

TRANSMITTAL LETTER

April 30, 2021

To the Honorable Mayor and City Council

2022 Fiscal Year Proposed Operating & Capital Budget Transmittal

Dear Mayor and Council Members:

In accordance with the City Charter, I am presenting the City of Palo Alto's Fiscal Year 2022 Proposed Operating Budget and Fiscal Year 2022 Proposed Capital Budget along with the 2022-2026 Capital Improvement Plan (CIP).

This Budget Message outlines a proposed budget balancing strategy that addresses the community's immediate service needs, while positioning Palo Alto to restore services and evolve as recovery takes shape. The proposed budgets are based on City Council direction to use the Long-Range Financial Forecast (LRFF) Scenario B for financial planning, which outlines a conservative financial balancing approach assuming an extended community recovery from the current pandemic over a three to five-year period.

To be clear, the proposed Operating Budget and Capital Budget balancing strategies to address the City's continued fiscal challenges, following an extremely difficult year, are neither recommended nor sustainable for the fiscal health of Palo Alto in the long-term. The Proposed Budget reflects our current fiscal reality as a result of the ongoing, extended pandemic, related economic challenges and continued resource limitations. As the hopeful signs for recovery continue, this Proposed Budget positions Palo Alto well to respond quickly and adapt should more moderate growth occur than forecasted. However, the City's long-term fiscal health must be addressed through more sustainable approaches to address the community's service priorities into the future. The budget process proposed provides an opportunity to advance public discussions on how to most effectively resource services that have the greatest impact on the community.

Reflections on A Challenging Year & Positioning to Pivot as Recovery Continues

In reflecting over the past year and the variety of adversity and challenges that came with it, the work of the City is a true testament to our team's ability to remain nimble and think strategically when faced with navigating the challenges of the unknown and unexpected. This proposed budget

TRANSMITTAL LETTER

is another step of this adaptation; it begins the next phase of a conversation on how best to deliver services and ensure the priorities of the community are maintained through the allocation of constrained resources. The Proposed Budget also recommends a balancing strategy that positions the City well to add back reduced services quickly should recovery occur at a faster rate than assumed. These strategies are continually revisited and adjusted as new and updated information becomes available, addressing the constraints and needs of today while planning for the future.

The California Governor's most recent announcement that the current 'Blueprint for a Safer Economy' will be lifted on June 15, 2021 if specific metrics are reached, provides a milestone to entering a recovery phase, while working to ensure continued safety for all. As we approach this next year, with limited fiscal resources and limited staffing, it will be more important than ever to be nimble and continue to seek opportunities through community partnerships, explore changes in service delivery and work together to handle unexpected challenges as they come.

Council Directed Budget Approach & Difficult Service Reductions Proposed

In February 2021, Council adopted the Long Range Financial Forecast (LRFF) and the financial balancing Scenario B for staff to use in development of this budget. This proposed budget assumes this conservative forecast and this budget does not assume restoration of the approximately \$20 million in service level reductions experienced in the prior year that addressed the nearly \$40 million loss in General Fund revenues.

FY 2022 Long Range Financial Forecast Council Directed Financial Planning Scenario

	Adopted					
	2021	2022	2023	2024	2025	2026
Total Revenue	\$196,474	\$196,532	\$205,162	\$216,193	\$223,168	\$229,605
		1.8%	4.4%	5.4%	3.2%	2.9%
Total Expenditures	\$196,949	\$203,322	\$217,846	\$229,681	\$238,974	\$247,163
		5.6%	7.1%	5.4%	4.0%	3.4%
Net One-Time Surplus/(Gap)	(\$475)	(\$6,790)	(\$12,684)	(\$13,488)	(\$15,806)	(\$17,558)
Cumulative Net Operating Margin (One-Time)						
Net Operating Margin		(\$6,790)	(\$5,894)	(\$804)	(\$2,318)	(\$1,752)

Cumulative Net Operating Margin

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

The operating budget totals \$690.1 million and the capital budget totals \$152.9 million in FY 2022 and \$726.8 million over the five-year CIP. As required by the City Municipal Code, the Planning and Transportation Commission (PTC) will review the 2022-2026 CIP in May 2021 to evaluate the program's compliance with the Comprehensive Plan adopted by City Council in November 2017. This proposed budget addresses near term fiscal issues to bridge us through a difficult time and, together with Community Economic

Recovery work and other strategic workplan activities, positions the City to continue its agile approach and respond to the needs of the community through the recovery period.

To balance the FY 2022 \$13 million gap, the Proposed Budget includes \$7.7 million in net service and capital improvement investment reductions, \$1.0 million use of program specific reserves (e.g. Development Center), an assumed \$1.6 million in labor concessions, and use of \$3.1 million in ARPA funds.

The Proposed Budget includes difficult service reductions to address the budget gap including impacts to all areas of City service delivery, and more detail on specific impacts are noted below in Department Specific Strategies.

Budget Message Elements

This Budget Message outlines the major Proposed Budget elements for the City Council's consideration including:

- Lasting COVID-19 Pandemic Impacts
- Fiscal Reality and Council Directed Budget Approach
- Community Economic Recovery and Long-Term Financial Planning
- City Council Priorities
- Summary of Other Funds (including the FY 2022-2026 Capital Improvement Plan)
- Budget Process and Key Dates
- Acknowledgments

Lasting COVID-19 Pandemic Impacts

In March 2020, the onset of the novel coronavirus (COVID-19) pandemic came with strict health orders for the safety of all and resulted in a drastic drop in revenues, specifically in two of the top three taxes that make up more than 50 percent of the City's General Fund. The City of Palo Alto took swift, decisive, and difficult action to balance an approximately \$40 million decline in FY 2021 revenues. This budget reflects a continuance of the significant service reductions taken in the first year of the pandemic and further aligns service levels with resources that continue to be dampened by the pandemic.

It has been a year since the Santa Clara County Shelter-in-Place Order was issued and since that time the one constant has been uncertainty. Examples of how the community has managed through this uncertainty together with community testing, practicing safety guidelines, and getting the COVID-19 vaccine when eligible. These efforts will materialize in recovery through the easing of restrictions such as allowing more indoor and outdoor activities, increasing economic activity and tax revenue collections. During this period of shelter-in place orders, the City has supported significant efforts, furthering Race and Equity initiatives, opening of Foothills Nature Preserve to everyone, launching the Uplift Local initiative, taking advantage of historic market conditions to advance capital projects, reopening City playgrounds after being closed for several months, and finalizing a Community and Economic Recovery work plan.

Fiscal Reality and Council Directed Budget Approach

To balance the FY 2022 \$13 million gap, the Proposed Budget includes \$7.7 million in net service and capital improvement investment reductions, \$1.0 million use of program specific reserves (e.g. Development Center), an assumed \$1.6 million in labor concessions, and use of \$3.1 million in ARPA funds. The current budget gap is a combination of impacts resulting from the pandemic and pending litigation related to the City's Utility Transfer.

Overall, the City's General Fund is estimated to collect \$205.6 million in revenues and \$205.6 million in expense, a balanced budget for FY 2022. These funding levels reflect an \$8.6 million, or 4.4 percent, increase compared to the FY 2021 Adopted Budget due to the pending Utility Transfer litigation. The City's Capital Improvement Plan reflects a \$152.9 million FY 2022 budget, and a \$729.8 million plan over the 2022-2026 five-year CIP. Of this, the General Capital Improvement Fund reflects expected expenses of \$51.5 million in the FY 2022 budget and \$177.5 million over the five-year CIP.

This year's budget continues the City Council's hard work accomplished in FY 2020 to address the loss of \$39 million in revenue in the General Fund in FY 2021. It is important to note that in FY 2021, the organization experienced an overall reduction in service in the General Fund totaling \$20 million as a result of the fiscal constraints experienced last year that are not restored in this proposed budget. Overall, including both FY 2021 and FY 2022, this reflects a net reduction of 104 full-time staff (equivalent of 96.0 FTE) and 129 part-time staff (equivalent of 31.04 FTE) resulting in a workforce of 938.85 FTE full-time positions and 75.28 FTE part-time positions. In the General Fund, full-time staffing is reduced from 574.43 FTE to 489.65 FTE (a reduction of 84.78 FTE) and part-time staffing is reduced from 81.31 FTE to 50.27 FTE (a reduction of 31.04 FTE).

The proposed budget balancing strategy seeks to navigate through this difficult time by focusing limited resources on funding services with the greatest community impact, maintaining core City services, and managing vulnerabilities and risk associated with a shrinking organization. The balancing strategy also uses the opportunity of one-time Federal funding to mitigate further and more steep service reductions in the long-term. The Proposed Budget also outlines \$4.3 million in additional "Tier 2" service reductions should the City be faced with additional economic uncertainties, not gain labor concessions, or should the Council choose to not use the ARPA funds to balance the budget or change current recommended balancing strategies.

The General Fund Tier 2 Potential Additional Reductions outlined reflect service reductions that would have been necessary however, are potentially mitigated by the assumption of achieving labor concessions and use of ARPA funding. These "Tier 2," more severe reductions include full closure of facilities and/or elimination of programs, public safety personnel, long-range planning staff, in-house sidewalk repair/maintenance, park and open space maintenance, reductions to human services contracts and grants, and further reductions of citywide administrative support, human resources, and more. These reductions reflect the most significant impacts such as limiting hours to two main libraries and no distribution of materials at any neighborhood libraries, the full closure of Fire Station 2, reductions in records and in investigation

Police staffing, reduction of Art Center availability to Thursday-Sunday, and closure of the Children's Theater.

Below are overviews of the Citywide Strategies, both in the long-term and specific to this proposed budget, and Department Specific Strategies that bridge the base budget gap identified in the LRFF. Details of specific department proposals can be found in each department section of this document. While this Proposed Budget builds on reductions taken in prior year and also assumes significant service level reductions, additional, more severe reductions totaling \$4.3 million have been offset through one-time use of ARPA Funds and expected labor concessions.

Citywide Strategies

As noted above, the City's budget strategy addresses immediate City service needs, but is not a sustainable fiscal strategy for the long-term to meet the needs of the community. From an operating budget standpoint, strategies include service reductions to address immediate resource limitations while hopeful that we can build back in future years. From a Capital infrastructure standpoint, the level of reductions seen and included in the Proposed Budget will require the City to play 'catch up' in future years. Overall, more sustainable budget approaches are needed as we look to recover from the pandemic such as increased use of non-profit partners to provide services, evaluating current core services and continued modernization of service delivery, and diversifying the City's revenue mix and/or increasing revenues to fund services.

Citywide Cost Containment: Continuing a hiring freeze and freezing all nonessential travel, eliminating current vacancies and reducing future vacancies through attrition, and service reductions such as reduced walk-in office hours. The FY 2022 Proposed Budget includes potential labor concessions for the City's represented groups which totals \$2.5 million Citywide and \$1.6 million in the General Fund.

City General Capital Infrastructure Fund Transfer Suspension: The City's General Fund transfers total \$9.7 in the Proposed Budget, a 67.7 percent decrease of over \$30 million annually to the General Capital Improvement Fund prior to the economic impacts of the pandemic. The transfer to the City's General Capital Fund consists of a baseline transfer (\$2.6 million) as well as the allocation of Transient Occupancy Tax (TOT) receipts (\$5.9 million) as designated by the City Council, and estimated interest earnings (\$1.2 million). Losses in TOT revenues and an additional \$2.4 million reduction in the General Fund base transfer to the Capital Improvement Fund impacts resulted in restructuring of how projects were previously programmed in the five-year CIP. The 2022-2026 CIP prioritizes investments in essential capital investments, the Public Safety Building, 2014 City Council approved Infrastructure Plan projects, and various transportation projects including grade separations.

Use of American Rescue Program Act (ARPA) Funding: the newly signed American Rescue Plan Act of 2021 (ARPA) signed into law in March provides over \$350 billion of relief funds to state and local governments. This amount represents approximately one-fifth of the bill's total allocation and will be deployed to state and local government agencies in two distributions and use of these funds is broadly defined in the bill. As of the printing of this document, specific guidance for the State and Local Fiscal Recovery Fund

TRANSMITTAL LETTER

component of ARPA, including metrics, requirements, and restrictions, is under development by the U.S. Department of the Treasury. The City expects to receive \$12.5 million over two years.

Of the first allocation of \$6.25 million, this Proposed Budget recommends use of \$3.1 million in ARPA funds to balance this FY 2022 budget, which has allowed the City to abate potential additional budget reductions as outlined in General Fund Tier 2 Potential Reductions. In addition, it holds \$3.2 million ARPA funds intended for Council / Finance Committee to use as options to adjust the proposed balancing strategy and/or to be available to address additional economic and labor concession uncertainties. It sets aside the remaining second year ARPA funds as formal guidance from the federal government on timing and restrictions of funding remains pending and the likely need for these funds to assist in a two-year bridge in FY 2022 and FY 2023 as the economy recovers. The LRFF articulates an expected gap in revenues and expenses in FY 2023 and staff expects that at least a portion of these funds would be necessary to even maintain the current lowered service levels as we manage through the recovery.

Guidelines for use of ARPA funds state that funds can be used to mitigate the fiscal effects stemming from the public health emergency including:

- Assistance to households, small businesses and nonprofits, assistance to hard-hit industries like tourism, travel, and hospitality,
- Response to workers performing essential work during COVID-19,
- The provision of government services to the extent of the reduction in revenue due to the pandemic in the most recent full fiscal year, and/or
- Making necessary infrastructure investments

Proactive Funding of Long-Term Liabilities: The City Council approved a proactive funding strategy to contribute to the City's Pension Trust Fund assuming a normal cost for contributions with a 6.2 percent discount rate. This resulted in additional annual contribution of \$5.1 million in all funds, \$3.1 million in the General Fund. Council adopted the Pension Funding Policy (City Manager's Report #11722) with a target goal of reaching a 90 percent funded status with CalPERS in 15 years. The Proposed Budget addresses Council direction by including the necessary funding to follow this Pension Funding Policy as well as the continued proactive funding of the City's Other Post-Employment Benefits (OPEB) liabilities as well.

Community & Economic Recovery Workplan: The focus areas of the adopted workplan are Managing Through the Pandemic, Community Wellness and Wellbeing, Business Support and City Priority Initiatives. The City's workplan includes further emergency resilience elements and exploration of a potential ballot measure to address long term funding needs. Current recommended projects have been prioritized based on both project readiness and short- and long-term impacts.

Budget Stabilization Reserve (BSR): This FY 2022 Proposed Budget anticipates a BSR balance of \$35.8 million, or 17.4 percent of General Fund expenses. This is below the City Council target level of 18.5 percent but within the targeted range of 15 percent to 20 percent of General Fund expenses.

Department Specific Service Impacts

Public Safety: Suspend specialized police units such as the traffic enforcement unit and investigation unit

to maintain minimal police patrol services and shift the priority of police services to focus on urgent calls and reduce the level of service and ability to respond to non-urgent calls for services. Limit coverage provided by crossing guards at schools to high-traffic streets. Subsidize Animal Control operations for one-year through use of donations. Brown out Fire Station No. 2 where the station is staffed without mandatory call back. Elimination of system maintenance for the railroad train crossing intrusion detection system.

Community & Library Services: Neighborhood library (Children's, Downtown, and College Terrace) closures with contactless distribution services. Full-service branches (Mitchell Park and Rinconada) open six days per week. Reduction in library programming. Reduction of operating hours and/ or closure, programming, and services for facilities such as the Art Center, the Baylands Interpretive Center, the Teen Center, and the Children's Theatre. Elimination of administrative support that will impact the level of service that program coordinators and managers can provide.

Planning, Transportation & Infrastructure: Understanding that this could delay services in development review, reduction of current planning will result in extended application processing timelines and delays in permit issuance. Reduced bicycle program and increased response time to transportation related 311 notifications due to reduction of traffic data services. Implementing license plate recognition for efficiencies in parking enforcement and initiating a paid parking program to increase revenues. Reduced facilities maintenance and repairs or replacement of street and traffic markings. Reduced capital plan investment via the General Fund annual base transfer.

Citywide Internal Support, Administration, and Council Appointed Officers: Administrative support functions in 7 departments reduced and functions shifted to other department staff, resulting in service delays across the organization. Specific to Internal Support departments - Information Technology, Human Resources, and Administrative Services Departments as well as the Council and appointed officers (City Manager, City Attorney, City Auditor and City Clerk) - reductions in these areas in line with the changes in services, increasing timeframes for assistance and review in areas such as recruitments, procurements, and risk management. Technology solutions will be constrained to only essential contracts and systems and to support equipment needs.

Once again, we must recognize that many of these budget balancing strategies are not sustainable over the long term. However, these, or similar solutions, are necessary to bridge the gap created by a steep economic downturn, contain costs, and support our economic recovery.

Economic Recovery and Long-Term Financial Planning

Work on Economic Recovery began in Fall 2020, prior to the City Council setting this priority in January. These efforts began with the "Uplift Local" initiative and convening a panel of experts to discuss national and local revenue trends, the future of workplaces, and initial reactions to staff's ongoing workplan. Through several conversations with the City Council in 2020 and 2021, the Community and Economic Recovery workplan was developed. This workplan identifies several recommended priority projects and work to connect the City Council's Priorities and ensure organization support and capacity to further these efforts in the coming year and beyond. The workplan emphasizes four key areas: Manage through the Pan-

TRANSMITTAL LETTER

dem; Community Wellness and Welfare; Focused Business Support; and City Priority Initiatives. A summary of the focus areas, including specific priority projects can be found here: City Manager's Report #12111

On February 8, 2020, the City Council approved the Long Range Financial Forecast (LRFF) (City Manager's Report #11954), the financial balancing scenario to be used in development of the FY 2022 budget, and the Budget Development Guidelines. At the time the LRFF was developed, it was found in reviewing a variety of economic resources that recovery will occur over a three to five-year period, with major tax revenues returning to pre-COVID levels in FY 2025. The Forecast did not assume restoration of service reductions taken in FY 2021 and, if annual budget shortfalls are balanced through service reductions, this would result in approximately a cumulative 25 percent, or \$56 million, overall budget reduction between FY 2021 and FY 2026. This balancing scenario resulted in an overall \$6.8 million budget shortfall for FY 2022 and that Shelter-In-Place orders will be effective through spring/early summer. Recognizing that some of the necessary measures may not be sustainable in the long-term, the forecast assumes deferrals of some long-standing priorities to respond to the downturn and allow for an economic recovery before resuming. We must assume this may take years and hedge against the unknown duration of this downturn.

This recovery is heavily reliant on resumption of travel to the region and return to pre-COVID level daytime population (e.g. return to in-person work for office and education employees). As of the production of this document, vaccines are being made more widely available and the County of Santa Clara has worked diligently to manage vaccine supply as the State moves to expand eligibility. In sharp comparison to this time last year, as society begins to adjust to loosened social constraints, we are working towards ensuring a safe environment for community activity. Looking forward, the City continues to face several pressures, not only from the global economic impacts of COVID-19, but also funding the growing costs of pension benefits, labor costs, and the current cost of living around Palo Alto; critical choices in balancing long-term financial impacts of pending litigation; and funding for the 2014 Council approved Infrastructure Plan projects.

City Council Priorities

In January of this year, the City Council held a retreat and selected four priorities to focus on in this year. While recognizing the devastating economic impacts of the pandemic by identifying Economic Recovery as the top priority for 2021, the City Council continues its priority of affordable housing from 2020. The priorities include:

- Economic Recovery
- Housing for Social and Economic Balance
- Social Justice
- Climate Change - Protection and Adaptation

For the City Council Retreat staff memo highlighting the results of the 2021 City Council Priorities Ranking Survey Responses, please go here:

<https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/at-places-memo/01-30-21-ccm-at-places-memo-item-1.pdf>

Summary of Other Funds

The City's Enterprise and other funds, including the General Capital Fund reflect the priorities from the FY 2022 budget development with updates for FY 2022 rates and limited adjustments for the zero to minimal rate increases approved for FY 2022. The capital budgets have been updated for the current status and cost estimates of projects based on engineering designs and prioritize investments of limited resources, including deferral of some large projects beyond the five-year CIP. The City will continue to maintain services and facilities for the community and the region, such as Utilities, Palo Alto Airport, and Regional Water Quality Control Plant. FY 2022 financial plans for City's utilities are developed to provide sufficient funding to cover increasing expenses for commodities, replenish lower reserves, and to repair and replace the City's aging utility infrastructure and is expected to increase the average month utility bill by 1.4 percent. Parking permit prices are also recommended to decrease to pre-pandemic prices, except for resident permits which are recommended to remain at \$50.

The City's Capital Improvement Plan reflects a \$152.9 million budget in FY 2022 and \$726.8 million plan over the 2022-2026 five-year CIP. Major investments continue in the Regional Water Quality Control Plant capital program, with approximately 64 percent of the expenses reimbursed by five contributing partner agencies outside of the City of Palo Alto. The general Capital Improvement Fund is the largest single fund in the 2022-2026 CIP with \$211.3 million planned for 71 projects. Responsible investments and essential infrastructure are prioritized in this budget and will be necessary as the uncertainty of economically sensitive TOT revenue remains.

Staff proactively re-evaluated the FY 2021 capital project status and funding needs throughout the year in response to TOT revenue declines impacting General Fund capital investments. In addition, the City Council directed staff to find an additional \$2.5 million in savings from the FY 2021 General Fund Capital Budget. The FY 2022 budget was developed accordingly, assuming an additional \$2.5 million reduction in the base capital transfer from the General Fund. In total, transfers from the General Fund to the Capital Improvement Fund decreased in FY 2022 by \$3.1 million, from \$12.8 million to \$9.7 million due to declines in TOT revenue and the \$2.5 million reduction in the base capital transfer. Capital projects were reviewed with the following specific objectives:

- Reduce carryover funding to "keep up" spending on essential infrastructure rather than fall behind and require new funding sources or levels to "catch up" in upcoming years;
- Position shovel-ready projects to take advantage of the favorable construction market pricing typical of a recession;
- Minimize near-term funding of discretionary projects; and,
- Ensure a steady flow of projects that minimizes peaks and valleys in project delivery staffing needs, as this would reduce efficiency and introduce bottlenecks in productivity.

Budget Process and Key Dates

An important aspect of the budgeting process is dialogue. This proposed budget includes significant reductions in services to the community and opportunities to strategically position both the City's financial position, service offerings, and goals over the long-term. To engage with the community and the City

TRANSMITTAL LETTER

Council, over the next several weeks we will conduct a series of public meetings to discuss the budget. In addition, staff is hosting an online survey to gain input and inform the City Council's budget deliberations involve the community in this dialog through Open Townhall, our online platform for community engagement. Key dates are listed below:

- May 3: Budget Overview with City Council
- May 4: Budget Overview with Finance Committee
- May 6: Open Townhall and Community Survey
- May 11-12: Budget Hearings with Finance Committee
- May 17: Finance Committee Budget Overview with the City Council
- May 25: Budget Wrap-up with Finance Committee
- June 21: City Council Budget Adoption

Acknowledgements

I would like to thank the City Council for your leadership and our Executive Leadership Team and the entire staff of the City for providing outstanding services to our community. It is through the support of this team we have overcome the challenges faced last year, and through this resiliency, our experiences have prepared us for the challenges ahead. Together, we must take action to address issues in the near term to best position the organization for the long-term so that we can meet the needs of the community today and beyond. The Palo Alto community should be proud of your leadership and commitment to service.

A budget document takes countless hours of teamwork, collaboration, and patience to produce. I would like to offer special thanks to Kiely Nose, our Interim Assistant City Manager and Chief Financial Officer and the dedicated Office of Management and Budget Team - Christine Paras, Paul Harper, Jessie Deschamps, Alexandra Harris, Sean Kilger, Oscar Murillo, Kayla Shapiro, Chaitali Paliwal, Steve Guagliardo, and Joshua Martinez. Completing this budget could not have been accomplished without the skill, dedication, and professionalism of this team. Their willingness to work through these unique circumstances and sacrifice countless hours are a testament to their commitment to this organization and to the community. I am also grateful to our Executive Leadership Team especially our Department Directors and Meghan Horrigan-Taylor our Chief Communications Officer who worked on the budget materials and the leadership they have demonstrated. There are too many to list here by name, but the budget could not have been produced without the senior/management analysts, division managers, administrative assistants, and others throughout the organization who helped produce this budget.

Respectfully Submitted,



Ed Shikada

City Manager