>3,595</td>
<td>3,698</td>
<td>3,814</td>
<td>3,913</td>
<td>4,014</td>
<td>4,118</td>
<td>4,225</td>
<td>4,335</td>
<td>4,447</td>
<td>4,562</td>
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<td>4,725</td>
<td>4,718</td>
<td>4,836</td>
<td>4,958</td>
<td>5,083</td>
<td>5,212</td>
<td>5,344</td>
<td>5,479</td>
<td>5,617</td>
<td>5,759</td>
<td>5,905</td>
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<tr>
<td>Cubberley Lease</td>
<td>5,584</td>
<td>5,584</td>
<td>5,751</td>
<td>5,924</td>
<td>6,101</td>
<td>6,285</td>
<td>6,473</td>
<td>6,666</td>
<td>6,867</td>
<td>7,073</td>
<td>7,286</td>
<td>7,504</td>
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<tr>
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<td>431</td>
<td>432</td>
<td>432</td>
<td>431</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
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<td>Rents &amp; Leases</td>
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<td>1,493</td>
<td>1,531</td>
<td>1,571</td>
<td>1,611</td>
<td>1,653</td>
<td>1,696</td>
<td>1,739</td>
<td>1,784</td>
<td>1,830</td>
<td>1,878</td>
<td>1,927</td>
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<tr>
<td>Facilities &amp; Equipment</td>
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<td>622</td>
<td>497</td>
<td>511</td>
<td>524</td>
<td>538</td>
<td>552</td>
<td>566</td>
<td>581</td>
<td>596</td>
<td>612</td>
<td>628</td>
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<td>18,642</td>
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<td>22,832</td>
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<td>50,314</td>
<td>49,101</td>
<td>51,353</td>
<td>52,809</td>
<td>53,736</td>
<td>55,136</td>
<td>56,571</td>
<td>58,017</td>
<td>59,531</td>
<td>61,086</td>
<td>62,682</td>
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<td><strong>Operating Transfers-Out</strong></td>
<td>1,834</td>
<td>1,834</td>
<td>1,834</td>
<td>2,094</td>
<td>2,129</td>
<td>2,169</td>
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<td>2,239</td>
<td>2,292</td>
<td>2,045</td>
<td>2,085</td>
<td>2,126</td>
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<td>15,852</td>
<td>16,216</td>
<td>16,563</td>
<td>16,918</td>
<td>17,283</td>
<td>17,657</td>
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<td>18,435</td>
<td>18,839</td>
<td>19,254</td>
<td>19,670</td>
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<td>5,025</td>
<td>9,232</td>
<td>9,713</td>
<td>10,109</td>
<td>10,530</td>
<td>10,975</td>
<td>11,446</td>
<td>11,933</td>
<td>12,433</td>
<td>12,949</td>
<td>13,483</td>
<td>14,034</td>
</tr>
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<td><strong>Total Use of Funds</strong></td>
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<td>$189,204</td>
<td>$195,355</td>
<td>$205,992</td>
<td>$213,730</td>
<td>$220,959</td>
<td>$227,398</td>
<td>$233,771</td>
<td>$239,481</td>
<td>$245,645</td>
<td>$251,779</td>
<td>$258,043</td>
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</tbody>
</table>

<table>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>N/A</td>
<td>-0.6%</td>
<td>5.2%</td>
<td>4.3%</td>
<td>2.9%</td>
<td>2.7%</td>
<td>2.5%</td>
<td>2.3%</td>
<td>2.2%</td>
<td>2.2%</td>
<td>2.2%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Benefits</td>
<td>N/A</td>
<td>-0.6%</td>
<td>6.4%</td>
<td>8.2%</td>
<td>5.7%</td>
<td>5.5%</td>
<td>3.5%</td>
<td>3.4%</td>
<td>2.7%</td>
<td>2.7%</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Contract Services</td>
<td>N/A</td>
<td>0.0%</td>
<td>-16.6%</td>
<td>8.7%</td>
<td>3.3%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Supplies &amp; Material</td>
<td>N/A</td>
<td>0.0%</td>
<td>-1.9%</td>
<td>2.9%</td>
<td>3.1%</td>
<td>2.6%</td>
<td>2.6%</td>
<td>2.6%</td>
<td>2.6%</td>
<td>2.6%</td>
<td>2.6%</td>
<td>2.6%</td>
</tr>
<tr>
<td>General Expense</td>
<td>N/A</td>
<td>0.0%</td>
<td>-0.1%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Cubberley Lease</td>
<td>N/A</td>
<td>0.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
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</tr>
<tr>
<td>Debt Service</td>
<td>N/A</td>
<td>0.0%</td>
<td>0.3%</td>
<td>0.0%</td>
<td>-0.3%</td>
<td>-100.0%</td>
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Chairperson Schmid called the meeting to order at 6:10 P.M. in the Community Meeting Room, 250 Hamilton Avenue, Palo Alto, California.

Present: Filseth, Kniss arrived at 6:17 P.M., Scharff, Schmid (Chair)

Absent:


Chair Schmid: Look at numbers, why don't we turn to Item Number 3, General Fund Long Range Financial Forecast.

Lalo Perez, Administrative Services Department Director and Chief financial Officer: Thank you Vice Mayor Schmid. We have staff from our (Inaudible) office and (Inaudible) office that's going to make a presentation and after we conclude our presentation from staff, we want to have Mr. Bartel do a presentation on a potential methodology of funding on (Inaudible) liability through the establishment of the 115 Trust we've been discussing. So with that, let me turn it over to Kiely Nose to start the presentation.

Kiely Nose, Budget Manager: Hi, I'm Kiely Nose, I'm the Project Manager. So the Long Range Forecast is really the kickoff of the 2017 fiscal year budget process and today, we're going to discuss what the short term and long term financial outlooks for the next 10 years primarily focusing on the major revenue and its expenditure reduction. So How are we doing? So before I start, you know, we talked about historically the picture perfect and that's with a--what the city can afford all of our service levels. We have the same amount of library hours, police services, you know, (Inaudible) staffing, able to be funded and generally a slight ongoing surplus, would be ideal. So that's How are we doing. The graph before you, is showing then surpluses and deficit as projected during the next 10 years. So for fiscal year '17, at this time, we're projecting very slight surplus of approximately 100k and then the fiscal year '18, we're primarily due to expend
expenditures growing at a more rapid pace than our revenues. The models projecting a slight short of all profits of at least 600k. Thereafter, we projecting annual surpluses somewhere between 500k and 12.7 million over the course of the remaining years. So as I said, the blue depicts the annual surpluses and shortfalls, however, typically as part of the annual budget process, the city spends the surpluses in respond to new service needs and solves those deficits hopefully on a long going basis. These new service needs have an ongoing budget impact, however. So for example, the blue line dipping in this fiscal year 2020 and starts to rise again in fiscal year 2021. Therefore, if we just focus on the blue line, it's not representing the entire picture, so we need to look and analyze year over year change of the annual surpluses as they're spend in deficit as they're resolved and that's what the red line is showing you. So the red line shows the year over year change of the annual surpluses and deficits. So for example, if we again take the fiscal year 2020 as the annual surplus after the fiscal year '19 starts to decrease, the red line is going to dip in 2020. This chart is just the Forecast Model in numerical format and it includes the percentage increases year over year. Most notably you'll see in fiscal year '18, that the expenses are growing faster at 5.4 percent and revenue is at 5.1 and this primarily due to salary and benefit adjustments based on projected cost of living increases and market changes. As the community is quite aware, with every model, there's a significant number of unknowns. So this slide is identifying all the unknowns noted in the report before you. The major ones you guys have probably seen before are things like the Fire Services contract to Stanford, obviously our pension, retiree, healthcare, trust, the unfunded liability. At this time, I'll turn it over to Tarun who's going to discuss the revenue sections in further detail.

Mr. Narayan: Good evening, my name is Tarun Narayan. I'm the manager of Treasury, Debt and Investment and I will spend about five minutes approximately in the next two slides going over in dept. into the five major revenue sources. To begin with, overall the city's revenue continues to see strong revenue recovery since the "Great Recession." In addition, sales, property and documentary taxes had in the last two years significant one time receipts that resulted in above normal revenues while transient occupancy tax had a rate increase, the 2 percent and new hotels. Utility User tax was the exception. Its performance was mediocre. Now, I'll be discussing the details of these in a moment. So the bullet point two in this particular slide, as in the past two years, per the council direction, the compound growth rate, known as the CAGR, is used to forecast the 2017 through 2026 projections. Imbedded in the CAGR are things like past recessions, however, reasonable and informed adjustments are made such
as the Tier 1 rate change, the new hotels, changes in major tax generation and one-time events. So if you go to slide number 8, the following graph shows 22 years of major tax revenues. The five major tax revenues; 11 years of actuals—

Chair Schmid: Could I just ask a question.

Tarun Narayan, Manager of Treasury and Debt Investment: Yes.

Chair Schmid: The compound annual growth rate comes from the past, is it 2005 to 2015 or is it the 20 year? How far is that—

Mr. Narayan We look at both the 20 year, 10 years, and 5 years typically. We used 10 years as the guideline, but we do also look at the shorter duration to just kind of get a reasonable [test].

Mr. Perez: Vice Mayor Schmid, just to remind the committee cause some of you were not part of the committee. That was based on directions from a prior finance committee that staff to use those compounded annual growth rates, focusing on the 20 years.

Mr. Narayan So as I was saying, this chart has 11 years of actuals and 11 years of projection. Property tax, the redline in the graph is the biggest receipt of the major five revenues. As indicated in the report, property tax has risen substantially in the last few years and are projected to have CAGR of 5.9 percent over time over the next 10 years. A slightly higher than last year's CAGR, which was around 5.4. City property tax estimate for fiscal year 2016 is based on information received from the quarterly meetings with the Santa Clara County Assessing office. Projections beyond 2016 are based on historical growth rate as well as the information provided by a consultant. Property tax receipt for fiscal year 2017 estimated at $37.5 million. At this point, I'd like to share a few statistical highlights about our property tax in the past, the council has shown interest in. We have approximately 8,000 or 43 percent of our residential properties have 600,000 in assessed evaluation. Of these, on average, a little over 3 percent—

Council Member Kniss: Would you repeat it once more?

Mr. Narayan About 8,000 or 43 percent of all residential properties in Palo Alto have a value of under 600,000, assessed value.
Council Member Kniss: You mean houses; you're not talking about apartments at all?

Mr. Narayan No.

Council Member Kniss: Just—

Mr. Narayan Well, residential does include not only single homes, apartments, multi condo units.

Council Member Kniss: Okay. So it's all of our residential are included in this—

Mr. Narayan Exactly, all residential, correct. Of these, a little over 3 percent annually change ownership resulting in today's sale price of nearly about 2.7 times above the assessed value. At this time, I like to bring your attention to an error on the top of page 16 of the (Long Range) Financial Report. It states the property tax within the assessed value of 1.0 million would sale for 1.7 million today. It actually would sale for 2.7 million. The 1.7 million really only represents a growth in assessment.

Council Member Scharff: Those on page 17 of the staff report.

Mr. Narayan: Actually on the top of 16 I believe, unless (Inaudible) have changed.

Council Member Scharff: Okay, got it.

Mr. Narayan: The top section, second bullet. So on average, 1 percent of all resident properties could change hands and the 7.1 percent includes all properties including the 600,000 that I just cited. However, this can vary greatly in a given year. So just give you a example. In 2010, only 1.7 percent of residential properties changed hands, while in 2012, 10.3 percent did. While in last year 2015, 6.4 percent did. So the 7.1 percent average, can be misleading when you get to any given year. On the other hand, on average, 1.2 percent commercial properties annually change hands. Similarly, they do fluctuate, but it's a small fluctuation. For example, in 2010, only 0.4 percent of property change hands.

Council Member Scharff: Do you know what it was this year, change hands?
Mr. Narayan: This last one was—hold on one second, I do. In 2015, it was like 1.9 percent.

Chair Schmid: What is that a share of 1.9 of what?

Mr. Narayan: 1.9 percent represents just the commercial properties, so overall we have about 1800 commercial properties and we have 18,000 residential properties.

Chair Schmid: And what's the ratio on average of turnover?

Mr. Narayan: So the average is 1.2 percent, but similar to residential properties it can fluctuate like in 2010, it was 0.4 percent and in 2015, it was 1.9 percent. So it can fluctuate in any given year. 1.2 percent is average for about 7-year period.

Mr. Perez: What this doesn't tell us is how is it turning over and what shape does it re-assess or not, depending on the way the ownership is transferring.

Chair Schmid: Right. It reassesses no matter how the ownership is transferred.

Mr. Perez: Not in commercial.

Chair Schmid: No, in commercial, it does.

Chair Schmid: Tell me how you would structure it so it doesn't. I mean, it does.

Mr. Perez: My understanding is depending on the percentage. In LLC, if you stay under 50 percent, it does not and this example—

Council Member Scharff: Right, if you stay under 50 percent.

Mr. Perez: Yes.

Council Member Scharff: But then you're not having an ownership change. If you sell less than 50 percent.
Council Member Kniss: It somehow do it Craig all the time. Same as Macy's case in 1986 when they challenge prop--13.

Mr. Perez: This property in Beverly Hills, so there's several examples. It's a process, it's not a single transaction.

Council Member Scharff: But you can come in under the assessment and look at as a step transaction and collapse if it's over a certain number of years.

Mr. Perez: It gets more complicated, but yes. I mean, I'm not an expert—

Council Member Scharff: Basically, if it's over 50 percent ownership change in an LLC, then you get reassessed.

Mr. Perez: That's my understanding. So I'm not insinuating all of these are not change in assessed evaluation, but my understanding is there are cases—and I've been in situations—

Council Member Scharff: I think they're really rare. I think they're really rare you're actually selling the property. I mean, there are ownership changes where someone comes in and says; I want, you know, I'm going to buy a portion or I'm going to buy a partner out. That's it. It's not really an ownership change in terms of what we think, you know, you still have the majority of ownership in when we actually sell these properties, but we have notice, right, I mean, the reason this comes in is because we always ask ourselves why is the share of property taxes continually pay more by residential and by commercial and that's--over time, that gap is widen. Before Prop 13, I forgot, I think it was actually more by commercial and less by residential and over time, it shifted into where residential was paying the bulk of it. And I think you hit on the reason for that, which seemed really clear, which is that the velocity of turnover in commercial is much, much lower.

Mr. Perez: Correct.

Council Member Scharff: And also we have many more residential properties and our residential properties are really expensive. I mean, they're, you know--and so, I think that's what's driving it and I think when we talk about the minor cases, which I believe to be minor cases—you know, when a partner buys another partner out, it doesn't get the 50 percent, that's not really the main case. I don't think you really have the situation
where every time someone does a commercial transaction, it's structured in a way that can't be turned over. I think that's really rare. It's really hard to do. You know, if you have a corporation for instance, if 50 percent of the stocks sells right? And those transactions are really hard to sale cause there's really negative tax consequences for selling real estate in a corporate form. So I think it's really rare frankly.

Mr. Perez: I think you're right on the residential and obviously we're seeing that there's a high number of properties held with assessed evaluation of 600,000 or less. It shows that a lot of our residence held their properties or a lot of the owners held the property for a long time and don't see the shift in changes.

Council Member Kniss: But one of the things—I met with the realtors last week about something else and they say that Palo Alto's turnover half as fast as most of the other cities on the Peninsula, which means that your property tax—that we need to look at that in light of the property tax. So it's one of the things that you might check on because the faster your houses turnover, the more your property tax goes up obviously.

Mr. Narayan One of the distinction of more so trend that I see, I've been looking at this for the last 15 years in Palo Alto, and a lot more of the residential properties are being put in trust, so you know, when the next generation typically would turn over by then on most of us be retired and probably not here anymore, that definitely will probably impact down the road in terms of future growth rates. But we're probably looking at maybe 20, 30 years down the road.

Council Member Kniss: Meaning that when they’re put into trust, that the tax basically stays the same.

Mr. Narayan: Right. I mean, typically—I'm not an expert in trust, but typically if they put it in a family trust and gave it to the children for example, they wouldn't really be a change of ownership as far as the county is concern and they wouldn't shake our reassessment to the market values.

Chair Schmid: Now in maturing of the city, property tax would be a decline in the share of homes that would have been owned for 40 years and are still near--at, or near 1979 limit. They're fewer those involved and there's more of those who are moving into trust, so you're undermining the most dynamic part of the property taxes and the question is, as you do a long term
forecast, wouldn't that employ the property tax would begin to level off, if there isn't a new dynamic entry.

Mr. Narayan: Yeah, that would be the implication that several decades down the road when typically, would have changed hands because a new generation would be coming in. That would definitely the growth would plateau.

Chair Schmid: Yeah. So your forecast does not contain that. You think as you say still 20 years to go?

Mr. Narayan: Yeah. I think it's along in the horizon because what I see is, you know, families in the last 10, 5 years etcetera, if you--and this is just my guestimate, if you take maybe probably a 30-year-old comes in, stays here and maybe, you know, 20, 30 years on average before they passed it one. Do it's still beyond, I think, our 10 year forecast, so eventually, it would have impact but not in the horizon we are looking at.

Council Member Scharff: So I don't actually understand the family trust thing either. So you know how it works? I mean, what you're suggesting is that I can take my property, put it in irrevocable family trust, which would not trigger reassessment at that point?

Mr. Narayan: I believe you have to change the ownership to do it, so if you had an existing property—

Council Member Scharff: But at the time you change the ownership, you're then get reassessed at that point.

Mr. Narayan: Yeah, yeah.

Council Member Scharff: Right? So I mean, for instance--so yes, so I think you might be able to do that, but are we saying people are actually--you know, if you have a 1970's assessment--

Mr. Narayan: Yeah.

Council Member Scharff: Take Greg Schmid, you know, pay no property taxes, right, have a 1970's -- you buy the house in the '70. the '80s?

Chair Schmid: '70's.
Council Member Scharff: In the '70s, right? If he put his property into a family trust for your kids, you would now have today's assessment. That's what would happen.

Mr. Narayan: That's correct.

Council Member Scharff: So if you did that—

Chair Schmid: Mr. Narayan, what were you say?

Mr. Narayan: I'm not an expert, but my general understanding, how my understanding was, is you had to change ownership, the trust would affect the change of ownership, but I'm not an expert on the legal, whether you could do it without triggering a reassessment market evaluation. Cause on of the thing that county does is, regardless of what the sales price of a property is, the county will review what the market evaluation is relative to the sales price—

Council Member Scharff: They never say it's less.

Mr. Narayan: Yeah, so it it's—

Ms. Nose: Sometimes they do.

Mr. Narayan: If it's significantly of, they will use the market value.

Chair Schmid: If it's within a family, is it treated as a reassessment ownership?

Council Member Kniss: No, no. The kids can (Inaudible0 it, which is the best deal going.

Suzanne Mason, Assistant City Manager: But in a trust, when a person dies, who owns the trust, I’m going through this now, then the value gets set and then when you go to sell that property, the growth that you're going to pay the capital gains on--

Council Member Scharff: That's capital gain.

Ms. Mason: Right. But then that growth, that assessed value at that point, became a tax base and so...
Council Member Scharff: See, I don't think we understand this. I think we make these statements without actually understanding.

Council Member Kniss: Why don't you invite the assessor to come to these (meeting.)

Council Member Scharff: Actually that might be a good idea because—

Council Member Kniss: Yeah or David, you know, David (Gainsburg) who works for him, very, very informative.

Council Member Scharff: Cause I mean, we have to—

Chair Schmid: Do you have an idea--you said you've been tracking this for a number of years. How many family trust?

Mr. Narayan: I haven't quantified because there's no easy way to kind of quantify without just looking at the name and see which ones has trust associated with it, but just of the top of my head, I see at least--initially I see these are a quarter, they're now by half, a little over half of that was--

Council Member Scharff: But you understand that a revocable trust has no impact on property taxes? No impact on anything? It's just in a state planning (Inaudible). So you'll see stuff in so and so family trust and so and so revocable trust, that is not what we're talking about here. That is no impact on it.

Mr. Narayan: Unfortunately the documents i see does not really tell me what type of trust they are.

Mr. Perez: So why don't we put a pen on that and invite the county assessor?

Council Member Scharff: I agree, but I just think that they're, I just think that they're this, there's this--the sense that we say this in the community and we make these statements, I don't think they're true. And I think we see on the thing that it says "Trust," but we don't understand that a revocable trust is not that kind of a trust which allows you to keep your 1970s assessment.

Chair Schmid: You were just finishing up property tax.
Mr. Narayan: Right. So moving on to sales tax, which is the blue line on the graph, as indicated, this is the second highest of the revenue sources. The city does employ consultant to help us analyze the forecast data for this revenue. Sales tax in the last two years had one-time event that resulted in higher revenues than normal. In fiscal year 2014, there was a lot of exceptional receipt from a single vendor and then in fiscal year 2015, there was an accounting one-time accrual adjustment was made that resulted in 14 months of sales tax being recognized in a month most of the typical 12 months, so those two events kind of elevated the sales tax beyond what the normal levels are. So the fiscal year 2016 and '17 projection, then returned the receipt levels to a more representative level of about 27.9 million for the '16 and 28.5 million. The sales tax has a CAGR of about 2.6 percent over the next 10 years, so very modest. Factor into the forecast, our weekly receipts over the past several years is from a few key generators. Areas of concerns, we have in this area is mostly of the online sales tax, which has been a concern for numerous years. So for example, the total online sales as was reported in the report for Cyber Monday rose about 16 percent compared to last year. Our consultant (Inaudible) Services tells us that annually it estimated that one percent of Palo Alto's retail sales moved to online sales. The (Inaudible) is in 2017, we estimating a Mercedes Benz dealership opening up in the last quarter of fiscal year 2017—

Council Member Scharff: Can I just ask a question? Are we going to make more money on the Mercedes dealership or the hotel? Which would have done it better for the city? I'm just curious.

Mr. Narayan: It's probably about comparable, I think between the two.

Mr. Perez: Those are some assumptions obviously on the room rate and the average occupancy. We were making a different assumption given the location.

Mr. Narayan: It's all on average--our consultant tells us a dealership like that can generate anywhere from 800,000 to maybe 1.1 million. A combination of car sales versus the operations side of it. The hotel is probably a little bit higher than probably that, but then the Mercedes could be a concern in this area. Who knows, could have a higher sale beyond the average, so. The negative of sales taxes is in the potential loss of the prior (Inaudible). The receipts have been declining for the last several years. The other concern we have, the HB Split, we do get some potential revenues from them and we just don't know what the potential impact may have on us. That concludes the sales tax item so if you—
Chair Schmid: Let's see, let me ask a couple of questions on the sales tax. I know in our comprehensive annual financial report, it has 10 years of data and very striking increase in the last three years in the non-retail, All Other it's called. Now, you mentioned the Tesla Special K's—

Mr. Narayan: In 14 years.

Chair Schmid: And then the 14-month year, we had—

Mr. Narayan: In the 15th.

Chair Schmid: But my understanding is also part of the Stanford Development agreement is that they would make all purchases on site. That's recording for Palo Alto and I'm wondering if there's a significant source of sales tax is coming out of that construction related purchases. Do you know anything about that?

Mr. Narayan: Unfortunately, I can look into it, but I don't have a break down on that. So no.

Chair Schmid: I'm concerned that it wasn't just two things that are happening, but it's this Stanford. You know, if you see the chart that you have there, the increase is not just the about, but it's actually a four or five-year increase, which coincides with the Stanford Development project. So I'm concerned that the sales tax might end up taking a bit of a hit once that's completed, what 2018.

Mr. Perez: Yeah, we can definitely get those numbers and look at it and the other concern is the shifting to more online sales as well.

Chair Schmid: Yeah, that's another question. I thought that online sales were being taxed and they were going to be redistributed through the county back to the city. Is that right?

Mr. Perez: With the exception of specific agreement such as Amazon. There were cut out agreements that wherever the warehouse distribution was, that's where the sales tax would go to, that particular agency. That was a deal with the state agree upon to keep Amazon and warehouses—

Chair Schmid: So we're not likely replace the retail sales, not likely all of them. Maybe some of them, but not all of them.
Mr. Perez: For these carved out agreements, correct.

Chair Schmid: I've noticed that our retail sector, put it together is about where were in 2006. There's no increase taking place.

Mr. Perez: Retail has been flat.

Chair Schmid: Yeah. I guess it's hard when you keep trying to put in grocery stores, they don't work. There might be a reason.

Mr. Perez: Probably.

Mr. Narayan: That'd be the questions?

Chair Schmid: Yeah.

Mr. Narayan: So will move on to transit occupancy tab. This is now represented by two line in the graph. The blue is the general fund portion while the brown color is the infrastructure receipts. So we broke it down to two so you can see what the general fund and the infrastructure portion are. So the hotel occupancy in daily room rates have risen substantially even with additional three hotels, we with the fourth expected to open up soon. I talked to the folks at Clemente they originally expected to open up in November, but they had problems with the contractors, so they're hoping to now either mid-January or February. As I said, they have all this staffs trained and waiting so they really, really want to open up as quickly as possible, but they have to get the construction out of the way.

Council Member Kniss: How big is--how many rooms are there? It looks small from the street.

Mr. Perez: It is. It's going to be mostly high end suits. You have 1.—

Mr. Narayan: There are 23 rooms.

Mr. Perez: Clemente was talking about—

Council Member Kniss: So you'll have the Sheridan at 112, and then you'll have the Western that's next—

Mr. Perez: Yes.
Council Member Kniss: And now you have the Clemente, which is your high-end—

Mr. Perez: Yes.

Council Member Kniss: Suites?

Council Member Scharff: And a boutique.

Mr. Perez: Yeah.

Council Member Kniss: Yeah, yeah.

Mr. Perez: He was--I don't know where's he's going to end up, but he was trying to do an all-inclusive suites concept in the range of $800 a night.

Council Member Scharff: That's cheaper than the (Inaudible).

Council Member Kniss: They should give us tours—

Mr. Perez: That's what he said. With the inclusive, it's even a better deal (Inaudible).

Council Member Scharff: Can we annex that?

Council Member Kniss: So just 23 rooms. That's ridiculous.

Mr. Narayan: To continue on, in 2010, the occupancy rate was about 66 percent while in 2015, it's 80 percent so that's represent about 21 percent increase while room rates while 140 back in 2010 is by 242 in fiscal year 2015. So that's a 71 percent increase. I looked at the last few months of 2016, it has a similar occupancy, slightly below in a given month like 77, 78 percent, but the average room rates are higher at $253. In some months, it's high as 266, so a day.

Council Member Scharff: It averages all the cheaper hotels in (Inaudible)—

Mr. Narayan: Yes, yes.

Council Member Scharff: Right? Like the glass slipper and—
Mr. Narayan: Yes. It's an average of all of them.

Council Member Kniss: It think those are less than 260 a day.

Chair Schmid: The increases are hard on taxes.

Council Member Scharff: I don't know. They might not be.

Mr. Narayan: So to kind of give you an idea on rooms on average can be like 275--oh, there's one at 434 in a particular given month, while the lower ends can be in the 70, 80, 90 dollars’ range. So there's quite a range, you know, from 450 to under a 100 dollars. So on the (Inaudible), let's focus on the TOT for the infrastructure. This includes estimated revenues for all of the new hotels build and about to open, so that's about four, Clemente is the fourth one, that's not opened yet, but does not include those in planning stages. In fiscal year 2016 and '17, we had a 9.2 million and a 9.7 million that are forecasted for infrastructure TOT. The shock increase TOT from 2015 of 3.3 million to 2016 of 9.2 million as a tri-burial to the following; the two Hilton hotels, they were opened four months in 2015. That means we have an additional eight months of new revenue in the 2016, so that's a substantial increase. As I mentioned, the Clemente is expected to open in the next month or two, so those will be new additional revenues as well as the 2 percent TOT increase. You know, we applied half the year in 2015, so when you analyze the rate, it adds another six months of new revenue. So that's where you see the 2015 spiking up tremendously to 2016. As for the- -so what did happen, not included in the TOT forecast? As you know the (Inaudible) hotel has been cancelled this time and now is being planned for the Mercedes Benz dealership. The two Marriott hotels in the planning stages, those hasn't been included in this particular forecast.

Chair Schmid: Included or decided where to include it?

Mr. Narayan: No, no, it hasn’t been included in the long range forecast. The two Marriott’s that are planning.

Chair Schmid: I guess the question is they are opened as to how that revenue is treated. That correct?

Mr. Narayan: Yeah, that's--.
Mr. Perez: In terms of where they go for infrastructure or the general? You know, we believe, but you know, obviously, this is a policy area for you as a committee for you to consider. We discussed what we knew at the time and again, I don't recall us talking about any future hotels should be included, I think you kind of left it open for yourselves to make those calls as you went.

Chair Schmid: Okay. Thank you.

Mr. Narayan: Okay. On the general fund TOTs representing by the green line in the graph, the CAGR growth rate for the next 10 years is by 4.3 percent. That does include a new source of revenue, which is that Air B and B revenue source is included in the general fund portion.

Council Member Scharff: How much are we getting from that?

Council Member Kniss: Yeah, that's like a (Crosstalk.)

Mr. Perez: We have to give you a range because we can't speaks to specifics.

Council Member Filseth: Do you have a range you could give us?

Mr. Narayan: Yeah. It's around, you know, 500,000 to about 800,000.

Chair Schmid: That's a big number.

Mr. Narayan: Yeah, it's a big amount.

Council Member Kniss: And we're getting?

Mr. Perez: Yes.

Council Member Kniss: It's gone up a lot.

Mr. Narayan: In 2015, we got six months' worth and so the annualized number is you know, in the 5 to 800,000 range.

Council Member Filseth: This is an old number, but in August, there were over 7,000 listings for the Peninsula South Bay for Super Bowl week and
there's an expectation that there's going to be huge numbers, so if you want to list your homes—

Council Member Scharff: I know; I was just talking my wife into it—

Council Member Kniss: The same. I tried to talk my husband into it—So, would you explain though on Air B and B, is the tax collecting from the parent company?

Mr. Narayan: Yeah. The one thing about Air—

Council Member Kniss: It's not individually, I presumed?

Mr. Narayan: Yes. We do receive it from the parent company, not individuals. In the prior years, we used to receive a handful from individuals, but now with the new agreement, it comes from the parent. The things they don't provide us is some statistics like the number of rooms are being rented, what the average is. Unlike our normal hotels where they do provide statistics about averages or things we can deduced based on what they do know what the averages are. Air B and B is kind of an exception. They send us a monthly total. That's pretty much it.

Council Member Kniss: Can we demand more than that or is that the agreement that cities have with the parent company?

Mr. Perez: They've taken an interesting approach that they gone into negotiations with almost agency by agency, which is kind of different.

Council Member Kniss: Kind of.

Mr. Perez: But we can tell you is that we were one of the early implementers beyond--in the area and others are following suit. We were up there with some of the major cities like San Francisco, New York in terms of early on, so you know, should acknowledge Joe and Karen, Molly and her staff for working on this and getting us ahead of the curb.

Council Member Scharff: It's a good question on this topic too (Inaudible), now it's delay I guess. So we're projecting that transit and occupancy taxes are going to grow at five percent compound over the next 10 years.
Mr. Narayan: Yeah, about four or five percent, the CAGR by 4.3 in terms of the general fund or are you talking about the infrastructure?

Council Member Scharff: You know; I was looking at both.

Mr. Narayan: Okay. They have about a similar growth pattern beyond the first one or two years.

Council Member Filseth: So that's about twice code. So why is that? Is it going to be a question of we think that hotel rates are going to continue to grow on sustain basis faster than the rate of growth of other costing barrier or we're expecting demand is going to increase faster than--cause we're adding--we're going to have supplies, but if there's no more people, it just going to (Inaudible). So why is that? What's the assumption?

Mr. Narayan: The data would suggest to do that. I mean, we do see the occupancy slightly declining, which is typical, but typically when that happens, the room rate would decline correspondingly, but it's actually going the other direction. The room rates, so the hotels are able to basically demand a higher price for what they got.

Council Member Filseth: Because there's no--because they get bigger, because there's more desire.

Mr. Narayan: Yeah.

Council Member Filseth: So we just put a growth limit on our offices through the city. Is that going to impact that at all?

Mr. Narayan: That's a tough one.

Mr. Perez: It's not something we're studying, it probably more appropriate for the fiscal study on the (complex) instead of--the planning and permit has hired an expert, an outside financial--It looks like that's --We are looking at long term study, 10 years’ horizon.

Council Member Filseth: But we do know its not just Palo Alto that is a destination. I was thinking we're a big destinations point, don’t get me wrong, especially this is Stanford--

Mr. Perez: You Google expansion.
Council Member Filseth: Exactly and you know, they love to have more hotels. Santa Fe is expending; Santa Clara is expending in terms of hotel growth. There's a huge demand, that growth is there. The concern we have, if we have another experience like we did with the dot.com bust, in two years, we lost about 50 percent.

Council Member Scharff: So I'd like to jump in on that since you mentioned (my name). I actually think it you'll have no impact whatsoever and the reason I know you'll have no impact is you're going to have continued Facebook expansion on one side and you're going to have the (Inaudible), and you're having--I think the bigger risk frankly is that they build a lot more hotels in Redwood City, right, which is also a huge expansion. Huge office space growth and that starts to capture--

Mr. Perez: Of course.

Council Member Filseth: If anybody looks out there and say wait a second, this thing is going to grow at five percent a year compounded, right? You know, from now until next century. They're going to do the same as we're doing.

Chair Schmid: Well, there're two plans in Menlo Park. There are two plans in Redwood City and there's the big one in Santa Clara.

Council Member Filseth: But we're talking about in 10 years. There'll be more. Right?

Chair Schmid: Yeah.

Council Member Scharff: So I actually don't think we're going to get the five percent growth because every city wants a hotel also. If anything, we're probably the most anti-hotel of all the cities.

Council Member Kniss: We are, absolutely.

Council Member Scharff: Everybody else bends over backwards to get a hotel and so my sense is they will build to the market. Right. At which point, occupancy will start to fall and they'll start to take ours, and so I don't see the five percent compounded growth rate.

Chair Schmid: I think I agree with you. I think that's right.
Mr. Narayan: The (Inaudible) has been our concern based on the information we have. You're probably right. As the surroundings areas, including maybe two Marriott’s. At some point, they will be at an impact. But based on what we have today, that's we have forecasted on.

Council Member Scharff: So the other thing I like to say on that is I think, since I went through it on the Finance Committee, I think if we think back to the way we were thinking in 2009, 2010, you know, very different attitude, very different occupancy rates, hotels were --you could see that, where it was dipping. Right? And if you look back at the financial forecast from 2011, 2012, they're so much more conservative. The revenues are $30 million less in the (outfields), 40 million dollars in the outfields, makes a huge difference. So I actually think, you know, in business cycle, we like at the peak right now. Right? We're on peak. That means, we're going to go down, one way to go.

Council Member Filseth: I know. This time it's different.

Mr. Perez: You know, that's a good observation cause you're actually right at that point, but my recollection and that's where Joe and I were very concerned was that we heard the economy just about, you know, we can't generalize what you hear, what's having doubts of us recovering really quick. We were very concerned about that and that's--we looked at our numbers then and obviously it didn't' turn out to be that way. We came out much, much faster than the rest of the nation in our period.

Council Member Scharff: Joe has never been a consensus of year out economist we're going to have a recession, ever.

Mr. Perez: There is--you know, most of them agree that if you look at it in a 10 year forecast, you're going to have--I think a statistical number around the area a year, so.

Council Member Kniss: You put that in every report, so.

Chair Schmid: We're going to thank you for doing that by the way.

Council Member Filseth: So yeah, I'm with you. I think actually the conditions sustain five percent a year. I don't see it.
Council Member Scharff: I think we should build a new office and build another 30 new hotels.

Council Member Filseth: But no parking.

Chair Schmid: Can we move ahead?

Mr. Narayan: The next big item is the document transfer tax, which is the purple line, the graph. This revenue source is somewhat unpredictable given the volume of the mix of promotional and residential transactions can vary significantly from year to year. The prior two years, document transfer tax receipts, the '14 and '15 fiscal years, have record setting years; $8 million in '14 and $10 million in '15. The fiscal year '14 has numerous commercial and high volume residential home sales while fiscal year 2015 had a $1 Billion in commercial sales by a single entity involving seven major properties that netted the city $3.3 million. So that $10 million dollars we received, 3.3 of them was from this transaction. This kind of transaction is like a once a decade event.

Council Member Filseth: That's the Hudson properties.

Mr. Narayan: Yeah, yeah. The sales price went by $1 billion of that, which was substantial.

Council Member Filseth: Another one-time event.

Mr. Narayan: You're not likely to see that for a while.

Chair Schmid: It's not a one-time event because that's a change of ownership of property.

Mr. Narayan: That's true.

Chair Schmid: Why doesn't it show up in the property tax? If you look at the property tax during that year, the share pays by non-residents.

Mr. Narayan: Yeah. We would actually see the full impact of that in 2017. We were just talk with the county, so there's transactions occurred around the April timeframe. So the way the county has it is, in the first fiscal year, it went to the supplemental property tax and the supplemental property tax
is shared by everybody in the county. We get a piece of San Jose’s; they get a piece of ours.

Because it occurred after January 1st, the second year, which is the 2016 will also went up in supplement, will summarily share. Actually, I calculated around 450 to 500,000 in terms of secure property taxes. We won’t really see that back until the ’17 fiscal year, so it's going to be a little bit delayed as what you would think of where it would hit immediately.

Chair Schmid: But we can anticipate then in '17 that there will be some recognition of what's happening in document transfer tax?

Mr. Narayan: Yes.

Council Member Scharff: So you think it's about 500,000 more?

Mr. Narayan: Yeah. So if you had about, you know--we looked at what the old AV was, compared it to what the new AV would be based on the sale--assuming the sale price, it does assume that they didn't exorbitantly overpaid because as the county said, they looked at all the transactions, look at the market valuation relative to the sale prices and if there's a big differential, they'll re-evaluate.

Council Member Scharff: So which transactions was this?

Mr. Narayan: These were, like I said 7 major series. You had a lot of --

Mr. Perez: Camino (Peach) property.

Council Member Scharff: So it's Palo Alto Square

Mr. Perez: There were four other properties; four or five total.

Mr. Narayan: Yes, so these cover like the hotel research center, the Palo Alto Square, there was the 3400 of the Hillview area, the Page Mill Center, the Clock Tower Square, the 3176 Quarter Drive and the Marketeer Place. Each of them have--some of them have multiple address location, multiple buildings.

Chair Schmid: A lot of those are on the Sanford property, so it did not include property?
Mr. Narayan: These were--the ones we counted for were all within the city's jurisdiction, therefore subject to--

Chair Schmid: But when you get to Porter and other places, the land is owned by Stanford, inside the city.

Mr. Narayan: Yeah. If it's inside the city, it would be subject to our property taxes.

Council Member Scharff: The fact that its own by Standard, it's long term grounding, so long term grounding changes--

Mr. Narayan: As long as its-yeah

Council Member Scharff: Assessment based on ownership of the long term grounding.

Mr. Perez: 50 years for long--

Mr. Narayan: As long as it is not within the Stanford boundary, it would be subject, yeah. So to continue on, the fiscal year 2016 is early projection of 7.1 million and 7.4 returns the receipts to levels more representative. As I indicated, the last two years, we think was exceptionally high and we have are not anticipating that levels will continue on. So that's for the documentary. I'll take a moment if there's any additional questions for that.

Chair Schmid: Are you going to add them up?

Mr. Narayan: Yes, they are.

Chair Schmid: I guess the bottom line, you have total source of funds run between 3.5 and 4 percent per year. Is that correct?

Mr. Narayan: I did not add--I mean, I do not have to add those specifics--but hold on one second.

Chair Schmid: Yeah, so bottom line.

Mr. Perez: You're asking about the growth rate?
Chair Schmid: Yeah.

Mr. Perez: It’s 3.8 percent.

Chair Schmid: Okay. But that includes the two years of--

Mr. Perez: 3.58 percent.

Chair Schmid: Okay. Yeah.

Council Member Filseth: Actually go back to the projected. They used the inserting point as planned, adopted? If you go back to projected, that's the number you get, 3.58 percent.

Chair Schmid: So that's your best interpretation over the next decade.

Mr. Narayan: Yes.

Chair Schmid: What we might anticipate our revenue probably be.

Mr. Narayan: Correct.

Chair Schmid: 3.5, 3.6.

Mr. Narayan: Yes.

Mr. Perez: It derived from finance committee directions to use a 20 year CAGR.

Chair Schmid: Right, but when we talk about sustainable budget, I guess want to be thinking in those terms. It's a very important number for us.

Mr. Narayan: I mean, we do analysis also with the recession model, which is represented to kind of reflect.

Council Member Scharff: We'd like you to do that and we'll get that corrected.

Mr. Narayan: Yeah, okay.
Council Member Kniss: I think this is all intriguing, it's fascinating. But once I go out 10 years, what's that really doing for me?

Mr. Perez: That's a good question. You know, sometimes there's discussion among our group of finance officers that maybe 10 is too long, other agencies use 5. Steven Levy, who we have reviewed this for us as a courtesy, tells us, the best couple of years, that's the best that I can help you. Beyond that, you know, it’s a guess.

Council Member Kniss: I agree with him. I don't know how you can make predictions. We can make guesses--

Chair Schmid: When we approve infrastructure investment, we're doing it for the long term.

Council Member Kniss: Of course we're doing it for the long term, but--

Chair Schmid: When we sign an employment contract, that's for the long term.

Council Member Kniss: I don't disagree at all. What I'm saying is 10 years out is pretty far and most economist that I've talked to said that's too far to project their income.

Chair Schmid: But we have to project revenue stream just as we are projecting expenditures.

Mr. Perez: When we talk about the city's long term, that's a 30 process. I'm not trying--

Council Member Kniss: That's true, if we're talking liabilities, but I think the projection for revenue is a tough one.

Mr. Perez: One of the reason that we want to do it as an organization beyond our planning is to demonstrate to the rating agencies that we're looking and we're planning and we're trying to adjust for the unforeseen. And that helps us when we go to the rating agency presentation. For example, when we bid the general obligation funds for the library, a lot the records that we have on place where--we had a deficit, we covered. We maintained our reserve levels and we projected what our long term expenses were and we showed them those documentations and that's what
led us to getting a triple A rating. So that's another reason why we want to do it beyond our typical plan.

Chair Schmid: I think when we look at number (Inaudible), is a critical number in what is available to have.

Mr. Perez: I think actually -- to answer your question, I think the list is fairly short, but it's very important. Right? One is anything relating to infrastructure, okay, is a long term kind of thing. Anything in this town that's going to inquire land, okay, is a very long term kind of thing because it's very, very expensive, okay. Anything related to our long term liability, that's a long term kind of thing. So I mean, if the alternative is, you know, we plan on a one-year basis. Right? Or a two-year basis, that just basically mean anything we get, we spend it. Right, you know. We have stuff that we have to deal with. So I agree with you, right, I think our ability to predict exactly what our revenues are going to be, you know, one year, two years from now. I think we did pretty good actually. As you point out, it's throw darts, but you have to understand the directions because small changes of this stuff, although long periods of time, make an enormous difference, so you have to project—

Council Member Scharff: That's the (inaudible) is what you just said; that it allows us to prove the point that if we change the pensions just a little bit, we change, you know, the healthcare just a little bit, we get the extra hotel, it's just a little bit. I mean, it's those small changes make huge difference and that's what this shows.

Council Member Filseth: We also go another one, it's not really our business, but it is our business, okay. We're just, you know--

Chair Schmid: Well, it’s the small change that (crosstalk) not a--

Council Member Filseth: To build another high school, it cost $500 million dollars.

Chair Schmid: Not a leap thing, but something that flows.

Council Member Filseth: So there's an element of this that's a great concern to all of us, the PAST's business cause its (Inaudible) school capacity. That's a long term thing.
Chair Schmid: So Mr. Narayan?

Mr. Narayan: Um-umm.

Chair Schmid: The bottom line is very important for us.

Mr. Narayan: Right. So the last item is, just to finish it off is our utility user tax, which is in the turquoise color. This resource has a 10 year CAGR of 3.2 percent. The utility user tax for 2016 beyond forecast equal points the two changes by the voters in 2014, that was the telephone UTT was reduced by (Inaudible) of 75 percent and the logic to use discounts was eliminated. The receipts anticipated from the UTT for electric, gas and water is basically (inaudible) plus 5-year revenue. A rate projection, and this is important because these estimates could change as the department discusses the proposed rate plan with the Utility Advisory Commission, the Finance Committee, as well as the City Counsel and based on decisions that are made will correspondingly change the forecast accordingly. The forecast assumed for '16 and '17 about 10.5, 11.2 million in UTT receipts. So overall, for the last couple of years, as you can see based on the forecast, we our projecting very healthy revenue increases with exception of UTT, which is more in the line of, you know, a slight increase, but mostly being on the flat side.

Chair Schmid: Great.

Ms. Nose: So turning to expenses, salaries and benefits comprised about 61 percent of our annual expenditures. Positions are budgeted at actual rate of pay including benefits as of fall 2015. The city's currently in negotiations with various bargaining groups, so our forecast includes salary assumptions, benefits increases based on projection increases and the cost of leaving and market (base services).

Council Member Scharff: So you're saying two and a half percent? What are you saying?

Ms. Mason: We're using CPI based figures and market based assumptions going forward and I'm not sure that they're absolutely flat.

Ms. Nose: No. Especially giving the current negotiations.

Mr. Perez: These are based on the data that's been compiled.
Council Member Scharff: So we must be using the number in our assumptions.

Chair Schmid: Walter, you must know about this.

Mr. Rossmann: What we do is--we obviously--as we're progressing from labor negotiations, we get updates from the authority we get from the council. That's included in that forecast. Once we go beyond the terms of the contracts, we range down to two percent salary increase, so it's (hourly) years of the forecast, and thereafter, with the corresponding benefits increases.

Council Member Scharff: So the hourly years, we're looking at two percent increase?

Mr. Rossmann: That's correct. That's tradition what we've done in the last few years.

Council Member Scharff: I know, do we capture, you know, there's the salary increase and then there's the, you know, general staff increases, and merit increases that occur.

Mr. Rossmann: That's correct.

Council Member Scharff: And the two different basic organizations, and so I understand why the two percent’s' in there, but--do we ever go back and look historically what the number is and use that number? Wouldn’t' that make more sense? I mean, we're not saying we're giving that--but historically, it's gone up three percent on average over the last 10 years or four percent or five, I don't know what it is.

Mr. Perez: So, there's been discussion about that and there's been different viewpoints from the council. Some feel that if you imbed something like that into this document, then it becomes the promise for future increases. We've gone back and forth over time, so what we basically said is well, instead of going one way or another, why don't we pick up a number that we take is a base for assumption purposes and use that knowing that the numbers could be different in some cases--

Council Member Scharff: Higher.
Mr. Perez: You know, we had several years where we didn't have any (inaudible). And so--

Chair Schmid: The way we kept back salary and benefit down though is recession only laid off 40, 50 people.

Council Member Scharff: Right. Almost 70 positions.

Chair Schmid: So it doesn't reflect what people are actually earning.

Council Member Scharff: Even in the recession, there's no cost of living increase? Like I know there were staff increases and I know there were merit increases.

Mr. Perez: Yes, there were.

Council Member Scharff: So you average that over the employees, I bet it's at least one and a half percent increase or something, I don't know, maybe one percent.

Mr. Rossmann: You see council member, if you look at the hourlies of the forecast, the last page of your CMR, that's on the board, if you take the tables of expenditure, we're showing you dollars as well as increases. So you see that (Inaudible) in there, it's the only staff increases which apply. What we do is we take a payroll snapshot. If somebody's in staff one, this would be in 2015, the second one in '16--actually, starting in '16, '17 staff two, etcetera, etcetera, until we reach the max. You see in the salaries, starting with 2019, 20, it drives down to about 2.2 average 2.2 average increase in salaries. Benefits goes down between 3.5 and the (Inaudible) below 2.5 percent. The reason--Cali will talk about it in a second, but I am going to preview it for you, the reason why benefits are actually decreasing, is health benefits are the same, but if we look to the Bartel presentation, we saw--in the finance committee in November, the Bartel--John is actually projecting pension rate increasing forward, he sees a flapping of the pension rate increase at the very last of the part of the 10 year forecast and we use those numbers. It's a (Inaudible) benefits actually decreasing per year. The rate of increase is decreasing.

Ms. Nose: So as Walter mentioned, he does assume things as staff increases consistent with (inaudible) raise as well as merit increases as well. The remaining expense options are outlined on this slide. Things like 80
percent of annual growth for 2010. Health benefits and other expenses are growing by the CPI.

Chair Schmid: A couple of questions before you leave salary and benefits. Are you assuming the same number of workers in the city now and 10 years from now?

Ms. Nose: Correct.

Chair Schmid: Yeah, that's a big assumption.

Ms. Nose: Yeah, big assumptions.

Chair Schmid: Because we're making changes or growth.

Council Member Filseth: You're assuming a head count in growth in 10 years?

Ms. Nose: Correct. It assumed the current level service, which is the current headcount of the organization. So if we wanted to increase services, you know, we would add positions and build expenses at that point.

Chair Schmid: So that's a big assumption. Second, big assumption on benefits. Now, I thought we had quite a dynamic meeting in November about the pensions and there were two big issues coming up in the future. One, under Estimate of (CalPERS) on mortality, length of life—healthy life and so on, I thought they had said they were going to start to adjust from that two years from now. That they are currently understanding that they might have done that and there will be a rate adjustment in two or three years. But I think there were some issue around that. The second issue with (Inaudible), which they just passed, instead of using 2013 as the baseline, we now had two years of very slow and investment returns and there will be some adjustment. What they would like to do would be to lower their risk profile by raising the rate and they have a way of doing that, they're just not going to (Inaudible) rate increase, but they have all sorts of slip it in. Those are two fundamental forces I thought we talked about and so I was surprised to see, but you actually have the benefit about percentage point lower than it was last year.

Mr. Perez: Why don't we talk to the pension and the assumption on those rates and then I'll cover the others.
Mr. Rossmann: So you're correct Vice Mayor. The comparison to last year's forecast, the pension benefits is lower than we actually see in this year's forecast. And with primarily (Inaudible) a lack of understanding the factual science, but we did last years, we look at the four to five years CalPERS has provided us and we literally extrapolated that. Talking to John Bartel, we actually realized that's not how Capers would have done it, that's not they actually do it therefore we adjusted that downwards. We see those changes in the tables under the pension section of the forecast. The second thing is you talk about there's—

Chair Schmid: The pension forecast tables though were based upon a rate of return which CalPERS has since acknowledged is too high.

Mr. Rossmann: That is correct. What CalPERS adopt is the risking strategy would say if indeed the rate of return is excess of 11 and a half percent, the assumed point of seven and a half percent points, then at that time, they will bring down the cost--they'll bring down a reduced investment term assumption with no cost to the city. That's what they're trying to do.

Chair Schmid: Which means an increase to the rate of the city.

Mr. Rossmann: Not necessarily an increase. They only like to do this once an investment is at 11.5 percent or higher in that years.

Chair Schmid: In that year.

Mr. Rossmann: In that year. That's when they're going to reduce it down. That's what they're saying today, it may change in the future.

Mr. Perez: What they said also is if through this process, it doesn't materialize, they will revisit those assumptions so you listed a little earlier in your comment, in February 2018, with discussion in the fall of 2017. In other words, if nothing changes, the rate still where it is, they would update that discussion and then the demographics, the image.

Chair Schmid: Yeah, I guess I'm concerned that the city is buying into their key assumptions that everything is okay and are taken care of and they show in the past they have not been very good at--

Mr. Perez: So that's a good point. Within our report, we're also talking about having a discussion with you about going forward with the Section 115
Trust because if that doesn't materialize, as you're stating, then we want to have the ability to cover all that and Section 115 Trust we believe it's appropriate to help us with that--

Chair Schmid: But you’re sort of undermine that case by accepting the CAGR's assumption that everything is okay.

Mr. Perez: Well, you know, I think you have to have a base. Right? And the base is it got to be in the report. Now, from there, I think we can do our own scenario. We kind of gave you our own scenario. Maybe that's too drastic--

Council Member Filseth: I actually think we should have a conversation about that tonight, which is what's the base scenario.

Mr. Perez: Sure.

Chair Schmid: Yeah.

Mr. Perez: And, you know--

Council Member Filseth: (Inaudible) cause right now or later, but--

Mr. Perez: What we've given you is from the direction we've been given from prior finance committees.

Council Member Filseth: Yeah. This is the base now. I think we should have discussion about this.

Ms. Nose: And then a little short later, we do have the alternative as well that has the lower risk investment.

Council Member Filseth: Yes.

Ms. Nose: So kind of looking at salary and benefits a little bit more at a (Inaudible) level, benefits cost is a percentage of our total salaries and benefits, increased from 15.6 percent in fiscal year 2017 to 53.7 in 2026. So over forecast period, salaries have compounded growth at 28 percent versus a compounded growth of benefit cost of 42.4 percent. So this compound growth is estimated as you guys noted, then the previous
forecast, primarily due to that lower city pension contributions in those app years.

Council Member Scharff: Can you go back to the previous slide for just one second?

Ms. Nose: Yeah, of course.

Council Member Scharff: Just want to observe that 3.9 percent annual growth salaries and benefits. I don't know that salaries and benefits, but historically, the general fund expenses are within 4.9 percent a year. Right?

Council Member Filseth: So it's much actually, a little higher than that. Okay. We just sort of concluded that with a projected increase in revenues is going to be 3.58 percent, so that's actually below the growth and salary benefit expenses.

Ms. Nose: Correct.

Council Member Filseth: Okay. Go ahead.

Mr. Rossmann: Recognizes that the budgets, salary budgets are only 61 percent of the total budget.

Council Member Filseth: Sure.

Mr. Rossmann: Right.

Council Member Filseth: Total budget historically have increased 4.9 percent a year. So that means that other 39 percent has a decreased.

Mr. Rossmann: That's correct. Not increases--

Council Member Filseth: Not increase (Inaudible).

Mr. Perez: Council Member Filseth, just so we understand when your crunch your numbers. Are you including transfers into now in your calculations?

Council Member Filseth: You know; I'm trying really hard to use the same numbers that you guys did.
Mr. Perez: My only concern is, for example, we've been more aggressive on infrastructure. We've increased our funding for infrastructure, which is in the transfers out, so--

Council Member Filseth: It's actually the same thing cause at some point, I like, you know, I don't know this, I'm not saying I did the same analysis with the citywide revenues and expenses and those gross were actually higher.

Mr. Perez: That's even a bigger variable because the commodities being involved. Right? So that's why it's important for us to figure out how we set up a view and comparison from other years because of these significant variables that we can have in different policy settings in one year to another.

Ms. Nose: So I think we've gotten to everyone's looking forward to, which is our alternative forecast model.

Chair Schmid: Oh, wait a minute.

Ms. Nose: Sure.

Chair Schmid: I guess in the other expenses--big item is Contract Services get a huge hit in Contract Services in 2017, 2018. What's taking place there? I thought there was a movement to try and find opportunism to bring in sufficient services. Is that possible?

Mr. Rossmann: Sure. So what you see is what happens every year as part of the budget. You might recall when you went through review of the 2016 budget, we asked for allotted one time additions, one time contractual services. These are taking out, so that's the change you'll see from '17. $4 million dollars in '16 down to 14.5 million dollars in '17. Then if we escalated the fact, which is an average CPI of the last 20 years in San Francisco Bay area of 2.6 percent. That's what the city has factored in the forecast. That does not minimize the point that we continuously try to seek opportunities to outsource--to change our alternative source LTTR models. You saw this in Fire Finance Committee in October with aquatic services as the next step. So staff still explore this, maybe not as systematically as we would like ourselves, but we still continue across departments to figure out how we can do things differently.

Chair Schmid: Just as an example, I mean we have substantially increased our spending on infrastructure and 80 percent of that is going to be based on contracting.
Mr. Rossmann: That is correct.

Chair Schmid: So shouldn't that show up as an increase in contracting?

Mr. Rossmann: No, it would not show up. It was going to happen in the Capital Improvement fund. We transferred the dollars from the Channel Fund to Capital Improvement fund and that's where you see the expense for contracting services. This is only channel funds pictures, not city wide all fund pictures.

Chair Schmid: Okay.

Council Member Scharff: So I have a question. You know, it's really hard for council member. We transfer money all over the place, we do different things. So I always look for simple measures if we're on track and I think one of the simple measures I like to see is what percentage over time is salaries and benefits versus other expenditures. You told us like 60, 61, right? So is there a chart that shows us, you know, over the last years, it stayed--if it stayed constant, then I think everything sort of going up together.

Mr. Perez: That is right. I've looked--

Council Member Scharff: And it has stayed constant.

Mr. Perez: I looked at 2000, it was 60 point something percent.

Council Member Filseth: You got to figure out what to do. Maybe you got to put half right? You got to figure out how to deal with capital expenditures in that mix to cause you're really looking at sort of--

Council Member Kniss: Apples and oranges.

Mr. Perez: It is apples and oranges, and that's what I was saying, It's kind of hard--because depends on how we were structure them, you know, we may change in that year on how we created (inaudible0 services for IT for example, when we positioned that, we put them in a service fund. So there's all sorts at play that makes it really complicated to have a constant comparison over a long period of time.

Chair Schmid: Okay, you were going to move on.
Ms. Nose: Okay. So as we discussed, in order to provide some potential alternatives, we analyzed to other long range options. One is the low pension budget return and the other is the projected recession beginning in the fiscal year 2018. The first one is the CalPERS Poor Investment Return Model. So this scenario reflects continuous poor CalPERS investment performance resulting in exceeding high pension rates. Our rates of return are between 0.2 and 4.1 percent and you can notice what happens to our bottom line. You'll see our operating budget surpluses reduced in fiscal year 19 and then in fiscal year 2020, we actually flip to a deficit in comparison to that base model.

Council Member Scharff: So in 10 years, it's about 50 million dollars in differences is what it looks like. Correct?

Mr. Perez: it goes from a surplus of 40 to a loss of 11.

Ms. Nose: Oh, I see what you're saying. Yeah. So then, the second model that we have presented is the 2000- an estimated 2019 Recession and this recession model assumes a reduction in our major tax revenues and they are anticipated to cline, but they are declining at a lower rate than those we saw in both the dot com bubble and the great recession.

Council Member Scharff: So, if I see that one right, you basically dig about a $100 million hold. Right?

Ms. Nose: Yeah.

Council Member Scharff: So it's about to a 140 short of the normal plan. Now I noticed on there, you used the normal expenditure train, not the low CalPERS expenditure train. Because of the big recession, you know, how realistic is it you'll have the normal CalPERS expenditures. It seemed like you'd have to add on cause if you added that on as well, you'd have another 100, another fixed rate, another 15 grand. Right? So you're $200 million dollar short over the 10 years. Now, that's probably not real, I mean I think 0.2 to 0.4 percent is probably pretty conservative right?

Mr. Perez: Very conservative.

Council Member Scharff: Pretty conservative, yeah. And in a recession, we'd only be a few years right, but I think it's going to be south of there right. Probably not a good assumption at seven and a half percent return compounded through the 10 years of big recession.
Ms. Nose: Definitely.

Council Member Scharff: Wonder if we did like, you know, six percent? You said before 6.5 percent or something like that. Right? That's what they got.

Mr. Narayan: We--I could--probably not off the top of my head right now, but that's a (calculated) ball number. I just don't think I have it right now.

Council Member Filseth: That actually was going to going to be--if we're going to sort of talking about this, it seems to me that the base planning case that the (Inaudible) use, you know, as good conservative folks shouldn't, you know, the CalPERS, I think we ought to look at--you think 6.5 percent is--?

Mr. Narayan: As long as you're asking me--

Council Member Filseth: Yeah.

Mr. Narayan: I think--what you would hear me say is the--ignoring for a moment the CalPERS risk mitigation strategy. So do me a favor set that aside.

Council Member Filseth: We set that aside a long time ago.

Mr. Narayan: I think that green line is what I would refer to as 50 percent confidence level number and what you may want to look at, is something that would be a little higher, maybe a 60 percent confidence level number. That probably comes closer to the seven rather than 6.5.

Council Member Filseth: I sort of think 6.5 might be a good number. I think if you took--

Council Member Scharff: So what kind of confidence you think 6.5?

Mr. Narayan: These are all of the top of my head, but I think that probably get closer to a 70 percent confidence level. When we're talking about the volatility, that's a very high confidence level with the volatility we have.

Council Member Filseth: We're a municipal kind of thing, you know. We're not like--we're not--it's not a Vegas road trip here.
Mr. Narayan: Yeah, think that's--

Council Member Scharff: Think it's too conservative. What about 6.75?

Mr. Narayan: Well, so you asked me before.

Council Member Scharff: You said seven.

Mr. Narayan: I did. So it doesn't mean that you couldn’t' use something other than that, but that's a--

Chair Schmid: Let me put the issue in a slightly different way, we're talking about long term (Inaudible). And you can have an average of seven percent return and if the last two years dipped down a little bit, your sum at the end, ends up being what your--close to what your projections are. But if those two years of dipping, where maybe the market is only four percent happen early on, it creates a whole in the deficit.

Mr. Narayan: It does.

Chair Schmid: Which is not recovered. Now the question is, you know, are we in such a situation now because if people ask you to get together with the first half of this year to raise the return fairly low, or if the market is overvalued and is going to go through a readjustment at point, we could see a substantial hole even if over 10 or 15 years, you've reached the seven percent.

Mr. Narayan: So how do I say this? It's almost as if you knew what my slides were. We kind of have a couple of sample investment return projection and our projecting annual rates based on those investment return and so I think we can get to and answer that help you with that question.

Council Member Filseth: So I was going to suggest that I think we should do that. Right? And the other factor I think we should put into this mix is if you go back to the slide about--go back about three slides, 3.9 percent of annual growth rate of salaries cause the annual growth rate of salaries, okay, also impacts this curve. So I think we ought to pick a number that' not two percent or whatever it is somewhere. I realize they're sort of like a bunch of things associated, but I think we ought to pick, you know, a number we feel more appropriate, put that next and that ought to be our base case. Cause, you know, everybody knows this, but I'll throw it around anyway, this chart,
you know, assumes that this is going to happen. Right? This doesn't happen, this doesn't happen, so I think we need to be a little more careful with the (Inaudible) here. I think we should be a little more conservative.

Mr. Perez: Why don't we switch on over to the presentation Mr. Bartel. John Bartel is here from Bartel and Associates. I won't have the presentation for you on paper, Mr. Bartel arrived this evening. I can provide that to you later electronically and make it available in the documentation.

Council Member Scharff: Is this Walter's last meeting with us.

Mr. Perez: It is unless you make him come back tomorrow.

John Bartel, Bartel and Associates: Mr. Bartel: Let me go through some of this information relatively quickly. You all have seen it before and I'm going to --if you want me to slow down, please tell me to, but my goal is to get towards the end where we look at supplemental pension trust. So I am only going to spend time on the very last score bullet there, the CalPERS Risk Mitigation Strategy. I do want to take a couple of seconds and talk about that. Everybody should understand that is not cost neutral. Everybody should also understand we have not yet factored it into our contribution projections. Here is really what CalPERS is doing. I'm going to start this out with, you know, there's a lot of great actuarial jokes. I'm going to limit it to this one. You all may have heard this before. Two actuarial are at the actuary range. One shoot misses the target 10 feet to the left. The other one takes the bull and arrow and go I can do better than that, misses the target 10 feet to the right. They turn to each other, shake each other's hands and go great. And then the guy watching goes, what the heck, are you doing? You didn't even hit the target. And they go, no, but on average, we got a bullseye. That really is sort of the natural of actuarial projection. What's going on here with CalPERS is they are moving one of those arrows a little bit. So what that means is, the two actuaries, if you move the arrows, don't get a bullseye. So what CalPERS is doing is taking off a portion of the expected investment return, the positive return and what that really means is that the average return will be less than the expected return. So the risk Mitigation Strategy will not--will almost certainly not be cost neutral, will increase rates over time. There's not really much doubt about that. You should expect that to be the case. That increase by the way, will be the last then if the increase happened all at once today.
Council Member Kniss: And that's an important point.

Mr. Bartel: No, it's very important. That's right. Slide two, Historical CalPERS Investment Return. What you're really seeing is that volatility. So if you think about this a little bit, we haven't done this graph, we almost certainly will, but if historically CalPERS has had their risk engagement, what would have happened is the lower returns would remain, but the upper returns would really drop because you're really pulling a large portion of those gains off the table.

Council Member Kniss: Would you go back to that other slide? Because what you've got written way at the bottom there, can't really see from here, it's pretty significant.

Mr. Bartel: No. They--well--$1.

Council Member Kniss: Cause that's taking you last, basically, 20 years.

Mr. Bartel- Yeah, that's right.

Chair Schmid: If I could just point out on that chart, in 20 years, the first has--first business cycle has six years of pro-rate of return.

Mr. Bartel: That's right.

Chair Schmid: The second one has four, third one has two, the fourth one has (Inaudible).

Mr. Bartel: That's right. I don't pretend to know what a good investment cycle is, but I will tell you is, the end of the '90s was particularly good. No questions about that.

Council Member Kniss: And the beginning of 2000’s, was particularly bad.

Mr. Bartel: That's absolutely right. There's really two periods there. There's the early 2000s that were particularly bad, and then of course the recession. That's absolutely right. You all have seen these graphs before. This is the contribution projection for miscellaneous. So this is the short term and this is the longer term. I'll just say this one thing. There's a change by CalPERS in terms of paying unfunded liability off before we've done these projections, before that change, you would not see the city's rate
dropping to the normal cost rate. You would see the rate getting to a slightly lower amount, but remaining quite high for a long period of time. So change--see the safety graph look somewhat similar. What I really want to spend a little bit of time on is the irrevocable supplemental pension trust. I am--the more we look at these trust, the more I'm convinced they a modestly good job of helping bring the unfunded liability down, but where their value really is, is really as a rate stabilization fund. You kind of see this in the next couple of slides, but there really are three variables here. Variable Number 1 is how much additional receipt money would you want to put into the trust could be a single sum amount right up front. Could be a constant amount over a period of time, so that's Variable Number 1. Variable Number 2 is what do you want to your contribution rate to be. What do you want your table contribution are to be and then option number three, or questions number three is, how long do you want the trust to be viable? How long do you want the trust to exist and essentially not run out of money? The idea really is that you put your supplemental contributions to the trust and then you compare your CalPERS actual rate to whatever your budgeted or to our target rate is and then if CalPERS rate is below that, you keep your budgeted rate and you put that difference into the trust and that's the CalPERS rate is higher than your budgeted rate, you pull money out of the trust to pay for it. So again, you keep your budgeted rate. So what we're going to do is look at two investment return scenarios. Investment return scenario A--both of these have some sort of investment return cycle to them, if you will. Investment Return A starts out with a 1516 and 1617 returns, quite bad and then you end up with three good years, two bad years, two good years and scenario B is two good, very good investment return; three bad, two good, two bad. And what you really see--we're going to show you the--we'll look at the miscellaneous plan is investment return scenario A, which starts out with those two very bad investment returns, gets to much higher contribution rate. If we were to extend this projection out a little bit, those two lines would actually cross. Green line, the scenario A line might come down a little bit. Purple or blue line for scenario B, might go up a little bit, but we're projecting out through 2024 and so what we're doing is for the purposes of our miscellaneous trust, we are assuming the city takes a -- we can certainly use different numbers, but we're assuming the city sets up a trust, puts an additional $1 million a year into the trust as additional contribution and sets the CalPERS contribution at 35 percent. So the buzzard in the mount is 35 percent, so if your CalPERS is below that, you put that additional amount into the trust, if it's higher than that, you pull it out of the trust. So what we did is we put those two scenarios, set the budgeted rate at 35 percent, so you can see early on for scenario A, what you're doing is, you're pulling, you're taking that delta and putting the additional amount into the trust and later on under scenario A, you pull that out--what is fascinating to me about this is, this particular scenario, we do
have an interactive model we could bring that up and kind of play it a little bit, but what you see here with this scenario is at June 30, '25, you have not exhausted your trust. And by the way, one thing--on assumption I did not put here, is the assumption is--the money in the supplemental trust is invested more conservatively. It's assumed to be a five percent rate of return rather--an expected five percent rate of return rather than a 7.5 return. In this scenario, at June 30, 2025, even though you're pulling a lot of money out late in the period, that additional million dollars here plus the additional contributions means that June 30, '25, you still have a positive balance in the trust. In the interest of full disclosure, you don't have a large--in this scenario, you do not have a large deposited balance, but you have not run out of money in the trust. And then you go to scenario B and scenario B, your contribution is consistently below your 35 percent budgeted amount. That is absolutely tied to that early--those early good returns, which drive the rate down and if we do the same projection with safety, but instead of 35 percent for safety, we use 51 percent contribution rate. If you go to compare the 51 to what we projected again under scenario A, you still end up with a positive balance; same scenario, a million dollars. So if you were to do one for both miscellaneous and safety, that would be a combined two million, so a million dollars into the safety account, again early on under scenario A, you would be feeding the trust and later on under scenario A you start withdrawing from the trust. You could come up with different contribution patterns, you could say, well, maybe we don't want to start out with a 51 percent budget for '16, '17, you could gradually build up to a number. My guest would be then if you gradually build up from the 51 percent, you probably have to--you probably have to end up at a slightly higher than a 51 percent in order to keep the trust solvent. This idea, the use of the trust for something like that is--I think allows you a lot more certainty in terms of budget. It has the added advantage, although I don't think this is a significant advantage, but it has the added advantage that anything you put into the trust, reduces your (Inaudible) 68 net pension liability. My expectation would be that it would be probably very positively received by the rate agencies. One thing that relatively quickly, happy to go back and answer any questions.

Council Member Kniss: And you'll make this available for us?

Mr. Bartel: Yes, yes.

Council Member Kniss: Great.

Chair Schmid: You mentioned concrete numbers, million dollars for each. Was that taken from our numbers or is it just a (crosstalk).
Mr. Bartel: No, it's a--it is a number that was discussed with staff as a--as something that might be achievable. But just to be clear, it's not--this is not a recommended approach by any stretch of the imagination. This is--

Chair Schmid: Just trying to carry that through, you know, at five percent interest over three, four years. You don't have a huge amount, so your ability to subsidize rate is limited.

Mr. Bartel: That's right. We wanted though to use a--so the five is going to vary a little bit because it does have some equity exposure, if you will. So we build it to be a--not as volatile as the CalPERS return, but if the idea is that its rate mitigation, I think of rate of mitigation as being more valuable when rates go up then when rates go down. And so the idea is that it accesses a little bit of an edge against the rates going down. So that's really why I would--I don't find--it's not really a recommendation, it's just kind of an example.

Chair Schmid: I guess my recollection of investment return is you earn 65 percent in the last three years of a 20-year investment and this seems like it'd be very active in and out over the business cycle.

Mr. Bartel: That's right.

Chair Schmid: It never gets big rates of return.

Mr. Bartel: I think that's right. The other comment I will make on this is, this process is not design to have a lot of money in it. It is designed so that if you--if you start to see it having a lot of money in it, you want to consider revisiting in, you know, if the trust ends up a lot of money, you ought to revisit every couple of years, your 51 percent or whatever your target rate is. So if you have a lot of money in the trust, maybe you bring the 51 down to 49 to be some advantage.

Chair Schmid: So it's more to help you over this cycle--

Mr. Bartel: It's exactly right.

Chair Schmid: That have been via the retirement fund.

Mr. Bartel: That's exactly what it--that's what I absolutely think the value when this (Inaudible), used to do exactly that.
Council Member Filseth: As opposed to paying down the UL early for example.

Mr. Bartel: That's right, that's right. I would not--

Council Member Filseth: If you wanted to pay on the UL early, what would you do?

Mr. Bartel: For me--let me give you my caveats cause the caveats is if I were--if I were on the city council, I would want very badly to pay that Unfunded Liability down as soon as possible. I will tell you, in normal environments, I think paying any Unfunded Liability sooner rather than later is absolutely the way to go. The challenge though is under the CalPERS model. If you pay the Unfunded Liability down very quickly, you end up with a high degree of likelihood that--much of that money you put in the trust is not--would not be useable. Meaning that your CalPERS contribution rate can't drop below the normal cost, so if you end up being more than a 100 percent funded, it would be the (Inaudible) equivalent of having a reserve in your city investment funds that you could not use for anything. If I were--for me, that's bad. And so I want to pay the Unfunded Liability down, but I want to do it cautiously so that I have access to that money. So that is an advantage to these trust. We think--

Council Member Filseth: Its part of the rational to keep the amount in the low so you don't have that much risk.

Mr. Bartel: That's right.

Council Member Filseth: Could you use this in combination with some other mechanism to pay down the Unfunded Liability quicker?

Mr. Bartel: The--just to be overly simplistic. If you wanted to pay Unfunded Liability down so bad, you couldn't resist that urge, I actually think you could move it into the Supplemental Trust. That reduces your Unfunded Liability, but it does not give that money to CalPERS quite as quickly, which I think mitigate your volatility and so it gets your Unfunded Liability. The downside to that is, the information coming from CalPERS still shows the higher Unfunded Liability, but it allows you to use that money to pay--to set a budget number that might actually be lower than the normal cost.

Council Member Filseth: I think we kind of rely CalPERS for our--I mean; I think you said it beautifully earlier this evening. You said "we got a liability
and we got an asset," and right now, we ask CalPERS to tell you what the value of our asset is. That's just too creepy. I think we need to know.

Council Member Kniss: I just want to ask, what (Inaudible) Mr. Bartel--

Mr. Bartel: Call me John, please. I know people call me Mr. Bartel, that was my father's name.

Council Member Kniss: I can remember John far better.

Mr. Bartel: I respond to John better, just so you know.

Council Member Kniss: Jim and I was just talking on the side. He did say you are the California expert on this.

Mr. Bartel: That's way too nice. In the interest of full disclosure, I like low expectations.

Council Member Kniss: Then so you cannot be disappointed.

Mr. Bartel: There you go, there you go.

Council Member Kniss: So as we look at something like this, tell us what other municipalities have done that is similar or dissimilar and who has come out ahead and who hasn't and you know, looking--one of the things about PERS that always bothers me is that their widely volatile in their returns. And we'll get all excited and they'll say no, that was 13 percent return year and next year, they go down two. So it's--I know what their portfolio looks like, but it just always seems--it always just seems kind of screwy to me.

Mr. Bartel: let me give you kind of a couple of--

Council Member Kniss: That's a technical term.

Mr. Bartel: A couple--yeah, no, I think you're absolutely right that volatility in the investment return--you should get used to it. It's going to be there and you should recognize that particularly in today's communication environment where newspapers are incredibly good at short articular, 30 second sound bites on TV, it's--you can't--it is veritably impossible to communicate other than short term volatility in the numbers. But you should absolutely understand that volatility is going to be there for a long
time. That's number one. Number two, that volatility will translate into contribution rate and budget volatility. There's no question about that. What I'm suggesting about a supplemental trust is a relatively new concept. A little over a year ago, Irvine Range Water District establish the first--it certainly was the first in the State, may very well be the first in the Nation. I'm told not, but I can't attach an agency mean to whoever else did it. It was a relatively new concept at the time and if you want examples of how these trusts have worked, we're brand new. Meaning, this is--sometimes for public agencies closer to the bleeding edge--they don't want to be on the bleeding edge, they're nervous about the leading edge, this is leading edge and that makes agencies nervous. We think--I've not talk with folks who really are setting these trusts up, but we think they're probably year to date, less than 20 agencies have actually set these up so far.

Council Member Kniss: So there's not much precedence here for predictability.

Mr. Bartel: There is not, there is not.

Council Member Kniss: Let me ask something else. Do you remember the (inaudible) scheme that went on here quite a while? We waited at the county three years to do it and then we absolutely, you know, (Inaudible). I remember thinking at the time, it was hard to believe this was real, but they sold it, sold it, and sold it, finally, the fourth year we brought it; went right down. And this sounds so appealing, but again it's that same, where will the--it's hard to remember what happened in '08, so with this, I think uh, it looks terrific. What happens when hit 2019 and the predicted recession happens?

Mr. Bartel: We can--just so you know, we can certainly model that. What I will tell you is--

Council Member Kniss: I would love to see that model.

Mr. Bartel: What I will tell you is what makes this work is not magic. You're not getting something for nothing. What you're getting, the reason you can have in this particular example 51 percent contribution rate is that there's nothing magic about that. The reason you get there is because of the discipline of two things and that discipline is the additional million dollars a year going in, okay.

Council Member Kniss: It's substantial.
Mr. Bartel: It is substantial. And the discipline for in this '16, 17 years, right here, having CalPERS sends you a report that says 44.6 and you pay that difference into the trust. So let's be clear here, there is no magic about this. It is all about having the discipline to put those additional monies in. So when we talk with our clients about this, we think this works better at an agency that number one is fiscally conservative; number one, and number two is has that discipline to put that additional money aside. If you don't have that discipline, there's--let's be clear, the money that's going into the supplemental trust is not, you know, we're not talking about leverage real estate here, we're not talking about slots, we're not talking about alternative investments, I'm suggesting it should be more conservative, not less.

Council Member Filseth: The thing you're talking about, the swap (Inaudible), is actually a swap for financial instrument. Is that what you're talking about?

Mr. Bartel: Yeah.

Council Member Kniss: Yeah, a very tempting financial instrument. This is putting aside a 13th mortgage payment on your house.

Mr. Bartel: Yeah!

Council Member Filseth: It's not, it's not--

Council Member Kniss: It's a good way of putting it, but it--

Council Member Filseth: It's not a full swap or something like that.

Mr. Bartel: That's a much better analogy--

Council Member Kniss: But what I'm hearing John say though is that the discipline factor is very interesting. We already said, if we hit a recession and your budget is really tight and you're going to say, sorry employees you're don't get that raise this year because we're putting a million in this--

Council Member Filseth: We're considering--

Mr. Bartel: Well let's be clear--

Council Member Filseth: We're considering two things.
Mr. Bartel: --That's exactly why it's there.

Council Member Filseth: We're considering two things. Right? CalPERS going to get hit by the same recession, okay.

Mr. Bartel: Right.

Council Member Filseth: They're going to get hit worst cause they're leverage.

Mr. Bartel: That's right.

Council Member Filseth: The second is, consider the alternative. The alternative is you spend it now. You foot the bill for future generations and they pay for it.

Council Member Kniss: Eric, I totally agree with you, but I've been in those situations where all of a sudden the income is just going down like this and you're saying, I just don't want to put that million in, and that means that--

Council Member Filseth: Well the alternative is you run it up on the credit card and you foot the bill to future generations.

Council Member Kniss: I guess you could do that, but--

Council Member Filseth: That is what you'll have to do.

Council Member Kniss: But what happens also is that we're not all sitting here in five years or 10 years or whatever that may--you got to practically swear in blood that whomever else comes along sticks that million aside and I think that's where the rub may come on this is can you get that long term commitment of a million every year for essentially forever.

Mr. Bartel: Let me go back and re-emphasize something that is said.

Council Member Kniss: I'm from New England, you know, we--

Mr. Bartel: I know. It--I don't think this is right for all of our clients. Let's be clear. Because you have to have some confidence that this discipline is going to be there, but let's be clear, if it's not, the money is still in the
irrevocable trust. You've access to it; not to fix sidewalks, not to fix infrastructure, but to supplement your contribution to CalPERS'

Council Member Kniss: It's a very tempting kind of thing to do. Pretty sophisticated and can be somewhat hard to explain especially when you have 1000 employees.

Chair Schmid: Jim?

Mr. Keene: Thank you. This may be a completely off the wall question, but sometimes I think when we're really talking long term, we're concerned about not only the volatility, but the stability of CalPERS. I know we talked about our behavior working relationship to not only how CalPERS invest money, but how other participants in the CalPERS system managed their responsibilities and reliabilities. To me it's not only just like a comparison of running up a credit card, it's also like you have your money invested in a bank that a bunch of other people have their money invested in the same bank. I mean, it ultimately, at some point in time, I think we have to be thinking about how much of our money we got in a bank that if the whole thing starts to have problems, we're not necessarily protected from the weakness in other sectors within the collective. And I don't know how we get to that when you start thinking out the long term and maybe I'm sort of over estimating. I mean, that's the very dark sort of look at this, but you know--

Chair Schmid: Let me give a contrary point of view. You know CalPERS got us in the late '90s, during a period of boon stocks and--will take care. But they got us permanently, we're in. The long term financial forecast is kind of in four ways to help us deal with some fundamental problems like we're in a situation now where our long term forecast said we can get two percent salary increases, and much more in the benefit package, but people need money in their pockets to live. This doesn't help us deal with the issue of how can we put more in the pockets? Can we hire workers; can we do infrastructure? It just helps us through the business cycle to say, okay, we'll keep doing it in a (steady way). So you know, it doesn't build up a fund that could substitute for CalPERS, it only says we can keep our rates up.

Mr. Bartel: I think I absolutely agree with everything you said, but maybe with one minor modification. Do me a favor and look at slide 19. So slide 19 is really crummy investment return early on, which drives up those rates later on. So for me, and I know this is not always the easiest conversation to have, but when you're talking with employees about pay raises, look at
this area right here. To the extent that you don't have the discipline to put the million dollars in, to the extent that you don't have the discipline in this scenario to put the 51 rather than the 44.6 in, you're going to be hit with those higher rates which will make it harder for you to give those pay raises.

Chair Schmid: Yeah, if this was true, but what you have here is you put in $3 million over three years. Now you have 10 years where you're putting in $40 million dollars and it doesn't add up.

Mr. Bartel: Well, what you're doing in this--so this is safety, right? And so what you're doing is you're taking your--the million dollars is really going in over that 10-year period. So you're really putting in 10 million bucks.

Chair Schmid: Oh, I see. That's a three-year period.

Mr. Bartel: Pardon me?

Chair Schmid: Isn't it a three-year period?

Mr. Bartel: No, the million, the presumption is they're two pieces to the additional contribution in this scenario and the two pieces are a million dollars every year annually. In addition to the million, you're putting in--your budget is 51 percent, so in the first three years, you're putting in 51 minus the CalPERS, but in off hand, you're putting in a million. And so what we're saying is, in this scenario, that buys you the ability to have a lower budgeted rate over that period of time, but kind of two things are really going on here--

Chair Schmid: But only if you've had 10 years of years of where you could build that up. Here you only have two years to build it up--

Mr. Bartel: No, just to be clear. This analysis is based on that scenario. So in other words--

Chair Schmid: Doesn't it say in 2019, you start paying--?

Mr. Bartel: In 2019, in the '18, '19 fiscal year, that's the first year you start drawing money from the trust. You're drawing from the trust, but you still putting money in because the presumption is, you can continue to put your million dollars in.
Chair Schmid: But just the space you have when you accumulate and when you de-accumulate is way out of line.

Mr. Bartel: What we didn't show here, we could show you the trust balances so that could see it. Now, everybody should be clear here. In this scenario, at June 30, '25, there is not very much money left in the trust, but it's still positive. It's a small positive--I'm sorry, I don't remember, but I bet it's less than a million and a half or something--it's a small number. But this does get you to that positive, that positive--

Council Member Kniss: So is this your--what Eric was saying here, you're making the 13th mortgage payment, and at the end of 10 years, you come out ahead because you put the money aside.

Mr. Bartel: Yeah, that's right.

Council Member Kniss: Yeah, no, I--

Mr. Bartel: That's really what's going--

Council Member Kniss: As I said, it's very tempting.

Council Member Scharff: So I think what the issue is you get to is the discipline. I think Liz raised the right issue. So actually, I don't think it's an employee issue. I'm thinking about in 2009, 2010, you know, we basically decided that we weren't going to cut services and instead we didn't give raises. A lot of cities gave raises and cut services, that's your two choices. We in Palo Alto, didn't cut services.

Council Member Kniss: You do one or the other.

Council Member Scharff: Right. Do one or the other. And you know, and what is it? One percent, one percent increase at CIU is a million dollars, right? Roughly, right? and then it's an ongoing --than ratchet it up, so you're at that extra million. So that's where all the money is. I mean, if we're talking a million dollars a year, that actually I think we can keep the discipline to do that. If it gets more than that, I think it could be a problem because what you're going to be tempted to do, is you're going to say, you know, we don't have no money to pay crossing guards and are we going to cut the crossing guards or we're going to cut this, we're going to cut this. I
mean, that's my sense of where that goes when you have 300 angry people show up, so--

Council Member Kniss: Or as we one-time try to raise the price according to the children's theatre. That's one of my favorites; don't do it.

Mr. Bartel: I understand the bigger context.

Mr. Perez: I'm going to clarify something. Please go ahead.

James Keene, City Manager: Maybe you've said this before. Supposed John, if we were to take what the cost is under that model, under the green line including the $10 million contribution or whatever and you're sort of explaining where we're going to be. If we didn't make that contribution or we adjust again the total up what our cost would be each year on the green line, what would be the delta between the expense over that period of time?

Mr. Bartel: I can't answer that question of the top of my head, but that's a very reasonable question.

Council Member Kniss: Probably the same.

Mr. Keene: Okay. I mean, if it's pretty close to the same--

Council Member Kniss: We're just stretching it out.

Mr. Bartel: It's the same. The question, under this scenario, is the saving.

Mr. Keene: Okay.

Mr. Bartel: But the reason it's a savings, is because you're putting more in sooner. That's the reason it's a saving.

Council Member Kniss: You're earning sooner.

Chair Schmid: A little bit, yeah.

Council Member Scharff: I do want to say it’s a benefit to the employees to do this. I think we should because they know that we're actually going to pay the pensions. I mean, that's really what it is.
Council Member Filseth: That's the bigger picture.

Mr. Keene: Can I put another thing in here I think it's a really, really important point, it's been--it's very difficult to get this across the labor and our employees is that--in one sense tries to stabilize our situation so we don't get in a situation where we're sort of over committing on in agreement and giving a bigger pay raise because in the short term, it looks like we're doing better that we really are and there's this pressure to do this, and then suddenly we get in a few years down the road in the future, we got another contract and suddenly it's way worst and we're down and yet it's way more erratic behavior.

Council Member Filseth: I mean, doing this is what enables us to make it secure for (SCU) in the future, right? By getting control of this stuff. Now there's a temptation, tricky road we want to go down, you know, well gee, that's somebody's else’s problem, I don't think we should do that. Right? This is--doing this, getting our house in order, you know, is good for everybody. Right? Cause it enables us to protect people, not just this year, but well into the future.

Mr. Perez: Yeah, to that point, I do believe--

Council Member Filseth: I don't think we're going to be (Inaudible) anytime soon, but the principle is the same.

Mr. Perez: Yes, and you know, I think, you know, there's a couple of things that from a staff's perspective that--we want some kind of stability and when we can figure out where the comfort level is on the contribution. We learned from the last recession, the pain you talked about earlier, reduced about 70 positions, we were fortunate to be able to freeze positions and not lay off but a handful. But that cost a lot of issues to the organization and to the staff and to the community because different services were impacted temporarily because of the vacancies. So if you have a mechanism where you can draw money from this trust, it allows you to have time to make those informed decisions as a whole and that's a huge benefit to the community and to the organization because then you're not freezing critical positions because you have to because of the (Inaudible) commitments that you have. So that's one thing that's attractive about this for us from an operational standpoint. The other piece to make sure that we're all clear, John, let me repeat it and please correct me. So what we're talking about here, this safety, so in miscellaneous, keep in mind that it includes the Enterprise Funds so it's not a million dollars, it's you know, 550,000—
Council Member Kniss: You mean to the General Fund.

Mr. Perez: To the General Fund contribution. So it's a little less, obviously it's still a number, but the other number is the difference to the delta between the 39.5 and the 51 percent. How much is that?

Council Member Scharff: I was going to ask that question.

Mr. Perez: I don't know if you have the chart that shows the dollar figure of that.

Mr. Bartel: I did not bring those. Sorry.

Mr. Perez: So what my point is trying to be is, you have a lot--we have a lot of obligations and commitments that we have. So we've been focusing tremendously on infrastructure. Right? And so we're going to have that as a priority. If we were to make some commitment to this, this would part of that equation and that we need to tie in to our thinking of how we go forward. We may not feel that we can be as aggressive, I'll say--I don't know what word to use right now, I'm trying to illustrate the point. We may not be as comfortable with that number. Let's just say for the sake of discussion that it's another $4 million plus the $1 million--half a million, so it's $4.5 that you would have to put in. That competes with everything else we have.

Council Member Scharff: That I'm concern about. I was going to say that.

Mr. Perez: Right. It's something that we can work towards. There's various ways to do it and we've had this discussion and obviously the lesser amount you put in, the harder it is. The illustration I can give you of how it works and you've had really good physical policies from my perspective that you adopted, is over a five-year period of time, we've contributed over $30 million to the infrastructure we (Inaudible). Setting that aside ahead of time and it was based on the research policy and the budget that was issued and sort of said anything above an 18.5 will go to infrastructure. So there's ways that you can think about it. You can say if there is a such a experience in the future year, and I'm just throwing out number--illustrations just so you can grasps some policy concept, we can say 2/3s of it go to infrastructure and 1/3 goes to Unfunded Liability or whatever.
Council Member Scharff: So I want to jump in. This is actually my whole concern in doing this. Is we have an infrastructure plan, construction cost rep from say again, 30--40 percent. What I'm really interested right now is finishing our infrastructure plan. And after we finished our infrastructure plan, then I think we can focus on this. And actually a little concern that we're going to need every penny that we can scrunch up to get our infrastructure plan done. I mean, I'd be fine if we took a look at the infrastructure plan and said, okay, where's all the money coming from? How are we going to do it? What are we going to fund it and then we look at doing this? But I don't really think that we can take out 3 or $4.0 million a year. I actually thought we could probably squeeze a $1.0 million a year for this, but it's the delta between the rest, I don't know, 51 percent and you know, I mean, I might not even be opposed to just saying let's just put a million aside starting now and then with the promise that after we finish infrastructure, we then do the 51 percent, but we start out having a fund already in there because we put a million aside every year. Something along like that. When we start the precedent, we start thinking--we do it, but we know we aren't there yet.

Mr. Perez: My sense is that, that's where you're going to be? So, you know, there's some one time dollars that we can identify in the tune of $3 million from various sources so we can go into--that we can seed funds. I think it's important to seed funds, not trust funds. We may not, you know, you may not be comfortable already for the whole amount, but what I would want us to consider as an organization and you know, discuss it with Jim, we're concerned about that recession that's blooming. Right? So we want to have that--

Council Member Scharff: Probably about six months long.

Council Member Filseth: Probably got one day, one day.

Mr. Keene: All those projections actually identify the recession occurring the year after he retire. Pointed that out to him.

Mr. Perez: And so it'd be great to have that trust fund so that because we want to have that flexibility of having that time to make informed decisions. Good job (cross talk).

Mr. Bartel: You mind if--yeah--so everybody should understand though that you delay putting in the additional amount in, what that means is your 51 target is not going to be a 51 target. It's going to be a 52--
Council Member Filseth: Or more.

Mr. Bartel: Fifty-two so don't kid yourself about that. I'm not trying to tell you; you should do this instead of--

Mr. Keene: I think Greg's point is really good and going back to that, the benefits of this lies in the discipline. The problem we have and this is budget Terry challenge always is that there's tradeoffs, we have a number of long term goals that require discipline; the funding of the infrastructure plan requires discipline over any number of years. Actually trying to keep our pay rates competitive enough in the marketplace requires discipline over the years, the same thing with this. I would say on the other hand though, Greg brought up a really good point is, I think we need to--I don't think we can just rest on our morals about growing revenues, on the other hand when we have some of these demands, we need to be opened to thinking about the fact that new revenues streams or increases in revenues allow us to maintain this discipline on the cost side of stuff too. I’m not advocating one way from the other, but it's like, you know, there's a hydraulics here between these different choices we have. Think of an equalizer on your stereo or something, I mean how you're going to adjust of these different beavers.

Mr. Perez: There's another factor to Joe just reminded me off, that's where- -and John pointed out earlier, that's where disclose more of our numbers and moving them into our financials. The rating agencies are also going to look to see what we're doing. Right? And so it's good that we put $70 million aside in our retirement/medical and if we have something, even a modest start, they will look at it in a positive way because we're going to issue more debt and we want to be--

Council Member Filseth: That's the only place (Inaudible), painless interest.

Chair Schmid: You know, I guess I'm concerned to make a once and for all contribution to get it started. But to get an annual payment, a guaranteed annual payment without a revenue base building on, you know, what the numbers tell us here, is that we have salaries growing at two percent per year and benefits are four percent per year and you want to exacerbate that deferential. Is that a benefit to the workers? That's my question.

Council Member Kniss: I think that's rhetorical, isn't it?
 Council Member Scharff: So are we going to talk about approving a long range financial cause I actually have issues with approving a long range financial forecast.

 Council Member Filseth: I got a whole list here too.

 Council Member Scharff: Well, I'm just thinking that it's 9:40 and--were you planning us to vote to recommend one of these trusts? Where are we in terms of action and--

 Chair Schmid: Yeah, what do we need to do?

 Mr. Perez: You know from a setting up the trust, that we have time. It's not--if you're not ready tonight--

 Council Member Scharff: No, I'm ready, I'm ready to make a motion on it.

 Mr. Perez: Okay.

 Council Member Scharff: I like to actually make a motion on it.

 Chair Schmid: Why don't we first go back to the long range financial forecast before we decide on it.

 Council Member Scharff: Why don't we finish this?

 Mr. Perez: Yeah, let's finish this.

 Council Member Scharff: Let's finish this because this is a different issue.

 Chair Schmid: Do you want to make a motion?

 Council Member Scharff: Yeah. Before I make a motion though, I think I just want to--so what we would need to--what would the motion look like? It would look like go direct staff to recommend to the council that we set up a trust. Right? Cause that's what we would be doing.

 Council Member Kniss: Don't you want to evaluate before you recommend it?
Council Member Scharff: Well, we have evaluated it. That's what we've been doing here tonight?

Council Member Kniss: Well, in for what? For 45 minutes?

Mr. Bartel: The one--what I think you should--there are more than one provider for these trusts.

Council Member Scharff: Okay.

Mr. Bartel: So I think if you direct staff to look at the providers and come back with a recommendation--

Council Member Scharff: And Liz is right. So it'd be to evaluate--there you go, use the words.

Mr. Perez: Yes, so that--we want to go through a competitive process, so request for proposal so maybe the staff (Inaudible) a request for proposal for the establishment of a trust and come back with additional information and options I would say because you would want to have options on how to fund such trust.

Council Member Scharff: Absolutely.

Council Member Kniss: And you may have to spend some time with the five council members who are here and--no, I think they probably would want a good deal of input on this.

Mr. Perez: Excellent point. Something to consider.

Council Member Filseth: You could refer to the next finance committee to vetted it out and then go to council. It's fine too.

Council Member Scharff: So but when would you get the request for proposal? You need council authorization to do that. You could do that with--So I mean, I think the best, the best of all possible worlds would be, do we ask you to evaluate, go get request for proposals, come up with options, come back to finance committee and finance committee then makes a recommendation based on having all that information and we had some full item and, you know, we talk about exactly how much money we want to put in with the different options, and then we go to council with a specific
recommendation that's been vetted by, you know, four people who either agree or disagree or come out cause this is a complicated stuff and I think this is exactly what a committee can do to make it easier on council.

Chair Schmid: One key thing that John brought up is to not just make a single payment to establish it, but rather to try and get it as (Crosstalk).

Mr. Perez: So whatever John is showing you, the different options, the model that John shows with the numbers--

Chair Schmid: Right.

Mr. Perez: I think that's key.

Council Member Scharff: Absolutely.

Mr. Perez: An alternative model would show me that a million or some number and then one-time funding as we went--off the top of my head, those three could be likely scenarios we could present you.

Council Member Scharff: Okay. So I'll make a motion that we--that staff go forth to request for proposals, evaluate it, come up with information and come back to Finance Committee with options.

Council Member Kniss: Whomever they may. Remember, it will be a new finance committee, but I think that's a good idea actually.

Council Member Scharff: Right, then there'll be more council members getting vetted on it.

Chair Schmid: Do you want to be more specific on what proposed, what the proposal is?

Council Member Scharff: Well, do I need to be? I mean a request for proposal to--of setting up one of these--what do we call them?

Council Member Kniss: 115 Trust.

Council Member Scharff: 115 Trust. An irrevocable 115 Trust.
Mr. Perez: Right now we know of two financial institutions that provide such services and so we'll see what else is out there.

Chair Schmid: Okay--

Council Member Kniss: Second.

Chair Schmid: There's a second, good. Do you want to speak? You want to speak?

**MOTION**: Council Member Scharff moved, seconded by Council Member Kniss to direct Staff to conduct a Request for Qualifications (RFQ), evaluate it and return with information to the Finance Committee with the options.

Council Member Scharff: I think this is definitely worth exploring. As I said, I think that I probably have issues putting the Delta in, but I think if we set this up and start the process--I understand that, you know, that we might be at 52 percent, but I do think, looking at these competing dollars, I do think we need to (Inaudible) our infrastructure and we may be fine. No one is actually vetted where we are on the infrastructure in terms of how much money we need and that's the big competing dollar amount. And there are other things that are interesting like we haven't looked at the issue that when the police move--the public safety group move out of their public safety building, there's all that space here. We might actually be able to move the people out of the development center into that space or rent the space out and cover a substantial amount of money that we can then use for the rest of the infrastructure projects. So I mean, I think there's lots of different--I do hope staff thinking of a financing plan, you know, based on new construction cost numbers cause that's going to come up fairly quickly. As we go to council on every item and you say--

Chair Schmid: It's not in your proposal at all.

Council Member Scharff: No, no, no, it's not, but I mean, I do think these are related in terms of different cost issues and what we're going to spend money on.

Chair Schmid: Liz, do you want to speak to your second?

Council Member Kniss: Only that I think this is still needs to be an exploration and that's what I hear us getting into. And then to remember
that this should not be taking lightly. This is a really major step and I support it, now I'd be interested in hearing what else you find out as you call around and go with an RFP and so forth and see what other entities have already tried it.

Chair Schmid: No other comments, then what I have here is where asking staff to evaluate proposals for irrevocable 115 Trust and come back to the Finance Committee with information and options.

Council Member Scharff: Well, to get our--who option?

Mr. Perez: We would.

Chair Schmid: Okay. All in favor:

Chair Schmid: That passes anonymously.

Council Member Kniss: And thank you John for coming.

Council Member Kniss: Aye

Council Member Scharff: Aye

Chair Schmid: Aye

Council Member Scharff: Aye

INCORPORATED INTO THE MOTION WITH THE CONSENT OF THE MAKER AND THE SECONDER to add to the Motion, “to return with an Irrevocable 115 Trust proposal.”

MOTION RESTATLED: Council Member Scharff moved, seconded by Council Member Kniss to direct Staff to:

A. Prepare and issue a Request for Qualifications (RFQ) to the creation of an Irrevocable 115 Trust; and

B. Return to the Finance Committee with options and analysis based on responses to the RFQ.
Chair Schmid: Okay. What are the steps we need to do with the long term financial forecast?

Mr. Perez: So to get to the point, we want to hear from your feedback on--it sounds like you had some ideas on what you think our base model should be, so we're open for that discussion.

Chair Schmid: Okay. First, suggestions, comments?

Council Member Kniss: So may I ask the outstanding question. How about how long you all want to stay late on this? I mean, are we talking about 11 again tonight?

Chair Schmid: We're trying to drive to a resolution of long range financial forecast, so if you want to make a motion, suggestions--?

Council Member Scharff: I have some suggestions.

Chair Schmid: Yeah.

Council Member Scharff: I think the first thing is that--I think that we should go with Mr. Bartel's seven percent in here. I think the seven and a half is too long.

Council Member Filseth: Think six and half is too conservative?

Council Member Scharff: I think six and half is too conservative. I think we went with seven. I still think these--I still think we're way too optimistic about how much revenues--I think we're going to have a recession. So I think if we re-did this with the seven, I think we're getting a lot closer and you know, I'm open to the thought of wage growth at a higher level at the moment. You know, where you talked about three percent or whatever?

Council Member Kniss: You mean factoring it in at higher level.

Council Member Scharff: Factoring in at a higher--

Council Member Kniss: Instead of two and a half?
Council Member Scharff: Instead of two percent. And I tell you, I don't think that's a--I think it's sort of a promise. I mean, I would actually--but on that issue, I would defer to Susan and (Laurel) really and then if you guys told us that you thought that would cause problems in bargaining, then we'll just leave it alone, and if you do, I mean, I could go either way on that. I do think, I do think that we could easily go--I easily think we're going to go negative on this stuff fairly quickly, which is fine. I think going negative on this stuff is just fine cause that's where I actually think we are. If we don't get new revenue sources, and the only reason we didn't go negative on this time is if you took out the TOT increase, right, we're going negative.

Council Member Filseth: The Hudson property is TOT.

Council Member Scharff: Right. I mean, so you took out (tasler) sales tax, one little bump for that, then the Hudson deal, then the, right? So I don't think all that stuff is sustainable except of in the top of the boom, which is where we are.

Ms. Mason: So all I want to say is I do think that going forward in the long term, we do need to look at a 115 Trust. We need to look at prudent measures that addressed the long term liability. We need to look towards our employees to be partners in this, that this is not just about the city's contribution, this is about us partnering and that's what I've heard council share, that they're looking for increased partnership on sharing the benefits. We're doing that with our health benefits, so I guess one of my concerns about going forward is I think it's important to start investing in the trust and maybe building a line item for that and then having a fair balance salary line. I just think that we need to think in both on a balance measure that employees are our partner in this and so maybe there is a higher salary amount down the road, but employees are also contributing to the cost of their pension and the cost of their health insurance. So I guess in the long term, I hope we have a balanced approach.

Council Member Scharff: Well that was one of the things I was saying is that we could actually start--you know, we start seeing this trust to get some in it, and then we actually have as part of the negotiations. Maybe there's an employee contribution to trust overtime.

Council Member Filseth: That's an interesting idea.

Council Member Kniss: I'd say that's a thought.
Council Member Scharff: You know, I don't think it's that far off. They contribute to other things and--

Ms. Mason: And if employees start contributing to the employer share and that possess the ability to create a more stable environment and jobs are protected.

Chair Schmid: Let's try and focus--

Ms. Mason: It's a partnership.

Chair Schmid: Let's try and focus on the recommendation we're making for this financial quarter.

Council Member Filseth: We're all in the same bucket. The fact is city has spent $500 million dollars we didn't have. Okay. We're all in the same boat, so how do we get out of it? If we could do it together, that's great.

Chair Schmid: Any other concrete changes recommended?

Mr. Perez: In terms of the concern about the use of the higher number, we do state in our tax over and over and in our staff report that these are for projections and not to be taking as a promise. So if you're comfortable with that language--

Council Member Scharff: Well, I'm comfortable. The only thing I want to run by is whoever does these, what do they call that, they're not mediations, they're fact finding, whether or not the fact finder will use it against us. If the fact finders will use it against us, then I don't want to do it.

Ms. Mason: So--

Council Member Scharff: I don't know, I'm just--cause one of the factors in fact finders is whether or not you have the money and whether or not you think about--

Ms. Mason: We do not, you know, we have many needs. Our infrastructure is a critical need and so, we negotiate based on fair place in the market and the cost of living. We do not negotiate based on our ability to pay because there are many needs in this community that need to be addressed. So the
fact finders could look at the long range forecast and say yes, you set aside that expense. And I'm not saying--

Council Member Scharff: So it's not a set aside right? What it is, is simply--I think we go negative. Do we go negative; you think if we do the seven percent on the forecast?

Mr. Perez: Yeah, most likely it will.

Council Member Scharff: I think we go negative.

Mr. Perez: In the out years, may not.

Council Member Scharff: But in the short term, we go negative?

Mr. Rossmann: If you bring in the best return on assumption to seven percent, that may not hit us in '17, it's probably will start hitting us in '18 or '19. If CalPERS faces some changes.

Mr. Perez: One option is for you to consider is leave the base model with the two percent, direct us to do an alternative model with higher salary, so it's an alternative, it's an option.

Council Member Kniss: So what don't you leave it at the two for now--

Council Member Scharff: Why don't we leave at the two and we'll do an alternative.

Council Member Kniss: The two and the four--

Council Member Scharff: And then we'll do an alternative. I do think we should change it to the seven.

Mr. Perez: We're fine with that. It's--your budget decisions aren't going to be driven by the year that's in front of you. Right?

Chair Schmid: We've got three discussions on valuating the pension fund and I think each time we come--I would make another suggestion that the sales tax revenue be a little lower. You can take a look at the Stanford impact on it, but I think that's a big plus.
Mr. Perez: Sales tax or hotel tax?

Council Member Scharff: Sales tax. I also think maybe the hotel goes up or it doesn't. I don't know. Maybe I think we're overly optimistic. I guess that's my—remember I showed you that in 2010, we thought we'd have a 167 million and 182,000 in 2016 and we'd have expenditures of 182,767, that was probably—and we went to revenue of 170,498 and expenditures of only 172, so we started and now we're at what? 190, 189 expenditures. So it's really tough to tell in the recession, we were really conservative on our revenues. Now we're in the peak boom, I think we're overly thinking our revenues (Inaudible) and they're much higher than I think they were then.

Council Member Filseth: Further on this path, I have another one, which is property tax growth is at 5.9 percent, but city rental growth is at 2.6 percent. Why? Why should rental income track property values?

Mr. Perez: So what we do there is we have an appraiser come every two years and help us do a general appraisal update of our properties and then we increase it by CPI. We've had that, that's an internal practice or policy for some time. We do not update on a yearly basis.

Council Member Filseth: So it's driven (Inaudible) not market?

Mr. Perez: In between prices.

Council Member Filseth: Correct.

Chair Schmid: Should we change that?

Mr. Perez: You have the ability to direct us to do that.

Council Member Scharff: I like to direct you to look at changing it. Evaluate changing it.

Mr. Perez: Okay. So we'll take that as a separate discussion from the long range if that's okay.

Chair Schmid: That's fine.

Mr. Perez: Then we can move forward with this and have that discussion. So I'll make a note to future finance meeting discussion.
Council Member Filseth: I have a second concrete question. The retiree healthcare fund. We're talking about 7.6 percent. We assumed 7.6 percent RY now, maybe going to 7 in the quarter. Why wouldn't that go to the same percent we were talking about here for the CalPERS, for the--

Mr. Perez: There's three rate assumption options and Walter did one of the scenarios and if my memory is correct, it's about a $2 million difference.

Mr. Rossmann: So what we planned in the forecast is 7.25 investment return. That is still pending for final evaluation for hotel, which we'll get in February. We'll come back to the finance committee, usually during the budget season and the city council would have to approve the evaluation. We believe it’s prudent to go to 7.25 at this time, 7.61 percent.

Council Member Filseth: Is there--why would we not go to 7 percent if we're talking about seven percent in (Inaudible). Why are they different?

Mr. Perez: Let me pull up the percentage real quick. 7 percent itself is not an option. Let me tell you what they are. So they're going to revise the numbers, they're telling us to 7.28 for strategy one. 6.73 for option two and 6.12 for option three.

Council Member Filseth: So CalPERS is at 7.5 and they're at 6.12?

Mr. Perez: Keep in mind that--

Ms. Mason: They give you the option.

Mr. Perez: In this trust, you have options and the risk tolerance and they don't invest in the same manner as the pension trust.

Mr. Rossmann: So we did ask Mr. Bartel to let us know how much the difference in cost would be. So at 7.25, it will cost us, all funds, not just general funds, $16.1 million. If we go to 6.75, it jumps up from $1.6 million to $70.7, so we felt that it was too much of a jump in one year, so we brought it down to 7.25, but our goal is definitely long term to come down to 6.5 percent investment turn option, which is what best practice has tell us. We bring it down every several years.

Council Member Scharff: And this is in the long range forecast?
Mr. Rossmann: The long range forecast, we assume 7.25 this time.

Council Member Scharff: So why not just assume the 6.5 in the long range forecast because it doesn't affect budget, it would just--

Mr. Perez: Well, we should probably use one of the numbers in their buckets right.

Council Member Scharff: yeah, we use their bucket, right, but I mean, why use the 6.73 or--in the long range forecast, why not use the number--in the budget, you might want to use separate number because you might want to break it down less, but--

Mr. Rossmann: Sure. I think the hesitancy often times to model this is every time we do this, we meet with Mr. John Mr. Bartel and we ask him to provide this for a fee, so if the Finance Committee is interested in seeing that, we'll be happy to go him. I'm sure he'll be happy to provide the information for a check. But we don't have to explain--

Council Member Filseth: How big of an account are we with John Mr. Bartel. I mean, I like the guy, right, so. How big of an account are we in?

Mr. Perez: How big--I'm sorry

Council Member Scharff: What are we talking about in cost?

Mr. Rossmann: His fees probably 200, $300 in hour.

Council Member Kniss: Say that again?

Mr. Rossmann: I think it's (Inaudible).

Council Member Scharff: Cheap for a law firm.

Council Member Kniss: That sounds way too low.

Mr. Rossmann: He said about 400, staff is (crosstalk).

Council Member Kniss: If you could find someone at 200, that is amazing.
Council Member Filseth: So a year we're paying him 10, 20, $30,000 or something like that?

Chair Schmid: Okay. Why don't we focus on what we want staff to do?

Council Member Filseth: That's my list. I'm done.

Mr. Perez: You've seen the 7 percent rate of return assumption for CalPERS. Salary increase have a separate assumption with the historical growth. Is that what you'd like to see on the salary?

Council Member Filseth: Yeah.

Mr. Perez: Sales tax lowered, one potential bench marking is taking out the Stanford dollars so we can identify?

Council Member Filseth: Yeah.

Mr. Perez: Would be one likely scenario.

Council Member Filseth: Hotel, gas, you think five percent is aggressive?

Council Member Scharff: Is that what we're doing right now, five percent increase?

Council Member Filseth: Five percent on the forecast.

Council Member Scharff: I actually probably think it's more like thee.

Council Member Filseth: You think.

Council Member Scharff: I mean, you know, I hate to just like pull something out of the air.

Mr. Perez: Yeah. Let us work on something there. Keep in mind we only use 70 percent of the projected income or the infrastructure.

Chair Schmid: Yeah, that's conservative.

Pere: We feel that we did an adjustment.
Chair Schmid: Yeah.

Mr. Perez: And then--I got side tracked and I didn't quite finish capturing the property tax request. I'm sorry.

Council Member Filseth: Oh, I think you guys were going to look at the possibility on the tax.

Council Member Kniss: Talked about lowering it.

Ms. Mason: Lowering the property tax.

Council Member Kniss: I think evaluate it maybe--

Chair Schmid: Yeah, evaluate might be good.

Council Member Scharff: So the property tax is the one I feel the most comfortable with actually.

Council Member Filseth: I think we were talking about increasing the rental. Look at Kendal Rentals (Crosstalk).

Mr. Perez: I think; I feel the same way for quite some time. Especially with the high number of under 600,000.

Council Member Filseth: Right.

Mr. Perez: Okay, so nothing on property tax. That's all I had.

Chair Schmid: Okay, so we have a motion with a list of recommendations. Is that what you need to go ahead?

Mr. Perez: Yeah. Our second recommendation or part of that recommendation is our question to you. Assuming we made these changes, we feel comfortable in sending our report to council if you do.

Chair Schmid: Yeah. I think it's important that council get involved. So it's time to get it to council.

Council Member Filseth: Shouldn't it combine back here first?
Council Member Scharff: It's a different finance committee, I'd say yes.

Council Member Kniss: It will be, yes.

Council Member Scharff: Except for that if different finance committee, will have the whole thing over again. If they have to do the whole thing over again, I'd probably take pity on them and just send it to council.

Mr. Perez: Thank you.

Council Member Kniss: Let's do that.

Chair Schmid: It's important to start the budget process. This document is helpful to get that underway.

Council Member Kniss: The budget process starts in January anyway.

Council Member Filseth: By the way, you're going where again, Sunnyvale? I'd send it to Sunnyvale.

Mr. Perez: They actually do a 20 year forecast.

Council Member Kniss: What?

Council Member Filseth: They do a 20 year forecast.

Chair Schmid: Are we ready for a vote to move to finance financial report? No other suggestions?

Council Member Filseth: What exactly are we voting on?

Chair Schmid: We're recommending--

Mr. Perez: To make those changes and then we would--

Council Member Scharff: Why don't you run through all of them again so we're (Inaudible).
Mr. Perez: Change the rate of return assumption on CalPERS to seven percent. Look at the salary increases historical and create a separate scenario maintaining the base model that the current staff recommendation.

Council Member Kniss: We're keeping the two and fourth?

Mr. Perez: Correct. And then revisit the sales tax and lowering with potentially the Stanford expansion dollars and then revisit the hotel tax scenario and separately, we're committed to review the rent increases separately.

Council Member Filseth: I know what I want to say. I want to make sure I understood this. I think you said it earlier is that the forecast that exist today, assumes no change in headcount for the next 10 years. Is that right?

Mr. Perez: Correct.

Council Member Filseth: There ought to be a big asterisk on that so everybody understands that.

Mr. Perez: We'll highlight it. It's been consistent with--

Council Member Kniss: That's been pretty stable.

Council Member Scharff: Well, the headcount hasn't been stable. It moved along (Crosstalk.)

Mr. Perez: No, the modeling sorry.

Council Member Scharff: Yeah, the modeling been stable, but the headcount changed dramatically.

Council Member Kniss: Well since when?

Council Member Scharff: Oh, in 2009, we cut back 30 or 40 positions.

Council Member Kniss: Since seven, eight years ago. I think the last three years been pretty stable.

Council Member Scharff: No, no, now it's going up.
Mr. Perez: Going up.

Council Member Scharff: Now it's going up at--

Mr. Perez: For some of the (crosstalk.)

Council Member Kniss: Well how much? Didn't we do 13 last year?

Council Member Scharff: 15 or something like that.

Ms. Mason: But there's a net reduction too. It wasn't a total (crosstalk.)

Council Member Kniss: Yeah, and we lost some others, and--

Mr. Perez: The net is about that.

Council Member Filseth: Net 15 over 10 years is a 150.

Mr. Perez: Because we had some reductions contracting out with some additions.

Council Member Kniss: I thought--didn't Greg insist on two extra positions going out? I think you did.

Council Member Filseth: Um, umm.

Chair Schmid: Okay. If there's no recommendation on staffing, we have a motion. All in favor.

Council Member Kniss: Aye.

Council Member Filseth: Aye.

Chair Schmid: Aye.

Council Member Scharff: Aye.

Chair Schmid: That passes unanimously.
Council Member Scharff: If it's unanimous, this doesn't go in council, right.

Council Member Filseth: It does.

Council Member Kniss: It shouldn't.

Mr. Perez: Unless you want something different.

Council Member Filseth: It should go for discuss.

Council Member Scharff: You'll make the changes first, then you'll go to council and then we should have a discussion with council on long range.

Mr. Perez: Okay.

Council Member Filseth: I think we're going to want to look at it again.

Chair Schmid: It is important--

Council Member Filseth: In some way, shape or form, we're going to look at it again before we just say--

Chair Schmid: It is important thought that I’d be available at the council retreat. So if it’s hard to find in an agenda spot, maybe we could have unconsent available for the retreat and can be used.

Council Member Filseth: Well, consent means the council approves it. I don't think--I mean, I don't know what I'm approving.

Mr. Rossmann: Vice Mayor Schmid, I think it'll be difficult for staff to get this done by the council retreat. The first engagement is to meet with Mr. Bartel, get his numbers. We have all of this in between, where the majority of our staff is not in the office. So this may not be a possibility.

Chair Schmid: Well I can see the motion on the benefit funds might not be available, but could there be a paper copy of the financial forecast revenues and expenditures?

Mr. Rossmann: I think (Inaudible) Carl and Marly (Inaudible) in front of you or an update one.
Chair Schmid: An updated one.

Mr. Perez: So the concern is can we get--cause Mr. Bartel has a lot of customers and usually that's why we--

Chair Schmid: Do you need him for the--?

Mr. Perez: For the seven percent assumption because we didn't have him do that.

Chair Schmid: Okay. Yeah, I mean it is beneficial to have this as the council begins to think long term.

Mr. Perez: So let us work, let us work with the timeline starting with Mr. Mr. Bartel and then we'll slide it into an action item.

Council Member Kniss: Yeah. I rather come out right and be available for budget, you know, that--

Chair Schmid: Yeah. I guess the CAC is also getting into discussions of the DEIR and the scenarios and again, that would be an important element both for the council and the CAC to have available, so when it's available.

Mr. Perez: Okay.

**MOTION:** Council Member Scharff moved, seconded by Council Member Kniss to recommend the City Council accept the Fiscal Year 2017 to 2026 General Fund Long Range Financial Forecast and forward the Forecast to the City Council for acceptance with the following changes:

A. Use a seven percent rate of return assumption for CalPERS pension; and

B. Revisit Sales Tax revenues and lower by some factor, such as Stanford Expansion Sales Tax Revenue; and

C. Revisit Transient Occupancy Tax projections; and

D. Produce an Alternative Scenario reflecting a three percent salary expense for projection purposes.
MOTION PASSED: 4-0

ADJOURNMENT: The meeting was adjourned at 10:34 P.M.