

**LONG
RANGE**

FINANCIAL FORECAST

Fiscal Years 2012 to 2022



Draft Council Version—May 7, 2012



**CITY OF
PALO
ALTO**

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I. EXECUTIVE SUMMARY

This report is the City's updated Long Range Financial Forecast (LRFF) for the fiscal years 2012 through 2022. The LRFF identifies key issues that impact the upcoming FY 2013 Budget process as well as the City's future financial condition. It also allows Council and staff to explore some "what-if" scenarios to see what alternative assumptions would do to the City's bottom line.

The economy has finally begun to show longer-term improvement both at the national and state levels. By January 2012, national unemployment had decreased to 8.3 percent, and state unemployment reached 11.1 percent in December 2011, its lowest level since 2009. Gross Domestic Product and Gross State Product both showed consistent growth, as did venture capital investment and new technology jobs in Silicon Valley. Even more positive was that Silicon Valley led the state in job growth. Less positive was (and is) the number of still-unemployed: 13 million nationwide, of which 5.5 million have been unemployed for 6 or more months; and 2 million in California.

The City's revenue projections look rosier than they have for a couple years, but benefit costs continue to outpace the rate of revenue growth. A new actuarial valuation of the City's unfunded retiree medical liability indicated that the General Fund needs to set aside an additional \$2.0 million* in FY 2012 to fund that liability. The City still has its work cut out for it in addressing its structural deficit.

In December 2011, the Infrastructure Blue Ribbon Commission (IBRC) presented to Council a report addressing the under-funding of the City's infrastructure. The IBRC report recommended that the City fund \$41.5 million to in "catch-up" projects; invest an additional \$2.2 million per year to more adequately fund its capital operating and maintenance ("keep-up") costs, and seek voter approval to fund a new public safety building and rebuild the MSC, among other reconstruction projects — to the tune of \$210 million. These recommendations are being reviewed and discussed at the Special Council Retreats. Meanwhile, as requested by the Finance Committee in February, the Forecast incorporates the additional \$2.2 million per year in infrastructure investment for "keep-up" needs. Other categories of needs defined by the IBRC Report—the \$4.2 million per year in "catch-up" needs and the \$210 million in new construction needs—are not incorporated into the Forecast.

The Base Model is summarized in the chart at the top of page 2. It shows a balanced budget in FY 2012 after a recommended \$2.3 million draw on reserves, and a deficit of \$1.0 million in FY 2013. The City added \$4 million to the Budget Stabilization Reserve in FY 2011, so there is room for a commensurate withdrawal in FY 2012. The report assumes Council will approve this request for forecasting purposes. For FY 2013 to 2022 (ten years), the combined deficits are projected at \$88.2 million.

This Forecast is not a prediction. It is a snapshot contingent upon a number of assumptions.

*\$2.0 million figure is the difference between the recommended Annual Required Contribution from the January 2011 actuarial valuation and that of the prior, 2009 valuation. It incorporates assumption changes approved by Council on April 16, 2012.

2012 EXECUTIVE SUMMARY

2012-2022 LRFF - SUMMARY OF BASE MODEL

	FY 2012 Projected	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
TOTAL REVENUES	150,203	150,978	154,887	158,830	163,765	168,727	173,930	179,931	186,294	191,718	197,901
TOTAL EXPENDITURES	153,988	152,000	158,628	164,623	170,860	177,310	184,000	190,997	197,878	205,530	213,320
GRAND NET SURPLUS (DEFICIT)	\$ (0)	\$ (1,022)	\$ (3,741)	\$ (5,794)	\$ (7,095)	\$ (8,583)	\$ (10,070)	\$ (11,065)	\$ (11,584)	\$ (13,812)	\$ (15,419)

Two directives from last year's Council are incorporated into the Base Model: (1) assume 10 percent annual medical cost increases, and (2) assume 3 percent annual increases in PERS rates from FY 2016 onwards. Note that PERS actuarial reports provided the base PERS rates used for FY 2013-2015; staff added another 1.5 to 2.5 percent as a result of PERS's reduced discount rate assumption. Staff suggests that a lower PERS rate increase assumption in the out years may be valid (for example 1.5 percent per year), given the discount rate change and higher rates already included in the Forecast. Details on the PERS calculations are outlined on page 15 of this report.

In addition, the Forecast includes Proposed FY 2013 Budget figures, including \$2.6 million in one-time savings due to frozen positions and \$1.6 million in one-time expenses. In the Base Model, these savings and costs are backed out after FY 2013 to project the remaining years of expenditures. An Alternate Scenario (pages 22-23) assumes the one-time frozen positions become permanent, with a reduction in cumulative deficits of \$29.5 million.

The model includes savings from recent concessions achieved with the International Association of Firefighters (IAFF) and the Fire Chiefs Association (FCA) as well as from the potential agreement with the Palo Alto Police Officers Association (PAPOA). As directed by the Finance Committee on February 28, 2012, no concession savings are assumed if not already negotiated with the bargaining unit.

Lastly, the Forecast incorporates anticipated savings resulting from library closures at Main and Mitchell Park during construction, as well as additional operating costs after project completion. In FY 2013, the Library Department anticipates \$0.45 million in salary and benefit savings during the remodeling of the two libraries, partly offset by an additional \$0.34 million in expenses. In FY 2014, salary and benefit savings are expected to be completely offset by added expenditures, and from FY 2015 onwards, an additional \$1 million in expenses are anticipated due to the completed Mitchell Park and Main Library projects. **(See Endnotes Number 19 on page 30 for breakout of new library costs and savings incorporated into the model.)**

As we say each year, this Forecast is not a prediction. It is a snapshot contingent upon a number of assumptions, all of which are outlined in the report. It is staff's hope that by examining this snapshot, Council members and staff may identify issues that must be addressed in the near term to improve the City's long-term outlook.

II. ECONOMIC OUTLOOK

Based on information available as of February 9, 2012

NATIONAL:

The economy ended 2011 on a surprising upswing. After months of concern about a return to recessionary conditions, most analysts now rule out another recession. The number of people applying for unemployment benefits reached 366,000 in the second week in December, down from a peak of 659,000 in March 2009. Employers added 100,000 jobs five months in a row, the longest streak since 2006, capped by a 200,000 increase in December and a 243,000 increase in January 2012. The national unemployment rate fell from 9 percent in October to 8.3 percent in January, the lowest in nearly three years.^{1,4}

Moreover, 2011 was a record year for the nation's retailers; sales totaled \$4.7 trillion – a gain of nearly 8 percent over 2010, the largest percentage increase since 1999. On the flip side, December sales were just 0.1 percent above November's.² Holiday spending was heavily fueled by discounts, raising concern about what it would take to get shoppers to spend again in coming months.³

Looking forward to the rest of 2012, economists are cautious, and do not expect growth in 2012 to keep pace with the fourth quarter of 2011. Historically, consumption accounts for 70 percent of Gross Domestic Product (GDP), with government contributing about 20 percent, so consumer spending has to “ignite” for growth to take off. However, inflation-adjusted weekly earnings dropped 1.8 percent from November 2010 to November 2011, and more than 40 percent of the new jobs in the last two years have been in low-paying sectors like retail and hospitality. So analysts are concerned that the rate of consumer spending shown in the 4th quarter of 2011 may not be sustainable.⁵

Consumers have several reasons to be cautious. More than one in five borrowers still owe more than their homes are worth. Turmoil in the stock markets in the late summer and early fall caused a \$2.4 trillion decrease in household wealth, and many people who borrowed heavily during the boom to make big purchases are still repaying debt and cannot win approval for new loans.⁵

On the positive side, employment growth has begun to look like a sustainable trend. While the unemployment rate dropped to 8.3 percent in January, the underemployment rate, which includes people who can find only part-time work and those who have stopped looking for

...“According to the US Labor Department, state governments sliced 49,000 jobs over the past year while local governments whacked 210,000 jobs. The result is that state and local government job cuts have become a drag on job recovery in a way they weren't during the last two recessions.”

*—Chris O'Brien, “Government job loss having huge economic impact,” *San Jose Mercury News*, Dec. 22, 2011*

2012 ECONOMIC OUTLOOK

work, also declined to 15.2 percent, down from 16.6 percent one year ago. Yet as a January 6 *New York Times* article put it, there remains “a deep hole to climb out of. There are still more than 13 million jobless Americans, 5.5 million of whom have been unemployed for half a year or more. And even those finding work are often taking salary cuts, with job creation concentrated in low-wage sectors.”⁶

“ Many of the jobs created in October 2011 were primarily at small and medium-sized companies. Businesses with fewer than 49 workers contributed 58,000 to the net monthly increase, while businesses with over 500 workers had zero net increase in their payrolls.”

—Cutwater Asset Management, “Monthly Market Review,” Oct. 2011

LOOKING FORWARD

Beacon Economics, in its December 2011 quarterly economic forecast, predicted that national unemployment levels would remain above 8 percent for the rest of 2012, and stay above 7.5 percent through all of 2013.⁷ Three dozen private, corporate, and academic economists recently predicted the economy (as measured by the GDP) would grow 2.4 percent in 2012, following a rate of about 2 percent in 2011.⁸ The UCLA Anderson Forecast had a more sober prediction: a sub-2 percent growth rate for most of 2012, followed by a 3 percent growth rate in 2013.⁹ Citigroup also forecasted slower, 2 percent expansion in 2012.¹⁰

CALIFORNIA

The state unemployment rate dipped to 11.1 percent in December 2011, its lowest rate since 2009. Even more encouraging was the fact that job growth was broad-based, with strongest growth in construction (a new entrant in the growing industry club), information, professional and business services, educational and health services. In December 2010, the state unemployment rate was 12.5 percent, having remained at or above 12 percent from August 2009 until April 2011.¹¹

The California recovery has been noteworthy for the disparity between the pace of growth in its various regions. The Anderson Forecast described the following in September 2011: “Coastal California enjoys a recovery rooted in exports, innovation and knowledge communities, while Inland California continues to suffer from a glut of housing and a contraction in government spending.”¹² That outlook has improved somewhat with the Central Valley now projected to finally see its economy recover in 2012.¹⁰ Most recently, in December, after leading the employment recovery with 15 consecutive months of job growth, the San Jose region posted a monthly *decline* of 1,200 jobs. In fact, much of the job growth across the state shifted to Southern California, with Los Angeles, the Inland Empire (east of Los Angeles), and San Diego posting the largest gains.¹³

Positive Recovery Signs include:¹⁴

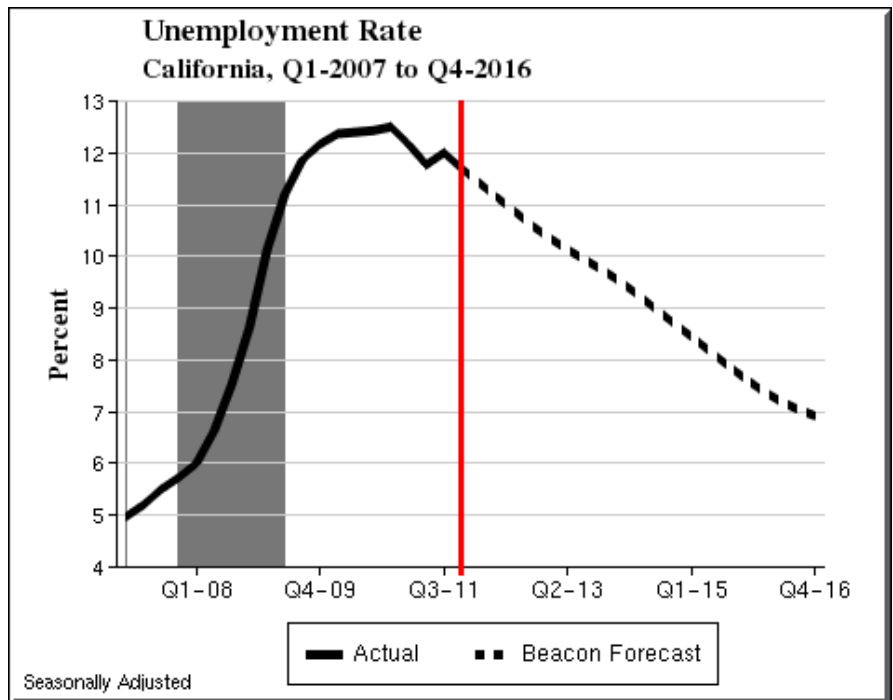
- Consistent Growth—State has seen 21 straight months of uninterrupted growth in GDP.
- State Exports—State exports rose 12.7 percent over this time last year. The boost in exports has been

led by technology products, though the state's agricultural sector has posted strong gains as well.

- Venture Capital Investment— Since hitting a low of \$1.7 billion in the first quarter of 2009, new venture capital investment has risen nearly 118 percent.

Areas of Concern include:¹⁴

- Skills Mismatch in the Labor Market — According to Beacon Economics, “there is a real dichotomy between the skill sets of the workers in...sectors that were pummeled by the downturn and the skill sets required by the sectors that are leading California out of the recession...”



- Disproportionate Impact of Recession on Lesser Educated — More than 17 percent of all adults over the age of 25 who have less than a high school diploma were unemployed last year, compared with roughly 5 percent of all Californians with a graduate or professional degree. What might explain this phenomenon? Again, Beacon Economics explains, “Construction, real estate, and retail trade were among the hardest-hit sectors in the region in terms of job losses. These sectors traditionally have low educational requirements and pay relatively low wages, which are two of the predominant characteristics of our unemployed population.”
- Continued Unemployment—More than 2 million working-age Californians remain without jobs and the state remains well above the national jobless rate of 8.3 percent.

BAY AREA

The Bay Area has enjoyed a quicker recovery than the state as a whole, but the recovery has been uneven among cities in the area. Several Silicon Valley cities – particularly San Jose, Sunnyvale, Mountain View and Palo Alto— showed the biggest jumps in the employment level between August 2009 and August 2011.

“Driving the differing recovery outcomes is one overriding factor, say economists: the technology industry. Large tech companies such as Apple Inc. and Google Inc. have been on a recruiting tear, while start-up hiring has also been brisk, fueled by the likes of Facebook Inc. Most of that activity is concentrated in South Bay cities such as Mountain View, Cupertino and mid-peninsula in Palo Alto...”¹⁵

2012 ECONOMIC OUTLOOK

The Bay Area is predicted to continue to outpace the state in job growth in 2012. According to a new University of the Pacific forecast, while the state job market is expected to grow by 1.1 percent in 2012, the Bay Area is expected to show employment expansion of greater than 1.5 percent.¹⁶

Beacon Economics predicts the South Bay will re-gain its pre-recession peak by the second half of 2013. The unemployment rate, which peaked at 11.8 percent in the 4th quarter of 2009 and reached 9.9 percent in October 2011, is predicted to fall to 8 percent by the end of 2013.¹⁷

ECONOMIC DEVELOPMENT IN PALO ALTO

Staff continues to work with Council to develop a *Policy for Economic Development*, to help guide the City's efforts to attract and develop business activity in Palo Alto.

In the meantime, staff is working on numerous fronts, including:

- Helping shepherd current hotel projects through the City's process
- Investigating possible auto dealership, retail or hotel usages of the Municipal Services Center (MSC) site
- Drafted an RFP for creating a digital billboard at the MSC
- Participating in the Development Center restructuring
- Creating a "Test Bed" for innovative, green, and clean tech companies. Staff has already created a Utilities-based funding source for new companies developing energy-efficiency-related technologies
- Engaging in extensive outreach to the business community to develop lines of communication and stay attuned to opportunities to help facilitate business growth
- Setting up meetings between business leaders, Council Members, and the City Manager
- Updating the business portion of the City's web site

IMPACT OF ECONOMIC OUTLOOK ASSUMPTIONS ON THE MODEL

The economic developments in the Bay Area and locally translate into a more positive outlook for City revenues. Palo Alto transient occupancy and per diem rates have moved up appreciably, as they have along the entire Peninsula, due to increased business activity. Sales tax revenue has been on an upward trend with strong department store and electronic equipment sales. While property tax revenue has been relatively flat due to commercial property tax appeals, once those appeals are resolved the City expects gradual improvements in this revenue category as well. Overall the picture is slowly improving for City revenues.

III. UPDATED MODEL

ASSUMPTIONS USED IN THE BASE MODEL

The following is a detailed description of the assumptions utilized in the Base Model. Note that some of the descriptions refer to “CAGR” or Compound Annual Growth Rate.¹⁸ This is the average rate of growth over a period of time in a particular revenue source or expense category. Generally, staff looked at the CAGR over fiscal years 2006-2011 as a guideline for future rates of increase, after removing one-time variations.

OVERALL ASSUMPTIONS

FY 2013 revenues and expenditures follow the Proposed Budget working its way through the Budget Process. The FY 2013 Proposed Budget includes a number of one-time expenditures and savings. The Base Model backs out these one-time items starting FY 2014, for forecasting purposes, until staff has an opportunity to review the impacts of the operational changes and determine whether positions can be permanently eliminated. In the Alternate Scenario, the savings attributable to frozen positions are assumed to become permanent reductions in headcount.

The specific one-time items included in the FY 2013 Proposed Budget are as follows:

1. \$2.65 million in salary and benefit savings due to the following frozen positions:
 - 6 Firefighters
 - 1 OES FTE
 - 1 Plan Check Engineer
 - 6 Police Officers
 - 1 Police Captain

2. \$1.6 million in one-time costs as follows:
 - \$0.15 million for a Planning Organizational Study and an Animal Services Study
 - \$0.34 million in election costs
 - \$0.31 million loan to the Airport Fund
 - \$0.8 million in additional technology investments for Development Center

Subtotal of One-Time Savings and Costs: \$1.05 million in net savings

In addition to the one-time savings included the FY 2013 Budget, the Proposed Budget also assumes the permanent elimination of the Animal Services program, although this policy decision has been discussed but by no means finalized by Council. The assumed closure impacts a few different revenue and expense categories in the Forecast, as noted in the discussion below.

REVENUES

Overall, City revenues are improving; expense increases, discussed on pages 11-15, continue to outpace the growth in revenues.

Sales Tax

FY 2012 sales tax revenue is estimated at \$21.6 million, an increase of \$1.4 million above the Adopted FY 2012 budget, and a \$0.8 million (4.1 percent) increase over FY 2011 actuals. The increases are based on year-to-date receipts and projected year-end figures from MuniServices, the City's sales tax consultant; they also reflect increased overall business and consumer spending in the area. In FY 2013, these revenues are estimated to increase 4.4 percent to \$22.5 million. This rate of increase drops to 3.6 for FY 2014, but then resumes growth in the 4 to 5 percent range through FY 2022.

Property Tax

FY 2012 property tax revenue is projected at \$26.0 million, a 1.2 percent increase over FY 2011 actuals—which aligns with County growth expectations. The Forecast then assumes gradual growth in property tax revenues over the next 8 years from 3.9 percent in FY 2013 to 4.6 percent in FY 2022. The City's near-term forecast assumes a steeper growth rate than that of the Palo Alto Unified School District, which, as of January 2012, forecasted 2 percent growth for the next few years.

Transient Occupancy Tax (TOT)

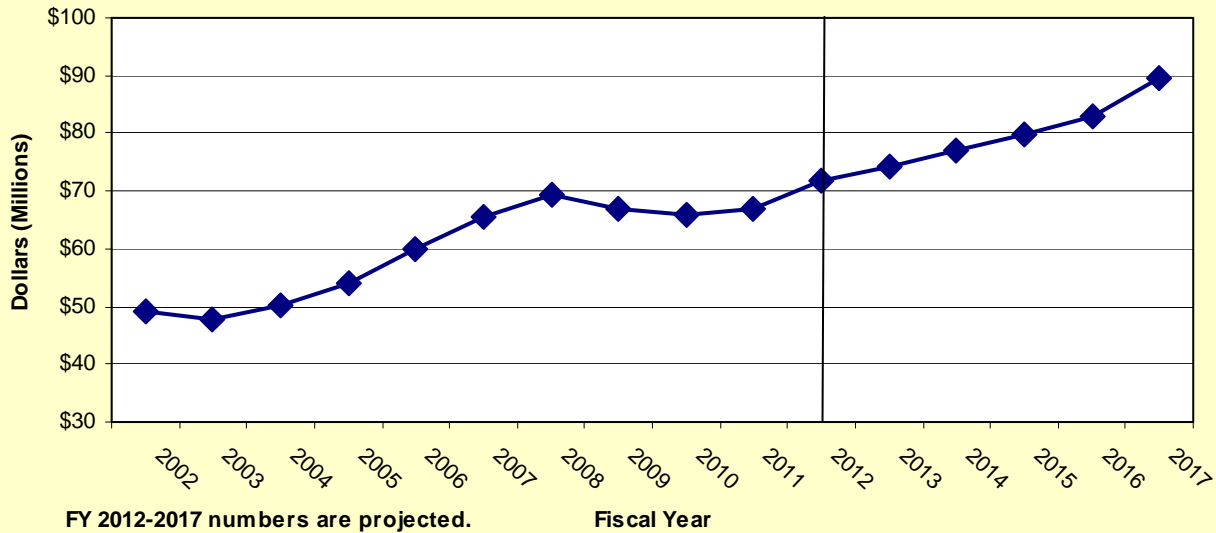
With the opening of Hotel Keen in May 2010 and strong receipts from existing establishments, the TOT rebounded in FY 2011 after two years of declines, with a 17.8 percent increase over 2010 actual receipts. FY 2012 first quarter receipts were 26.2 percent higher than first quarter FY 2011 receipts, and for FY 2012 TOT revenues are projected to exceed FY 2011 revenues by \$0.6 million or 7.3 percent—reaching \$8.7 million. FY 2013 revenues are expected to be \$9.6 million, or 10.6 percent above projected FY 2012 revenues. Note that the Forecast does not include revenues for potential new hotels. Two hotels (Hilton Garden and Palo Alto Bowl) have submitted plans while another two are expected to do so in the next 6-9 months. Hilton Garden plans 170 rooms, with an expected opening in 2014 and potential TOT revenues of \$1.0 to \$1.2 million.

Utility Users Tax (UUT)

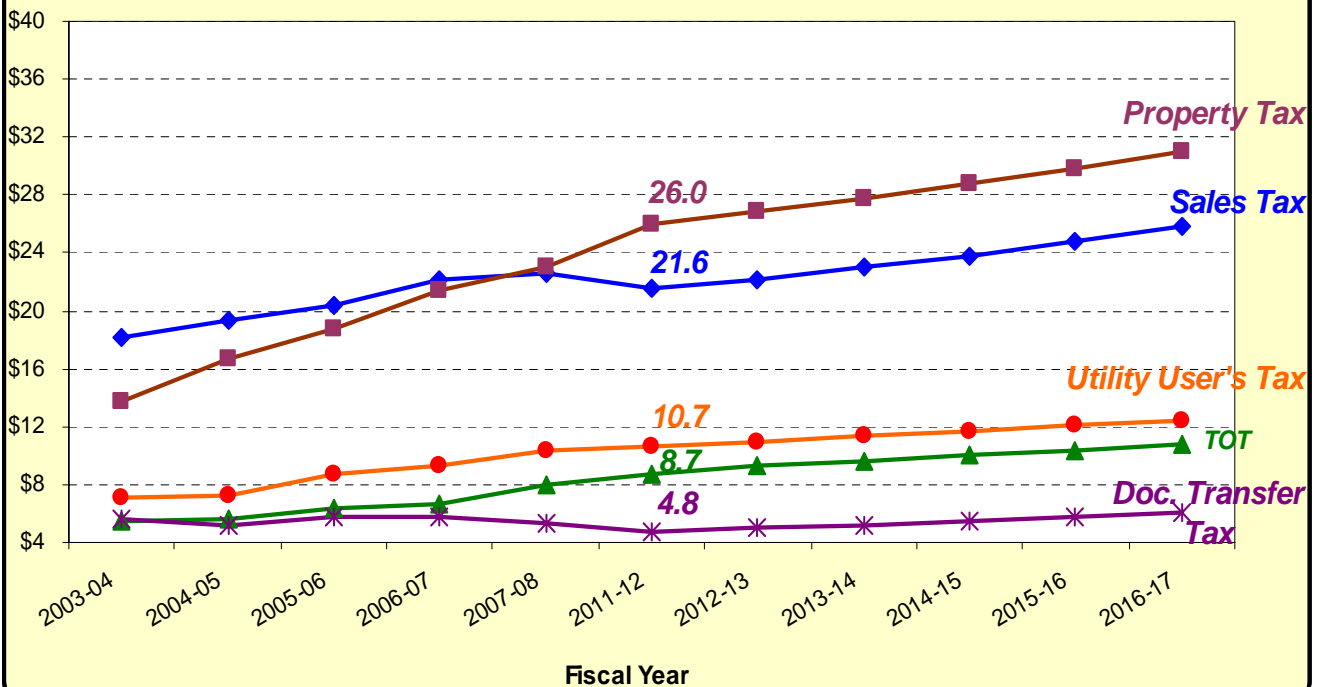
The UUT is levied on electric, gas, and water consumption, as well as on telephone usage. FY 2012 UUT revenues are expected to be 1.7 percent below FY 2011 revenues, or \$10.7 million. The utility-generated portion of the FY 2012 UUT comes in 1.3 percent higher than those in FY 2011, while the telephone-generated portion comes in 9.5 percent lower. Telephone-generated UUT revenues are projected to decrease at an average rate of 3.4 percent per year for the length of the Forecast, due to carriers' unbundling of services, leaving a lower taxable portion of users' telephone bills.

Note that the Utility-generated portion of projected UUT revenues assumes the rate change assumptions shown in the table on page 10, utilizing Utility Department-generated 5-year revenue projections. The remaining years' increases for Gas and Electric are based on the CAGR for the first 5 years. For the Water utility, given the steep expected increases in water rates over the next couple years, staff modified the CAGR downward for out years.

Top 5 General Fund Tax Revenue Sources: Property Tax, Sales Tax, UUT, TOT, Doc. Transfer Tax



General Fund Major Revenues (in millions)



UTILITY RATE INCREASE ASSUMPTIONS IN UUT PROJECTIONS

FISCAL YEAR	12-13	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22
Electric	0%	0%	4%	6%	5%	4%	4%	4%	4%	4%
Water	15%	15%	9%	3%	2%	4.3%	4.3%	4.3%	4.3%	4.3%
Gas	-10%	4%	5%	4%	4%	0.8%	0.8%	0.8%	0.8%	0.8%

Documentary Transfer Tax

FY 2012 revenues are projected at \$4.8 million — 7.7 percent below FY 2011 revenues. This revenue source is challenging to forecast accurately, since it is highly dependent on sales volume and the mix of commercial and residential sales. For example, in FY 2011, 17 large transactions—just 2 percent of all transactions—accounted for two-thirds of the \$1.5 million year-over-year increase. The forecast for FY 2012 and beyond is based on recent revenue trends and the real estate market outlook. In FY 2013, the tax is projected at 6.5 percent above 2012 levels—at \$5.1 million. From FY 2014 onwards, rates of increase are in the 5 percent range.

Other Taxes & Fines

Close to 76 percent of this category is comprised of Parking Violation revenue. It is assumed that continued gaps in staffing levels, due to disability and workers' comp leave, will make it difficult to bring Parking Violation revenue back to 2008 levels. Experience over the past five fiscal years has shown this to be a volatile revenue stream with year-to-year changes ranging from an 8 percent increase in FY 2007 to a 17 percent decrease in FY 2010. Another portion of this category is the Vehicle-in-Lieu Fee (VLF), which is projected to be \$0.2 million lower than the Adopted Budget. As part of FY 2012 state budget adoption, Senate Bill 89 eliminated the allocation of VLF to cities and counties. According to the League of California Cities, Cities should expect zero VLF revenue in subsequent years unless there is a change in the law. Therefore, staff is projecting no VLF receipts in this forecast. In the remaining categories, a 1 percent annual increase is assumed.

Charges for Services

Major changes in Charges for Services are anticipated from the projected increase in activity at the Development Center in FY 2012 and 2013, as well as from the possible contracting out of Animal Services. For FY 2012 and 2013, the combined increase in Development Center revenue is projected at \$1.4 million or 6.2 percent. However, this is offset in FY 2013 by an assumed decrease in Animal Services fee revenue of \$0.7 million. The City is currently undertaking a Cost of Services study which may have an impact on this revenue category starting in FY 2013.

Permits and Licenses

The City's Chief Building Official anticipates a \$0.6 million or 11 percent increase in revenue for FY 2012 as compared to the Adopted Budget, followed by five years of lower revenues, before resuming annual increases in FY 2018. The FY 2012 projection represents a \$1.4 million or 28 percent increase over FY 2011 revenues; the longer-term forecast reflects the periodic ebbs and flows in this revenue source. The Cost of Services study may also impact this category as early as FY 2013.

Return on Investment

Since the recession began in FY 2009, interest income has fallen roughly by half. In FY 2009, revenues were \$2.0 million; in FY 2012 they are projected at \$0.97 million. As higher yielding maturing investments continue to be re-invested in a historically low interest rate environment, interest income levels are expected to decline further. Starting in FY 2015, interest income is projected to increase each year by between 1.3 percent and 2.2 percent.

Rental Income

The largest components of rental income are the City's Enterprise Funds and the Cubberley Community Center. The rent from the Enterprise Funds will decline by \$2.5 million — 16.5 percent of the overall category — in FY 2013 with the closure of the landfill, the Middlefield Well Site, and the former Los Altos Treatment Plant (LATP) site. Starting in FY 2014, staff projects that rent increases in other City properties will more than make up for the loss of the LATP and Well site. For this forecast period, rental income is expected to increase at approximately the same rate as the Consumer Price Index, which drives Enterprise Fund rental fees.

The City is conducting an assessment of all General Fund properties which might impact the rental income from Enterprise Funds starting in FY 2014.

From Other Agencies

Revenue from Other Agencies includes income from Community Services Outreach theatre programs, PAUSD programs, State of California grants for Police, Libraries and Community Services, and donations from Friends groups. Many of these are unpredictable and are influenced by the economy. For example, State grants are reduced when the State of California experiences budget difficulties. Due to this category's unpredictable nature, the Forecast assumes a zero growth rate from FY 2014 onwards.

Charges to Other Funds

Seventy-eight percent of this category comprises General Fund administrative cost plan allocation charges. The FY 2012 projected amount is equal to the Budgeted amount of \$10.5 million, rising by 3.5 percent or \$0.37 million in FY 2013. From FY 2014 onward, forecasted increases range from 0.74 percent to 1.6 percent.

Other Revenues

In FY 2012, Other Revenues are projected to be \$0.7 million higher than the Adopted Budget as a result of a \$0.5 million one-time donation from the Palo Alto Library Foundation to support library programs; \$0.13 million in donations to fund Community Services Department programs; and \$0.06 million in reimbursements from various agencies to public safety departments. In FY 2013 onwards, the Forecast assumes that the City will contract out its Animal Services program with a revenue loss in this category (from partner agencies only) of \$0.6 million. An annual increase of under-one-percent is assumed from FY 2013 onwards.

Operating Transfers In

Operating Transfers In include the equity transfer from the Electric and Gas Funds, as well as transfers from the University Avenue Parking Permit Fund and the California Avenue Parking Permit Fund. The FY 2013-2016 equity transfers are based on Utilities Five-Year Projections of capital-based returns, increasing roughly 3 percent per year.

EXPENSES

Salary and Benefits

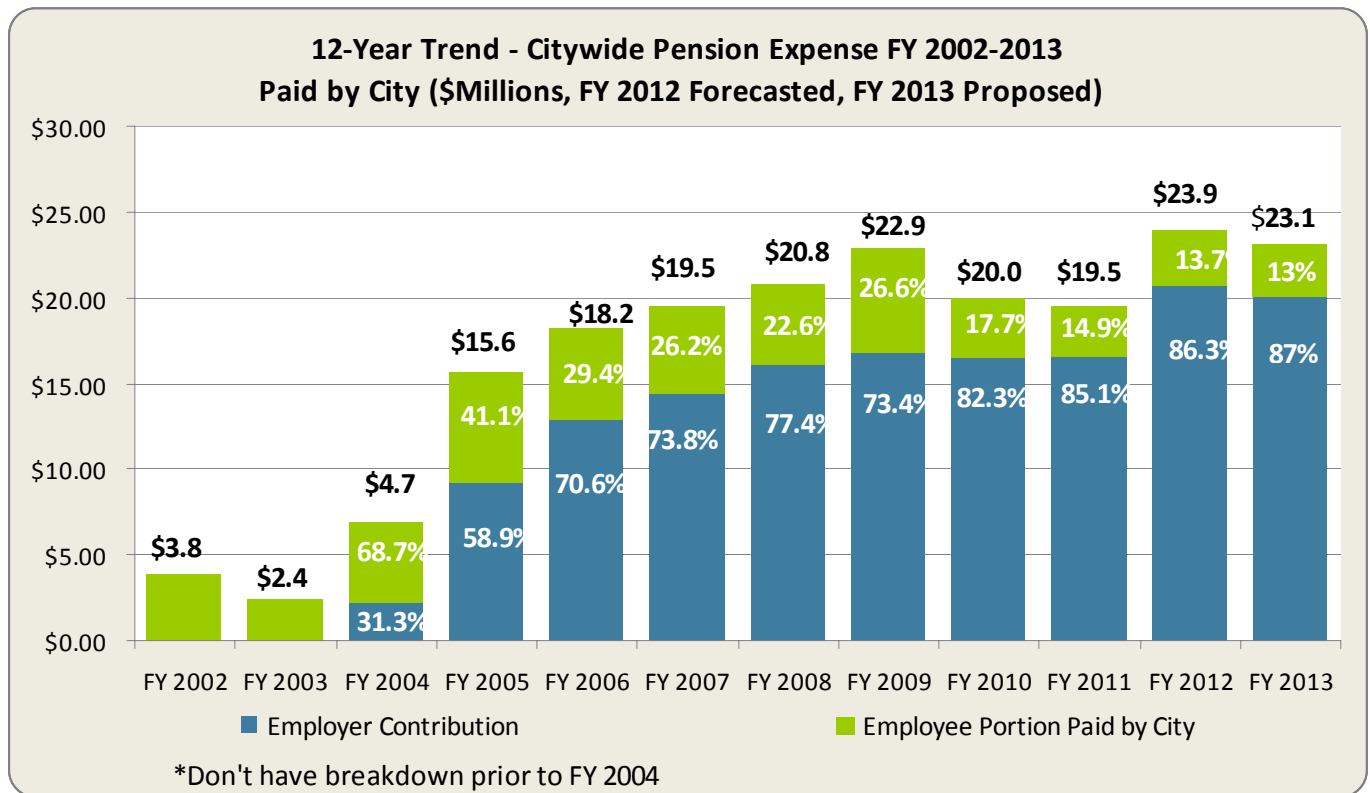
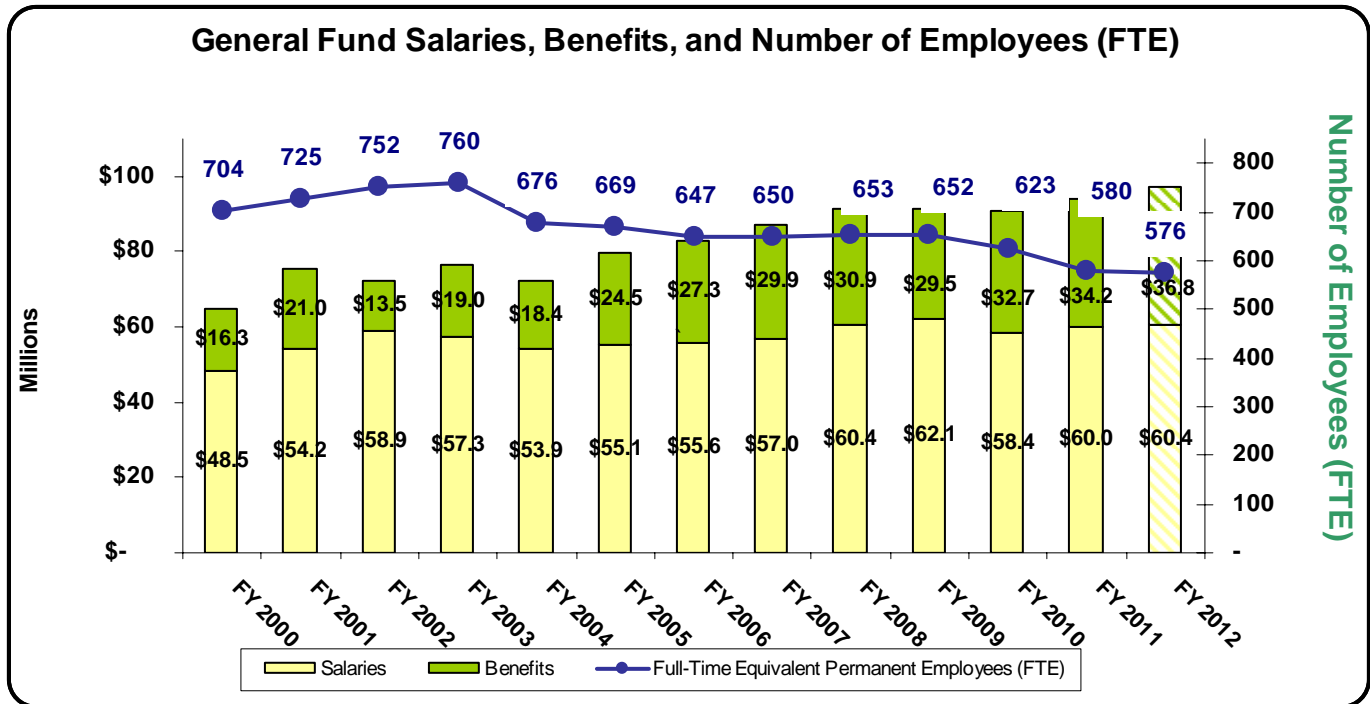
Salary

- All bargaining units are assumed to have 4 years of salary freezes followed by 2 percent annual increases. While it is difficult to contemplate salary increases in years in which budget gaps are forecasted, such increases are included for forecasting purposes.
- SEIU and Management (Miscellaneous) groups are assumed to receive 2 percent salary increases every year starting FY 2014. Note that the Miscellaneous group's last cost-of-living increase was July 1, 2008.
- Fire unit receives 0 percent increases in 2013 and 2014, and 2 percent annual increases start 2015, pending the absence of a budget gap, as per the contract approved October 2011.
- Police unit receives 0 percent increases until 2016 when it commences 2 percent annual increases.
- The Library Department has estimated \$0.45 million in salary and benefit savings for 2013 and 2014 while the Main and Mitchell Park libraries are under construction. Starting in 2015, though, the Library Department estimates \$0.3 million in additional salary costs for the two newly remodeled libraries. **See End-notes Number 19 (page 28) for breakout of new library costs and savings incorporated into the model.**

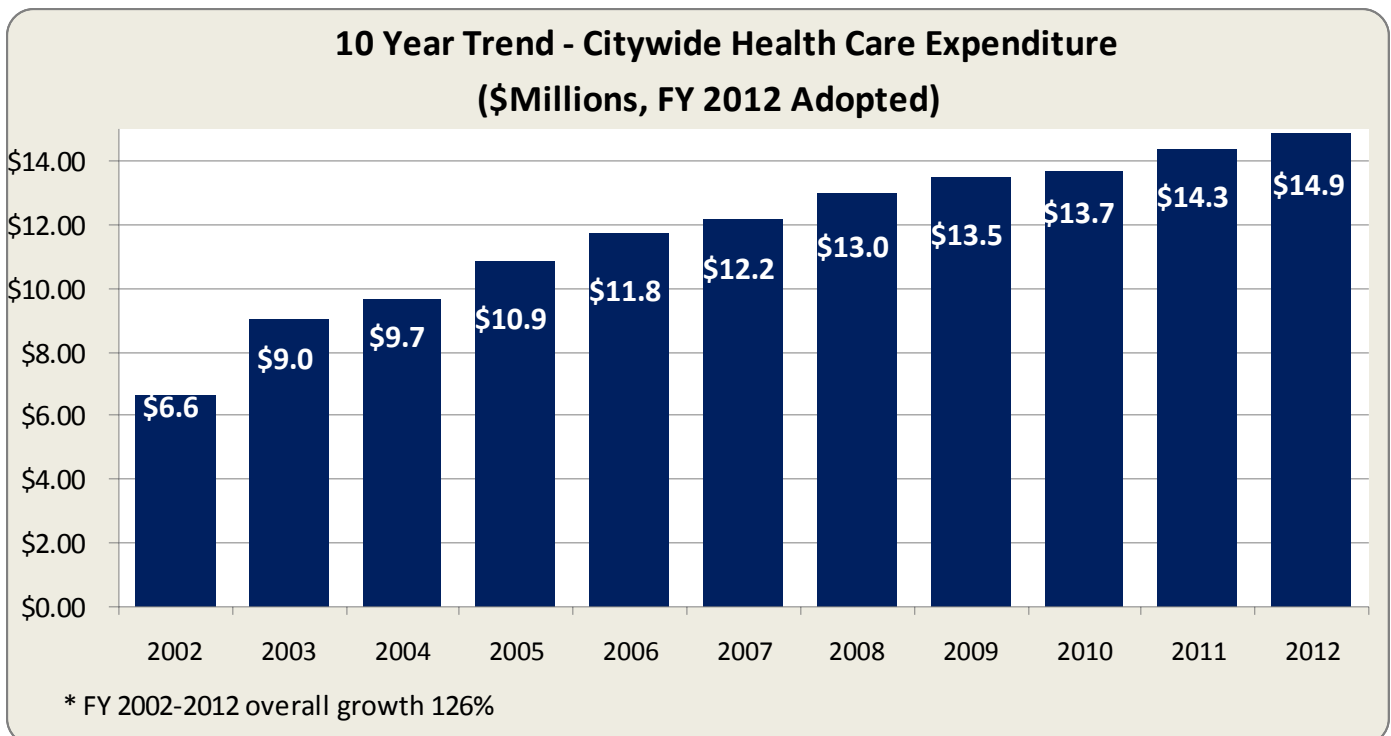
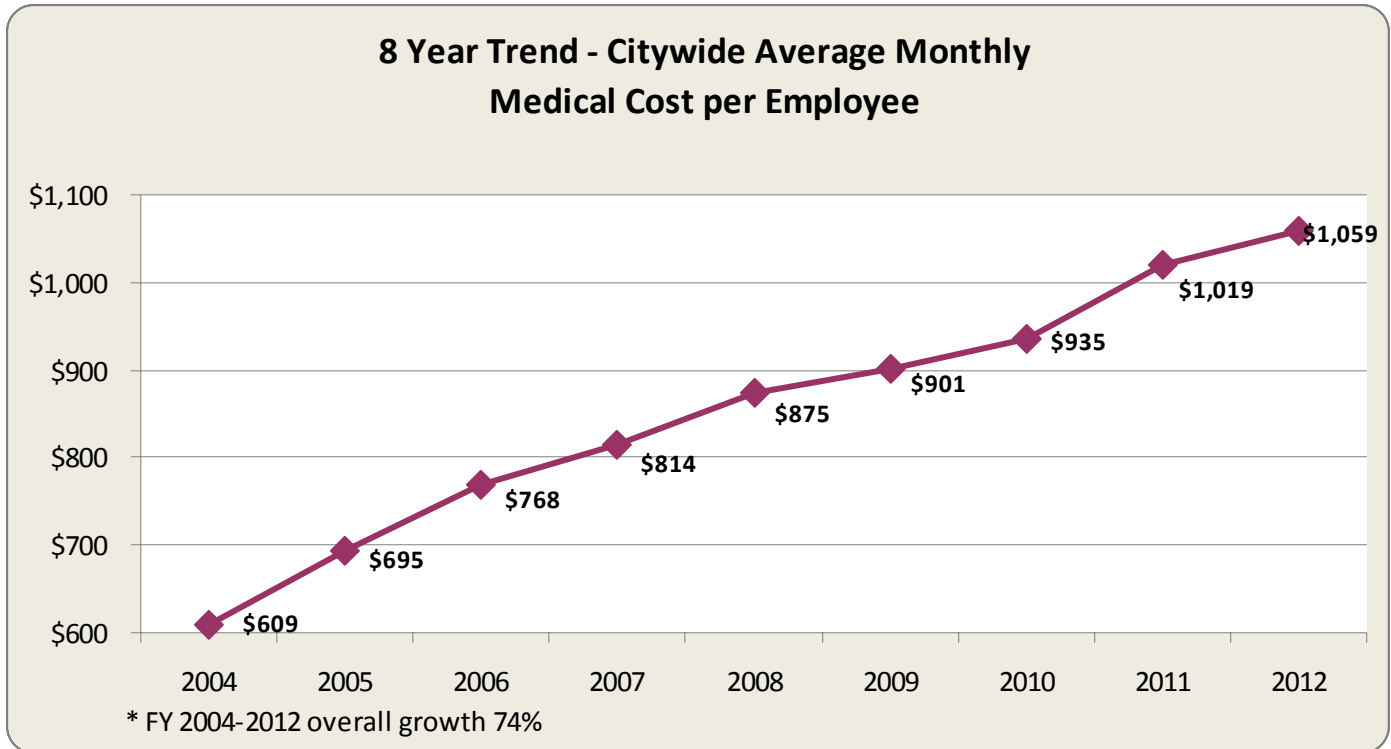
Benefits

- Forecast includes PERS's estimated rates for FY 2013, 2014, and 2015 (as of their October 2011 actuarial report) - as revised by their March 2012 decision to lower the assumed discount rate from 7.75% to 7.5%. **See PERS Rates Detail chart on page 15 outlining historic and projected PERS rates.**
- The rates are assumed to increase 3 percent per year after FY 2015, as per Council direction in March 2011. If a more moderate annual increase of 1.5 percent were assumed after FY 2015, \$25.7 million in savings would result for FY 2016-2022.
- For Two-Tier savings, Forecast based estimates on Bartel & Associates analysis of September 26, 2011, but delayed savings by two years from implementation of each relevant agreement, since CalPERS bases its pension calculations on information from two years prior.
- Forecast assumes 10 percent annual increases in medical costs as per previous Council direction
- Forecast assumes 4 percent annual increases in Dental and Vision costs
- FY 2012 medical calculation includes \$86,000 in savings from partial year of cost-sharing by the International Association of Firefighters (IAFF).
- FY 2013 medical calculation includes full year of cost-sharing by IAFF, the Palo Alto Police Officers Association (PAPOA) and the Fire Chiefs Association (FCA).
- For FCA and PAPOA concessions, model includes combined savings of \$1.6 million for FY 2013 and about \$17.6 million over the remaining nine years of the Forecast
- Retiree Annual Required Contributions (ARC) are based on the January 1, 2011 actuarial study for FY 2012, 2013, and 2014, as amended by the Council direction of April 16, 2012. The model also assumes 3.25 percent annual increases in ARC, as assumed in the January actuarial valuation study.

The following chart illustrates the increasing salary and benefit costs that the City has experienced in the General Fund, despite reduced headcount.



The following two charts illustrate the trend in health care cost.



The following chart shows historical employer PERS rates for FY 2007 through 2012, and the projected rates used in this Forecast for FY 2013 to 2022.

PERS RATES DETAIL CHART									
	FY 2007	2008	2009	2010	2011	2012	2013	2014	2015
Miscellaneous	11.4%	17.4%	17.0%	17.1%	17.6%	21.7%	23.0%	24.1%	25.2%
Safety	24.2%	23.6%	24.5%	23.9%	24.7%	30.1%	31.1%	32.8%	34.5%

Notes:
 1. FY 2013, 2014, and 2015 rates are based on PERS actuarial valuations for Miscellaneous and Safety groups received October 2011.
 2. For FY 2014 and 2015, base rates are revised upwards over two years by 1.5% for Miscellaneous and 2.5% for Safety due to PERS Board's change to 7.5% discount rate assumption.

Non-Salary/Benefit Expense

Contract Services

FY 2012 Projected Contract Services include \$0.3 million in one-time contracts. The FY 2013 figure includes \$0.11 million in additional costs for the Mitchell Park and Main Library remodeling projects. Additional costs of \$0.23 million are assumed in FY 2014, and from 2015 onwards, an additional \$0.28 million per year for the two remodeled libraries. This expense shows 1.5 percent annual growth from FY 2015 onwards.

The Attorney's Office, Human Resources and Community Services have discussed the possible need to convert many outside contractors, particularly class instructors, to hourly personnel. Were this to happen, contract services expense would decrease and Salaries and Benefits expense would increase. Some of these converted workers would become SEIU hourly workers, requiring benefit expense in addition to salary.

Supplies & Materials

FY 2012 projected Supplies and Materials costs are about \$0.6 million higher than the Adopted Budget, due mainly to a one-time donation from the Palo Alto Library Foundation for collection materials for the new Mitchell Park Library. Aside from that one-time gift, Supplies & Materials costs are expected to remain relatively constant in outer years, with a 1 percent yearly increase. The FY 2013 amount is \$0.1 million lower than the FY 2012 Adopted Budget, despite \$13,000 in additional needs for the Mitchell Park and Main Library projects and \$20,000 increase in Community Services Department related to Project Safety Net. The net decrease is due primarily to the proposed elimination of Animal Services program.

General Expense

The majority of General Expense comprises the lease payments to PAUSD for the Cubberley facility. For FY 2012 that payment is \$7.1 million or 65 percent of the \$10.9 million total for the category. The current lease contract calls for the City to make a decision on the next 5-year option by December 2013. The Forecast assumes that the lease contract with PAUSD will continue beyond 2014. For FY 2012, actuals are projected at \$31,000 above FY 2012 Adopted Budget, due to the expense of an additional ballot measure in November 2011. In FY 2013 and 2014, staff projects small (less than 1 percent) increases, and from FY 2015 onwards, annual increases of 3.3 percent are assumed.

Rents and Leases

FY 2012 and FY 2013 show increases of \$174,000 and \$106,000 above Adopted FY 2012 Budget due to Development Center space needs. After FY 2013, Rents and Leases expense growth is expected to be fairly steady at a 3.5 percent annual rate.

Facilities & Equipment

The FY 2012 projected amount is \$162,000 higher than budgeted, due to one-time increases in Development Center expenses. In FY 2013, an additional \$30,000 is expected for library remodeling-related expenses; from 2014 onwards that number increases to \$86,000. In addition to the one-time increases, there is an ongoing annual increase in the 4 percent range for this category.

Allocated Charges

Allocated charges vary significantly from year to year, since they include a variety of sources, such as City use of utilities, liability insurance, technology costs, and vehicle replacement costs. Technology costs are increasing in FY 2012 and FY 2013 due to the Development Center Blueprint Process. These include one-time charges of \$1.7 million for technology enhancements over two years, ending in FY 2013. In addition, the remodeled Mitchell Park and Main libraries are expected to add about \$0.1 million in Allocated Charges from 2014 forward. Lastly, the General Fund has been repaying the Technology Fund its \$4.8 million loan at about \$1.2 million per year over four years. FY 2013 will be the last year of the loan repayment. Beyond 2014, the Forecast assumes a 2 percent annual growth rate.

Operating Transfers Out

Operating Transfers Out includes transfers to Debt Service and Capital Project (Infrastructure) Funds, which change along with any new debt issuances or changed funding levels. Debt Service Fund transfers are based on payment schedules for the 2002 B Downtown Parking Improvement Project Certificates of Participation (COP) and the 2011 Golf Course debt. The Golf Course debt will be paid down by 2018.

For FY 2013-2016, transfers to the Capital Project Fund are based on the FY 2012-2016 Five-Year Capital Plan. Beyond FY 2016, transfers to the Capital Project Fund are based on a fairly complex formula, described below:

1. The “annual base transfer” of \$3.6 million and a “dedicated year-end surplus” of \$1.0 million remain constant.
2. The transfer for specific projects receiving General Fund reimbursements varies year-by-year with the 5-year CIP Budgets. The FY 2012-2016 CIP Budget’s average annual rate of increase is 2.7 percent, so this is used as the assumed increase in each of the years from FY 2017-2022.
3. \$5.9 million is increased by 7 percent per year, as a result of Council’s “\$3 million challenge” begun in 2007, whereby they committed to spend an additional \$3 million on infrastructure, growing by 7 percent per year.

Beginning FY 2013, the base model adds an additional \$2.2 million per year in infrastructure investment, as per Finance Committee direction. This is meant to fund remaining “keep-up” needs defined by the Infrastructure Blue Ribbon Commission (IBRC) Report, but does not address either the “catch-up” needs or new construction needs discussed in the IBRC report.

Combined additional costs in FY 2013 and 2014 due to the Mitchell Park and Main Library remodeling projects are projected to be 100% offset by salary and benefit savings due to library closures during construction. However, from FY 2015 onwards, about \$1.0 million in additional costs is expected.

FACTORS NOT INCLUDED IN THE BASE MODEL

The following factors are not incorporated into the base model assumptions:

- Impacts from possible conversion of selected contractors to hourly personnel
- IBRC recommendations regarding \$42 million in “catch-up” needs, as well as new construction needs, such as for the MSC and public safety building
- Any additional employee cost-sharing needed to close budget gaps
- Possible TOT revenues from hotels, such as the Hilton Garden and Palo Alto Bowl, that have not yet begun construction

BASE MODEL

The Base Model may be found on the following pages (18-21). The first table shows General Fund revenue and expense projections for FY 2012-2022. The second table shows year-over-year percentage changes in each category. The Base Model shows a balanced budget in FY 2012 after a \$2.3 million draw on the BSR. In FY 2013 it shows a deficit of \$1.0 million, and for the ten-year period from FY 2013 through FY 2022, cumulative deficits are projected at \$88.2 million.

2012 UPDATED MODEL

2012-2022 LRFF - BASE MODEL

	FY 2012 Adopted	FY 2012 Projected	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
Revenues												
Sales Taxes	\$ 20,246	\$ 21,594	\$ 22,545	\$ 23,361	\$ 24,218	\$ 25,199	\$ 26,248	\$ 27,350	\$ 28,529	\$ 29,793	\$ 31,142	\$ 32,634
Property Taxes	26,052	25,989	27,006	27,949	28,938	30,006	31,161	32,435	33,827	35,325	36,933	38,624
Transient Occupancy Tax	8,204	8,674	9,591	9,909	10,299	10,711	11,150	11,615	12,105	12,626	13,171	13,782
Utility User Tax	10,859	10,666	10,731	11,099	11,473	11,855	12,176	12,459	12,745	13,034	13,319	13,601
Documentary Transfer Tax	4,269	4,769	5,078	5,330	5,600	5,886	6,188	6,508	6,850	7,213	7,599	8,014
Other Taxes & Fines	2,330	2,156	2,037	2,057	2,078	2,099	2,120	2,141	2,162	2,184	2,206	2,228
Subtotal: Taxes	71,960	73,848	76,988	79,705	82,606	85,755	89,042	92,508	96,219	100,174	104,369	108,883
Charges for Services	21,841	22,702	23,197	23,406	24,225	25,073	25,950	26,859	27,799	28,772	29,779	30,821
Permits and Licenses	5,778	6,406	6,495	6,244	6,003	5,762	5,532	5,302	5,567	5,845	6,138	6,444
Return on Investment	1,318	974	959	957	969	986	1,005	1,028	1,049	1,070	1,093	1,117
Rental Income	13,914	13,914	12,651	12,988	13,298	13,617	13,947	14,286	14,634	14,993	14,047	13,469
From other agencies	155	155	157	157	157	157	157	157	157	157	157	157
Charges to Other Funds	10,505	10,505	10,874	10,954	11,036	11,118	11,203	11,288	11,375	11,502	11,686	11,873
Other revenues	1,428	2,093	662	665	667	670	673	675	678	681	683	686
Total Revenues Before Transfers	126,899	130,597	131,983	135,075	138,960	143,139	147,509	152,103	157,478	163,194	167,952	173,451
Operating Transfers-In	19,606	19,606	18,995	19,812	19,869	20,626	21,218	21,827	22,454	23,100	23,766	24,450
TOTAL REVENUES	146,505	150,203	150,978	154,887	158,830	163,765	168,727	173,930	179,931	186,294	191,718	197,901
Expenditures												
Salaries	57,422	60,389	56,957	59,719	61,509	62,752	64,019	65,312	66,632	67,978	69,351	70,752
Benefits	34,648	36,138	36,022	39,297	41,808	45,211	48,815	52,573	56,543	60,738	65,178	69,878
Subtotal: Salaries and Benefits	92,070	96,527	92,979	99,016	103,317	107,963	112,834	117,886	123,175	128,716	134,529	140,629
Contract Services	11,297	11,607	11,641	11,726	11,952	12,182	12,365	12,551	12,739	12,930	13,124	13,321
Supplies & Materials	3,206	3,761	3,104	3,158	3,381	3,412	3,444	3,476	3,508	3,541	3,574	3,608
General Expense	10,897	10,928	11,006	11,368	11,742	12,130	12,531	12,946	13,376	13,820	14,276	14,753
Rentals & Leases	831	1,005	1,111	1,150	1,190	1,232	1,275	1,320	1,366	1,414	1,463	1,514
Facilities & Equipment	460	622	517	600	625	651	678	707	737	769	802	837
Allocated Charges	15,762	16,450	16,860	17,416	17,763	18,138	18,499	18,867	19,242	19,625	20,016	20,414
Total Expenditures Before Transfers	134,523	140,901	137,218	144,434	149,970	155,708	161,626	167,752	174,142	180,814	187,784	195,076

Transfers to Other Funds																							
Operating Transfers Out	859	2,109	1,605	660	666	664	666	666	668	668	235	233	-										
Transfer to Infrastructure	10,978	10,978	13,178	13,534	13,988	14,488	15,018	15,583	16,186	16,828	17,513	18,244											
TOTAL EXPENDITURES	146,360	153,988	152,000	158,628	164,623	170,860	177,310	184,000	190,997	197,878	205,530	213,320											
Net Surplus/(Gap)	145	(3,785)	(1,022)	(3,741)	(5,794)	(7,095)	(8,583)	(10,070)	(11,065)	(11,584)	(13,812)	(15,419)											
BAOs Approved by Council:																							
Add'l legal counsel		185																					
Loan to Refuse Fund		1,250																					
Development Center Blue Print Plan		4																					
Midyear Decision Points		(451)																					
Salary/FTE related - ongoing		485																					
Revenue/Non-Salary related		2,312																					
Proposed Midyear BSR Draw																							
Subtotal	-	3,785	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
GRAND NET SURPLUS (GAP)	\$ 145	\$ (0)	\$ (1,022)	\$ (3,741)	\$ (5,794)	\$ (7,095)	\$ (8,583)	\$ (10,070)	\$ (11,065)	\$ (11,584)	\$ (13,812)	\$ (15,419)											

2012 UPDATED MODEL

PERCENTAGE CHANGES IN BASE MODEL

	FY 2012 Projected	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	Cumulative % Change 2012-2022
Revenues												
Sales Taxes	4.09%	4.40%	3.62%	3.67%	4.05%	4.16%	4.20%	4.31%	4.43%	4.53%	4.79%	
Property Taxes	1.17%	3.91%	3.49%	3.54%	3.69%	3.85%	4.09%	4.29%	4.43%	4.55%	4.58%	
Transient Occupancy Tax	7.32%	10.57%	3.32%	3.93%	4.00%	4.10%	4.17%	4.22%	4.30%	4.32%	4.64%	
Utility User Tax	(1.70%)	0.61%	3.43%	3.37%	3.33%	2.71%	2.32%	2.30%	2.26%	2.19%	2.12%	
Documentary Transfer Tax	(7.70%)	6.48%	4.96%	5.06%	5.11%	5.13%	5.18%	5.26%	5.29%	5.35%	5.46%	
Other Taxes & Fines	1.27%	-5.52%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	
Subtotal: Taxes	1.63%	4.25%	3.53%	3.64%	3.81%	3.83%	3.89%	4.01%	4.11%	4.19%	4.32%	47.44%
Charges for Services	1.40%	2.18%	0.90%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	
Permits and Licenses	28.19%	1.40%	-3.87%	-3.86%	-4.01%	-3.99%	-4.16%	5.00%	5.00%	5.00%	5.00%	
Return on Investment	82.33%	-1.50%	-0.24%	1.31%	1.76%	1.91%	2.31%	2.01%	2.04%	2.11%	2.19%	
Rental Income	(2.76%)	-9.08%	2.66%	2.39%	2.40%	2.42%	2.43%	2.44%	2.45%	-6.31%	-4.11%	
From other agencies	(47.46%)	1.29%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	
Charges to Other Funds	(6.80%)	3.51%	0.74%	0.74%	0.75%	0.76%	0.76%	0.77%	1.12%	1.60%	1.60%	
Other revenues	12.95%	-68.37%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	
Total Revenues Before Transfers	1.78%	1.06%	2.34%	2.88%	3.01%	3.05%	3.11%	3.53%	3.63%	2.92%	3.27%	32.81%
Operating Transfers-In	9.33%	-3.12%	4.30%	0.29%	3.81%	2.87%	2.87%	2.87%	2.88%	2.88%	2.88%	
TOTAL REVENUES	2.71%	0.52%	2.59%	2.55%	3.11%	3.03%	3.08%	3.45%	3.54%	2.91%	3.23%	31.76%
Expenditures												
Salaries	0.73%	-5.68%	4.85%	3.00%	2.02%	2.02%	2.02%	2.02%	2.02%	2.02%	2.02%	17.16%
Benefits	5.54%	-0.32%	9.09%	6.39%	8.14%	7.97%	7.70%	7.55%	7.42%	7.31%	7.21%	
Subtotal: Salaries and Benefits	2.48%	-3.68%	6.49%	4.34%	4.50%	4.51%	4.48%	4.49%	4.50%	4.52%	4.53%	45.69%
Contract Services	24.31%	0.29%	0.73%	1.93%	1.93%	1.50%	1.50%	1.50%	1.50%	1.50%	1.50%	
Supplies & Materials	32.30%	-17.48%	1.73%	7.06%	0.93%	0.93%	0.93%	0.93%	0.94%	0.94%	0.94%	
General Expense	17.20%	0.71%	3.29%	3.29%	3.30%	3.31%	3.31%	3.32%	3.32%	3.30%	3.34%	
Rents & Leases	57.29%	10.54%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	
Facilities & Equipment	112.92%	-16.85%	15.99%	4.16%	4.19%	4.22%	4.24%	4.27%	4.30%	4.32%	4.35%	
Allocated Charges	4.70%	2.49%	3.30%	1.99%	2.11%	1.99%	1.99%	1.99%	1.99%	1.99%	1.99%	
Total Expenditures Before Transfers	6.47%	-2.61%	5.26%	3.83%	3.83%	3.80%	3.79%	3.81%	3.83%	3.85%	3.88%	38.45%

Operating Transfers Out	84.51%	-23.90%	-58.85%	0.87%	-0.27%	0.24%	-0.04%	0.43%	-64.80%	-1.14%	-100.00%
Transfer to Infrastructure	11.37%	20.04%	2.70%	3.35%	3.58%	3.66%	3.76%	3.87%	3.97%	4.07%	4.17%
TOTAL EXPENDITURES	7.43%	-1.29%	4.36%	3.78%	3.79%	3.78%	3.77%	3.80%	3.60%	3.87%	3.79%
Net Surplus/(Gap)	(230.21%)	-73.00%	266.02%	54.88%	22.45%	20.98%	17.33%	9.88%	4.68%	19.24%	11.63%

2012 ALTERNATE SCENARIO

IV. ALTERNATE SCENARIO

The following scenario assumes that positions frozen in FY 2013 are permanently cut. This reduces the cumulative deficits from \$88.2 million to \$58.7 million—a reduction of \$29.5 million, or 33 percent.

2012-2022 LRFF - SCENARIO "MAKE FROZEN POSITIONS PERMANENT CUTS"												
	FY 2012 Adopted	FY 2012 Projected	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
TOTAL REVENUES	146,505	150,203	150,978	154,887	158,830	163,765	168,727	173,930	179,931	186,294	191,718	197,901
Expenditures												
Salaries	57,422	60,389	56,957	58,039	59,789	60,997	62,229	63,486	64,768	66,077	67,411	68,773
Benefits	34,648	36,138	36,022	38,230	40,676	43,987	47,493	51,150	55,011	59,093	63,413	67,985
Subtotal: Salaries and Benefits	92,070	96,527	92,979	96,269	100,465	104,984	109,722	114,635	119,780	125,170	130,824	136,758
Contract Services	11,297	11,607	11,641	11,726	11,952	12,182	12,365	12,551	12,739	12,930	13,124	13,321
Supplies & Materials	3,206	3,761	3,104	3,158	3,381	3,412	3,444	3,476	3,508	3,541	3,574	3,608
General Expense	10,897	10,928	11,006	11,368	11,742	12,130	12,531	12,946	13,376	13,820	14,276	14,753
Rents & Leases	831	1,005	1,111	1,150	1,190	1,232	1,275	1,320	1,366	1,414	1,463	1,514
Facilities & Equipment	460	622	517	600	625	651	678	707	737	769	802	837
Allocated Charges	15,762	16,450	16,860	17,416	17,763	18,138	18,499	18,867	19,242	19,625	20,016	20,414
Total Expenditures Before Transfers	134,523	140,901	137,218	141,687	147,117	152,728	158,514	164,501	170,748	177,268	184,079	191,205
Transfers to Other Funds												
Operating Transfers Out	859	2,109	1,605	660	666	664	666	666	668	235	233	-
Transfer to Infrastructure	10,978	10,978	13,178	13,534	13,988	14,488	15,018	15,583	16,186	16,828	17,513	18,244
TOTAL EXPENDITURES	146,360	153,988	152,000	155,881	161,771	167,880	174,197	180,750	187,602	194,332	201,825	209,449
Net Surplus/(Gap)	145	(3,785)	(1,022)	(994)	(2,941)	(4,115)	(5,470)	(6,820)	(7,670)	(8,038)	(10,108)	(11,548)
Subtotal Midyear items	-	3,785	-	-	-	-	-	-	-	-	-	-
GRAND NET SURPLUS (GAP)	\$ 145	\$ (0)	\$ (1,022)	\$ (994)	\$ (2,941)	\$ (4,115)	\$ (5,470)	\$ (6,820)	\$ (7,670)	\$ (8,038)	\$ (10,108)	\$ (11,548)

2012 ALTERNATE SCENARIO

PERCENTAGE CHANGES IN SCENARIO "MAKE FROZEN POSITIONS PERMANENT CUTS"

	FY 2012 Projected	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	Cumulative % Change 2012-2022
TOTAL REVENUES	2.71%	0.52%	2.59%	2.55%	3.11%	3.03%	3.08%	3.45%	3.54%	2.91%	3.23%	31.76%
Expenditures												
Salaries	0.73%	-5.68%	1.90%	3.01%	2.02%	2.02%	2.02%	2.02%	2.02%	2.02%	2.02%	13.88%
Benefits	5.54%	-0.32%	6.13%	6.40%	8.14%	7.97%	7.70%	7.55%	7.42%	7.31%	7.21%	
Subtotal: Salaries and Benefits	2.48%	-3.68%	3.54%	4.36%	4.50%	4.51%	4.48%	4.49%	4.50%	4.52%	4.54%	41.68%
Contract Services	24.31%	0.29%	0.73%	1.93%	1.93%	1.50%	1.50%	1.50%	1.50%	1.50%	1.50%	
Supplies & Materials	32.30%	-17.48%	1.73%	7.06%	0.93%	0.93%	0.93%	0.93%	0.94%	0.94%	0.94%	
General Expense	17.20%	0.71%	3.29%	3.29%	3.30%	3.31%	3.31%	3.32%	3.32%	3.30%	3.34%	
Rents & Leases	57.29%	10.54%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	
Facilities & Equipment	112.92%	-16.85%	15.99%	4.16%	4.19%	4.22%	4.24%	4.27%	4.30%	4.32%	4.35%	
Allocated Charges	4.70%	2.49%	3.30%	1.99%	2.11%	1.99%	1.99%	1.99%	1.99%	1.99%	1.99%	
Total Expenditures Before Transfers	6.47%	-2.61%	3.26%	3.83%	3.81%	3.79%	3.78%	3.80%	3.82%	3.84%	3.87%	35.70%
Operating Transfers Out	84.51%	-23.90%	-58.85%	0.87%	-0.27%	0.24%	-0.04%	0.43%	-64.80%	-1.14%	-100.00%	
Transfer to Infrastructure	11.37%	20.04%	2.70%	3.35%	3.58%	3.66%	3.76%	3.87%	3.97%	4.07%	4.17%	
TOTAL EXPENDITURES	7.43%	-1.29%	2.55%	3.78%	3.78%	3.76%	3.76%	3.79%	3.59%	3.86%	3.78%	36.02%
Net Surplus/(Gap)	(230.21%)	-73.00%	-2.72%	195.83%	39.92%	32.93%	24.67%	12.47%	4.79%	25.76%	14.25%	

V. CHALLENGES & CONCLUSIONS

Thankfully, the City's revenue outlook has improved with the economy. Overall projected FY 2012 revenues are approximately \$3.7 million higher than the FY 2012 Adopted Budget. While these revenue increases are welcome, they bring the City's tax revenues to where they last were in FY 2008. The City will just emerge from the trough of the Recession after four years of decline.

On the flip side, a new actuarial valuation of the City's unfunded retiree medical liability showed an increase of \$30 million – or 29 percent - since the 2009 valuation. After making the three assumption changes approved by the Council on April 16, 2012, this translated to an increase of \$2.0 million in the amount the General Fund needs to set aside in FY 2012 to fund that liability.

In addition, the FY 2012 Adopted Budget assumed that negotiations with the City's public safety units would yield \$3.4 million in savings for this fiscal year. Of that, about \$1 million was realized via the agreement with IAFF, and another \$0.1 million was realized via the agreements with FCA, plus about \$0.2 in savings from the potential agreement with PAPOA, leaving a \$2.1 million gap between budgeted and projected savings. Therefore, the unexpected \$3.7 million in revenues for FY 2012 are "undone" by \$2.0 million in unforeseen expenses plus \$2.1 million in unrealized savings—\$4.1 million total in added costs and unrealized savings.

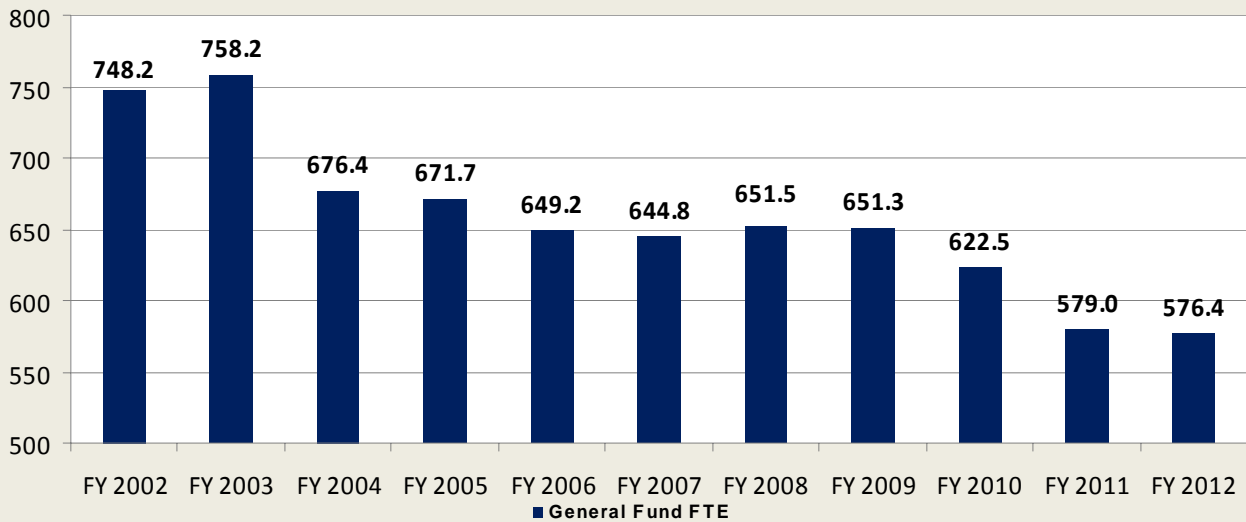
This Long Range Financial Forecast projects 2.8 percent average annual increases in revenues and 3.4 percent average annual increases in expenses. Of that, salary and benefits are expected to increase an average 3.9 percent per year. This gap reflects the City's continued structural deficit, without taking into account the significant increase in infrastructure investment that will be critical to the City's future.

The chart at the top of page 25 (at right), "10 year Trend General Fund FTE," shows the decreases in General Fund staffing since FY 2002.

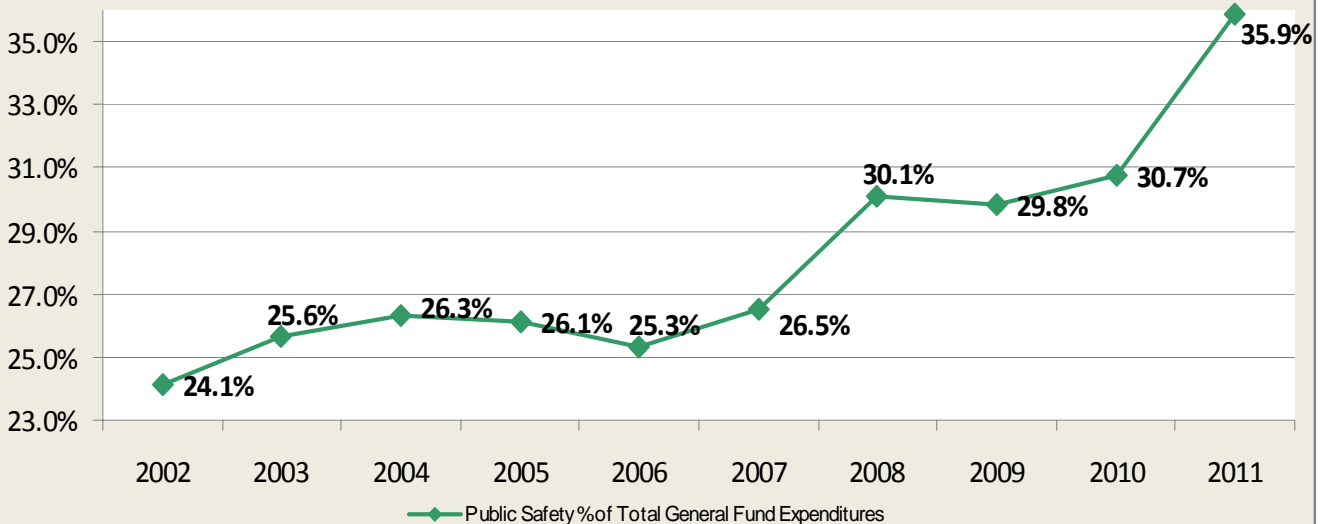
The rate of increase in staffing costs has varied among the City's bargaining units, with public safety costs outpacing those of non-safety groups. In FY 2006, approximately 25 percent of the City's general fund was allocated to public safety services, with the remaining 75 percent shared roughly equally between Public Works, Community Services and Administration. Just five years later, public safety's portion had grown to 36 percent, due to large salary increases for public safety employees and significant concessions made by the Miscellaneous group. The chart at the bottom of page 25 (at right), "Public Safety % of Total General Fund Expenditures" illustrates that trend.

This discrepancy contributed to the City's adoption of a guiding principle of fairness across all bargaining units while negotiating employee concessions.

**10 Year Trend - General Fund Full Time Equivalent (FTE)
(FY 2012 Adopted)**

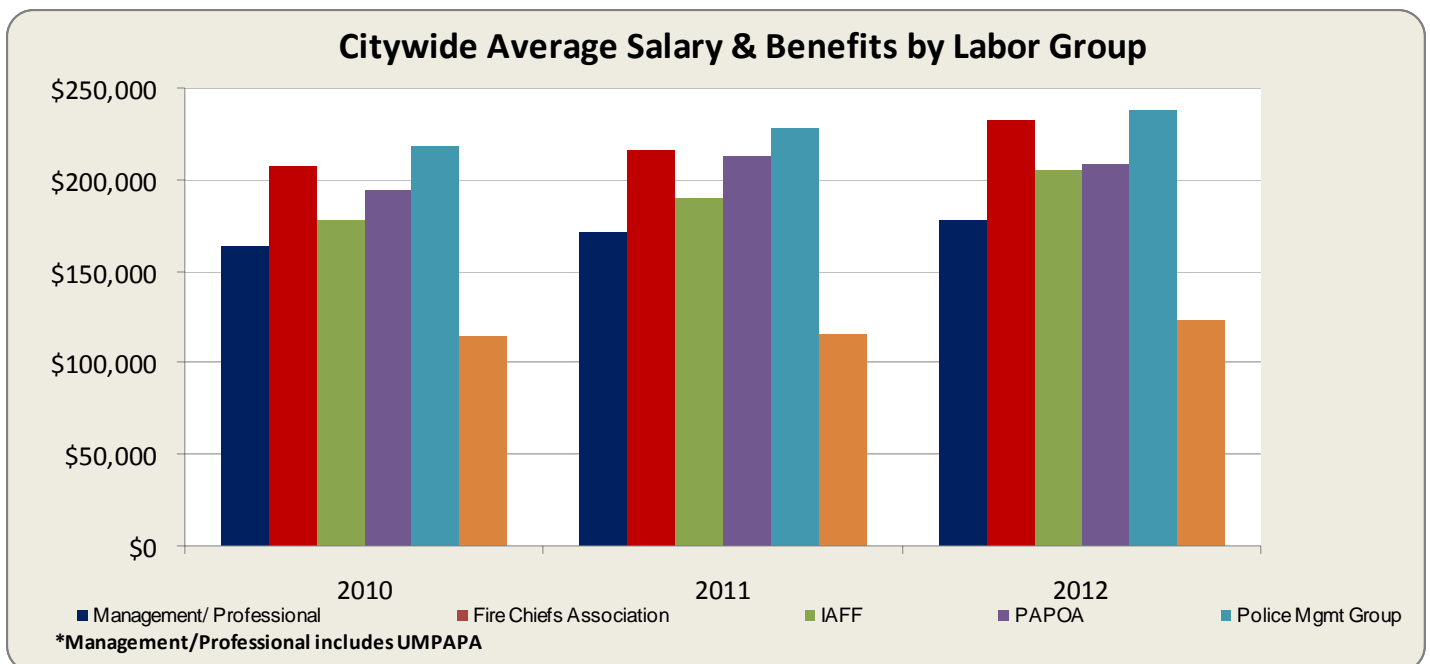
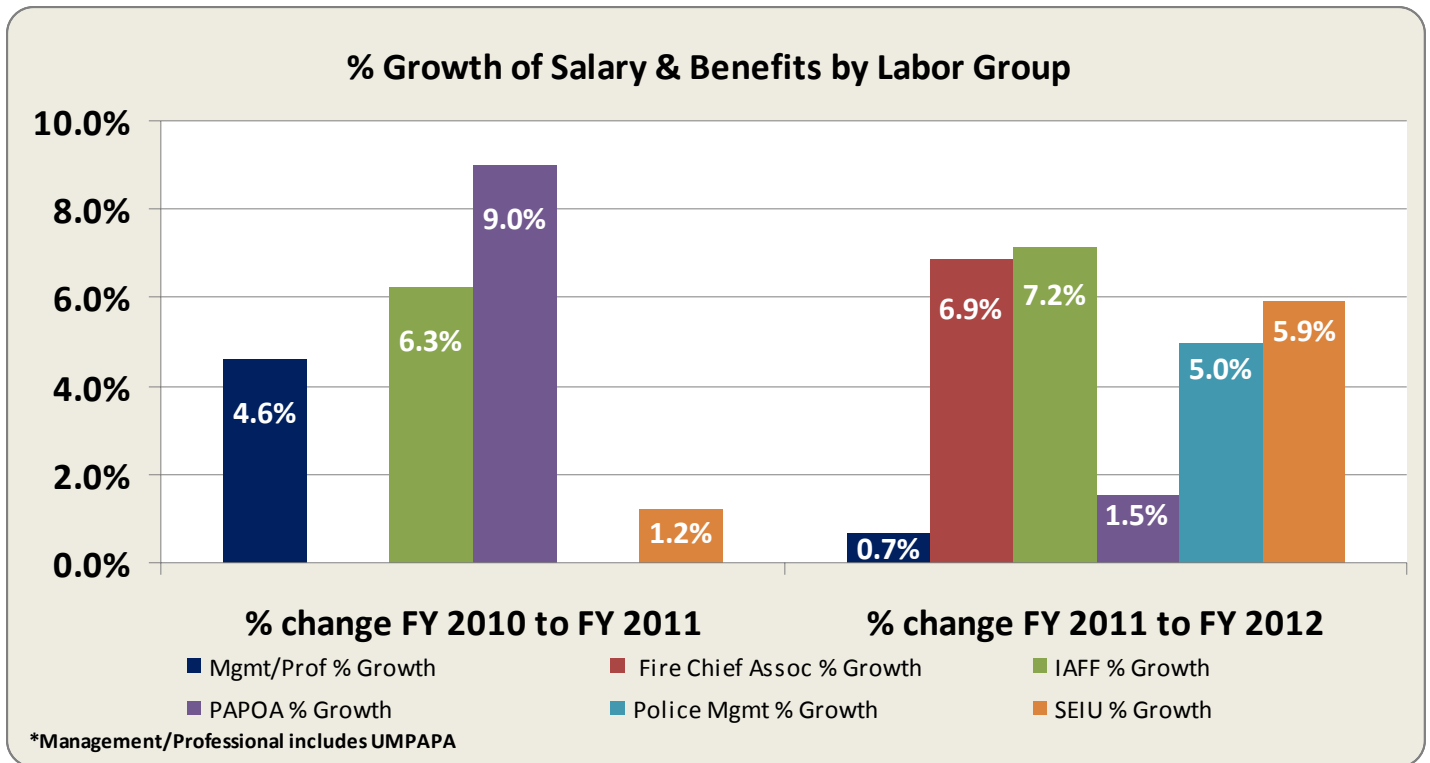


Public Safety % of Total General Fund Expenditures



2012 CHALLENGES & CONCLUSIONS

The following two charts show the rates of growth of the different bargaining units' compensation from FY 2010 to FY 2011 and from FY 2011 to FY 2012.



CONCESSIONS TO DATE

With recent structural adjustments, Council and staff have eliminated more than \$14 million in expenses and over 60 positions from the General Fund budget. The following concessions have been approved since fall of 2009:

Current SEIU contract:

- Created a second tier to our retirement structure (2 percent at 60) for new employees hired on or after July 17, 2010.
- Reduced City payment of employee share of PERS for SEIU employees 3.75 percent - with employees picking up the difference.
- Implemented a 90-10 medical cost sharing plan that began April 1, 2011
- Implemented cost-of-living freezes in FY 2010, 2011, and 2012
- Eliminated Tuition Reimbursement program

Estimated Savings: \$2.7 million per year, or 4 percent of total compensation

Current Management and Professional agreement:

- Eliminated the Variable Management Compensation plan as of FY 2009
- Implemented a 90-10 medical cost sharing plan that began April 1, 2011
- Implemented cost-of-living freezes in FY 2010, 2011, and 2012
- Created a second tier to our retirement structure (2 percent at 60) for new employees hired on or after July 17, 2010.

Estimated Savings: \$1.7 million per year, or 4 percent of the total compensation

Current agreement with Fire personnel (approved October 2011):

- Created a second tier to their retirement structure (3 percent at 55) for new employees
- Ceased paying the full 9 percent of the employee portion of pension expense. Fire employees themselves will pay the 9 percent.
- Eliminated final year “spike” of 9 percent for pension formula calculation
- Eliminated minimum staffing requirements
- Implemented a 90-10 medical cost sharing plan
- Implemented cost-of-living freezes from FY 2012-2014
- Eliminated Tuition Reimbursement program

Estimated Savings: \$1.4 million per year, or 7.14 percent of total compensation. Taking into account the 4 percent salary increase received in FY 2010, Fire salary and benefit concessions are in line with the 4 percent of total compensation given by SEIU and Management.

2012

CHALLENGES & CONCLUSIONS

Current agreement with Fire Chiefs Association (approved March 2012):

- Created a second tier to their retirement structure (3 percent at 55) for new employees
- Ceased paying the full 9 percent of the employee portion of pension expense effective 3/10/12 to 3/10/13. After 3/10/13 employees will pay 5.1 percent of employee portion
- Eliminated Tuition and Professional Development Reimbursement program
- Implemented a 90-10 medical cost sharing plan
- Eliminated Variable Management Compensation program

Estimated Savings: \$0.85 million per year, or 8 percent of total compensation

Potential agreement with PAPOA (not yet approved by Council):

- Creates a second tier to their retirement structure (3 percent at 55) for new employees
- Ceases paying the full 9 percent employee portion of PERS. Police employees to pay the 9 percent themselves.
- Implements cost-of-living freezes from FY 2012-2014
- Eliminates Tuition and Professional Development Reimbursement program
- Implements wage reduction of 1.33 percent
- Eliminates three paid holidays
- Well before this agreement was negotiated, PAPOA voluntarily postponed a scheduled salary increase of 6 percent for one year from July 1, 2009 to July 1, 2010, saving the City \$0.8 million in one-time expenses.

Estimated Savings: \$1.3 million per year, or 7.14 percent of total compensation

Prior to 2009, between 2004 and 2006, the City implemented for all bargaining units:

- All new hires have a 20-year vesting period to qualify for lifelong City-paid health coverage
- Highest cost health care plan option eliminated, saving almost \$10,000 per year for each employee moved away from this option

The aforementioned concessions and staffing reductions have been tough decisions that were not taken lightly. Like the City, our employees face rising household costs and diminished asset values. Furthermore, the impact of the position eliminations is that our employees are stretched thin, and our ability to take on new projects is reduced. We have also experienced a significant amount of staff turnover as a result of the compensation adjustments.

Yet the need to make additional difficult choices will remain until the structural budget gap is eliminated. Additional employee concessions will be required. The City is in the process of realigning and recalibrating its organization to match available staff and financial resources. This includes looking at alternate ways to provide services, including contracting out services, evaluating delivery of services through a regional model, and much more. Through the Cost of Services Study, the City will reach out to the community to determine the services they value most.

This Forecast shows that, without further action, the City can expect more deficits in the coming years. However, the City has received a vote of confidence in the form of a General Obligation Bond Triple-A credit rating from Standard and Poor's. Staff trusts that the community, Council and staff will act, as they have in the past, to balance the budget and to maintain the assets that make Palo Alto a renowned place to live.

Staff trusts that the community, Council and staff will act, as they have in the past, to balance the budget and to maintain the assets that make Palo Alto a renowned place to live.

VI. ENDNOTES

1. Paul Wiseman, "Economy ends year on surprising upswing," *San Jose Mercury News*, Dec. 22, 2012
2. Martin Crutsinger, "Retail sales hit record despite slow December," *San Jose Mercury News*, January 13, 2012
3. Anne D'Innocenzio, "Retailers pay the price for holiday deals," *San Jose Mercury News*, January 6, 2012
4. "The Employment Situation—January 2012," Bureau of Labor Statistics News Release, February 3, 2012
5. Motoko Rich and Stephanie Clifford, "For 2012, Signs Point to Tepid Consumer Spending," *New York Times*, January 3, 2012
6. Shaila Dewan, "U.S. Economy Gains Steam as 200,000 Jobs Are Added," *New York Times*, January 6, 2012
7. Beaconomics, "United States: Unemployment Rate" Forecast dated December 2011
8. Paul Wiseman and Derek Kravitz, "Steady as we go with economy," *San Jose Mercury News*, December 27, 2011
9. UCLA Anderson Forecast, "The National Economy Remains Mired in a Long Slump but Double-Dip Possibilities Abate," Press Release, December 2011
10. "U.S. Macro Focus, The Outlook for 2012: Unfinished Business," Citigroup Global Markets, December 14, 2011
11. Don Thompson, "State's jobless rate drops below 11%," *San Francisco Chronicle*, January 21, 2012
12. UCLA Anderson Forecast, "The National Economy is Stalled, but No Recession in the Forecast," September 2011
13. *The Beacon Employment Report*, Beacon Economics, January 2012
14. Christopher Thornberg, *Beaconomics*, September 2011
15. Pui-Wing Tam, "Uneven Growth as Region Revives," *Wall Street Journal*, November 17, 2011
16. George Avalos, "'The worst' may be over on job front in Bay Area," *San Jose Mercury News*, November 16, 2011
17. Beacon Economics, "The Regional Outlook-South Bay," *Quarterly Update*, December 2011
18. Compound Annual Growth Rate calculations use the following equation:

$$CAGR = \left(\frac{\text{Ending Value}}{\text{Beginning Value}} \right)^{\left(\frac{1}{\# \text{ of years}} \right)} - 1$$

19. Library Costs (Savings) Projected from Mitchell Park and Main Library Remodeling (in thousands):

Fiscal Year	FY 2013	FY 2014	FY 2015	FY 2016—FY 2022 (annual costs)
Salary & Benefit	(\$ 453)	(\$ 453)	\$ 300	\$ 300
Contracts/Supplies & Materials/Facilities & Equip	\$ 200	\$ 453	\$ 703	\$ 723
Technology	\$ 137	-		
Total	(\$ 116)	-	\$1,003	\$1,023



AMERICANS WITH DISABILITIES ACT STATEMENT

*In compliance with
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Printing

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The City of Palo Alto is located in northern Santa Clara County, approximately 35 miles south of the City of San Francisco and 12 miles north of the City of San Jose. Spanish explorers named the area for the tall, twin-trunked redwood tree they camped beneath in 1769. Palo Alto incorporated in 1894 and the State of California granted its first charter in 1909.



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Finance Meeting 2-28-12, Item #3 Excerpt

3. Long Range Financial Forecast Fiscal Years 2012 to 2022.

Administrative Services Director, Lalo Perez stated that the "at place" document which was placed before the Committee was to correct a missing line item in the 2012-2022 Long Range Financial Forecast (LRFF)-Summary of Base Model table. The missing line item was in *Total Revenues* that reflected transferred amounts in the Report and did not change the Grand Net Surplus. He stated that on the reverse-side of the document was Scenario #3 that was added to the FY2013 Base Model to include savings resulting from Long-term Employee Concessions. Portions of the concessions still needed to be achieved.

Senior Financial Analyst, Nancy Nagel gave a summary of the LRFF. She stated that City revenues were improving; however, last year's revenues had not yet matched the FY2008 revenues. The Top 5 General Fund Tax Revenue Sources she was referring to were Property Tax, Sales Tax, Utilities User Tax (UUT), Transfer Occupancy Tax (TOT), and Documentary Transfer Tax. Certain concessions were assumed in the Base Model Assumptions (2) for FY2013 only, and not carried forward. Fire Department concessions were carried forward for the full term of the forecast. In FY2013, concessions in the amount of \$2 million were assumed from the remaining Public Safety groups other than the International Association of Fire Fighters (IAFF). In 2011, the Council directed Staff to consider assumptions in the medical trend and Public Employee Retirement System (PERS) rates. A 10 percent increase in medical and a 3 percent annual increase in PERS was projected in 2015-2022 and assumed in the Base Model. A 2 percent cost-of-living adjustment (COLA) increase was assumed in FY2014 for Service Employees International Union (SEIU) and the Management Groups. Base Model Assumptions (3) noted that the full-time employees (FTEs) in the General Fund had decreased by 18 percent since FY2000, while salary and benefit costs increased by 50 percent. Pension expenses had increased by six-folds since 2002. The required medical annual contribution for retirees had grown by \$2.6 million and had adjusted from \$6.8 million in FY2011 to \$9.4 million in FY2012. Factors not included in the Base Model were additional Mitchell Park Library expenses beyond FY2013, Infrastructure Blue Ribbon Commission (IBRC) revenues from new hotels not yet approved, additional required cost-sharing from employees beyond FY2013, and ongoing concessions from the remaining Public Safety groups. Alternate assumption scenarios included: Scenario #1: PERS rate increase of 1.5 percent per year after 2014, rather than 3 percent

that would result in a \$27.1 million in savings over 8 years. Scenario #2: invest an additional \$6.6 million per year in infrastructure that would result in a \$67 million additional deficit over 10 years. Scenario #3: continued concessions beyond 2012 that would result in \$33 million in savings over a 10-year period. She referred to the visual Base Model chart in the overhead presentation that reflected combined deficits of \$74.9 and said the City could anticipate improvements if concessions in 2013 were carried forward.

Mr. Perez stated that the City needed to ask employees for more cost-sharing and if the organization was able to work through these challenges it would be less painful because the numbers were getting smaller. It was necessary to continue the exploration of regional service delivery and the cost-of-services study. He said the City was more complex and diversified than other agencies and had over 1,000 fees, which were more than other agencies. There were 25 percent in Community Services Division (CSD) fees, 25 percent in Police Department fees, 25 percent in Planning and Transportation Division fees, and 25 percent in the remaining City departments.

Council Member Price asked why the study findings were delayed.

Mr. Perez said this was a significant project for the organization to undertake. His department lacked Staff capacity and it was necessary to hire a temporary Staff member to do the work.

Council Member Price asked if Staff had the ability to set the fee base for resident and non-resident fees.

Mr. Perez said there was a difference in the fee structure and that non-resident fees were higher. Part of the review and analyses that was conducted was the limitations the City could face with Proposition 26. He said infrastructure needed to be addressed in the 10-year forecast.

Council Member Price said she felt that the additional Mitchell Park Library and other library expenses were actuals and should be factored into the Base Model.

Mr. Perez said there were preliminary numbers that would get factored into the 2013 budget.

Council Member Price had raised concerns regarding overtime expenditures and recovery of cost that were incurred with public-

partners events. The City had waived fees that should have been collected. She asked why this was being done.

Mr. Perez stated the issue needed to be addressed to determine whether the practice should continue.

Council Member Price asked why Utilities Management Professionals Association of Palo Alto (UMPAPA) was not listed in the LRFF.

Mr. Perez said the group was omitted because it was fairly new but it was considered in the numbers. He stated that \$600K was proposed for Mitchell Park with a breakdown of \$100K for Facilities Management, \$200K for technology, and \$300K for operations. They were preliminary figures for only half a year since the Library Community Center would be opening in the middle of the year.

Council Member Shepherd asked if the \$600K was in the Model.

Ms. Nagel confirmed the Mitchell Park figures were included in the Model for FY2013 only and not in FY2014 going forward. The historical chart was showing trends and Staff did not have information available on UMPAPA because it was new.

City Manager, James Keene clarified that the acronym UMPAPA stood for Utilities Management Professionals Association of Palo Alto.

Council Member Burt asked if the revenues projected for 2012-13 had been adopted.

Mr. Perez said it was projected and included in the midyear calculations.

Council Member Burt asked why there was not a larger increase in revenues from FY2012 to FY2013.

Mr. Perez said the big change in 2013 was the Refuse Fund rental income change that amounted to several million dollars.

Council Member Burt referred to the color handout chart and said that page 7 of the Report, under Sales Tax noted an estimate of \$26.1 million for FY2012, an increase of \$1.4 million. He asked if that was a FY2013 projection.

Ms. Nagel clarified it was a 2012 projection based on increased sales tax assumptions.

Council Member Burt asked if the bases for FY2013 projections were being addressed.

Ms. Nagel said not in that category.

Council Member Burt said he needed clarification of what the FY2013 projections were based on.

Mr. Perez said a sales tax consultant was hired by the City to help realign sales tax projections. The School District and the County were considered to determine property tax. The TOT was doing well. There was a continued concerns regarding telephone usage in the UUT, volume or rate set in utilities, and the need for sufficient volume in the Documentary Transfer Tax, parking citations, and high levels in job-related injuries. He said increased activities in the Development Center would be a good sign in terms of permits which would create job opportunities and spending that would impact sales tax.

Ms. Nagel asked what level of detail the Council wanted to see in the 2013 projections.

Council Member Burt stated that the forward years were more speculative. FY2013 would be based on the recent trend patterns and that certain specific projections could be used as a baseline in going forward.

Mr. Keene said a 10-year forecast would be an ideal tool for planning. The goal would be to get as close to the real numbers as possible without going over.

Vice Mayor Scharff said he viewed the LRFF different from the budget. He said the deficit progressively increased but would decline as revenues increased and efforts to eliminate budget cuts in the upcoming years. He supported Council Member Price's request to include the Mitchell Park Library expense, as well as other expenses and expressed the importance to be as accurate as possible in forecasting. Revenues needed to be correct because of unexpected expenses. He said it was common to get more revenues than what was expected which could cover unanticipated costs. Expenses were usually less than what was budgeted for except in Capital Improvement Projects (CIP). Infrastructure costs must be included in

the Model. There would be more in infrastructure costs and would require a policy-decision on how to fund the costs annually. He felt to not include hotel revenues that had not been approved was appropriate because there were instances where the revenues had been approved and did not move forward. He asked what the process was for hotel revenues.

Assistant Director, Joe Saccio said the current focus was to work with the existing hotels and hotels currently under construction. Hotel Keen was the latest hotel that had one-year's worth of data. Data was obtained by measuring the trend in the occupancy and per diem rate increases as well as projecting out to the near future.

Vice Mayor Scharff asked if the same TOT rate was being used.

Mr. Saccio said yes, which was 12 percent.

Vice Mayor Scharff said his understanding was that there would be a \$2 million concession in the FY2013 budget and would be subtracted in FY2014. He felt it should remain in the FY2013.

Mr. Perez said it was a matter of preference. Staff was looking for guidance on what should be included in the Base Model and scenarios.

Vice Mayor Scharff referred to page 16 of the Base Model and said in FY2012 salary projection was \$60 million, a decreased of \$57 million in 2013, and reverted back to \$60 million in 2014.

Ms. Nagel said most of the \$2 million was put in salaries and distorted the balance of salaries and benefits in 2013.

Mr. Perez said the figures would change assuming that Staff would be directed to include the ongoing employee concession.

Chair Shepherd made reference to the reorganization and staff size. She felt the delivery of City services were not sustainable. There was a need to reconsider services that were optional services and to rethink how they should be delivered. She felt delivery lacked aggressiveness. For example, there were discussions to have more public-private partnership; however, strategies were not set. She expressed the need to develop cost-neutral policies or set a 5-year plan in getting to a sustainable program with minimal subsidies. She wanted "add-on" expenses to be reflected as line items in the LRFF-Summary Base Model chart such as Infrastructure Blue Ribbon

Committee Report, Library, and Infrastructure and forecasted as items that were forthcoming. The data would be known and would allow the Council to make decisions on the “add-on” items.

Mr. Perez asked for clarification on how “add-ons” should be displayed.

Chair Shepherd said the Base Model chart had two line items: *total revenues* and *total expenditures* and asked that the Mitchell Park Library be added as a line item. She wanted Staff to expand on the Main Library and asked if the Main Library was to going to continue operating as it did.

Mr. Perez said the main focus had been on the Mitchell Park Library and had not looked into specific details for the Main Library. He said he would be able to provide a table that would specify projects that were forthcoming.

Mr. Keene said he viewed the LRFF as a project where current activities were considered and projected into the future with assumptions and drivers that pushed revenues and expenditures in a particular way. Strategic policy shifts happened in each budget year that caused a ripple affect into the future in re-negotiating social contract, reinvesting in assets, restructuring benefits, and redesigning work roles. It was important to capture its progress and to summarize and predict how the City shared responsibilities with the community.

Council Member Shepherd said it was important that the correct figures were used if the Mitchell Park Library and the other libraries were to be added to help determine future expenditures in the LRFF.

Council Member Price spoke regarding the Scenario #1 alternative that included the lower Public Employee Retirement System (PERS) increase after 2015. She found the original document in the narrative compelling because it resulted in a \$27 million difference between a 1.5 and 3 percent assumption. She asked what the impact would be on the Scenario #1 alternative.

Mr. Keene said a lot was based on predictions on the City’s current situation or on the inflating or deflating of things over time and would become dynamic over the 10-year period.

Council Member Burt spoke regarding revenues from hotels and reviewing hotels under construction. He said hotels often get approved and do not move forward while under construction. He said

a long-term projection on the anticipated school lease was not noted in LRFF.

Mr. Perez said the school lease was assumed to continue, status quo, and the assumed consumer price index (CPI) was 3 percent.

Council Member Burt said when looking at the lease there was a need to differentiate between the lease for the space, which could continue or diminish over a period of time, and the covenant not to develop which was antiquated. His understanding was that benefits gained in efficiency from animation and the trend towards E-Books was unknown and would not materialize until they were in place. There were uncertainties in cost.

MOTION: Council Member Burt moved, seconded by Vice Mayor Scharff that infrastructure keep-up be added to the Base Model.

Council Member Burt stated there needed to be a way that keep-up was part of the Base Model. He said catchup and future needs may or may not have future revenue sources to address. He did not think it was reasonable to go to the voters and ask for new revenues to achieve the keep-up element.

Vice Mayor Scharff said he agreed with Council Member Burt to include keep-up and would be going down a wrong path if it was not included. It would not make sense to talk about infrastructure and not put the base keep-up.

MOTION PASSED: 4-0

MOTION: Vice Mayor Scharff moved, seconded by Council Member Burt to carry forward Option 3 in the Long-term Forecast

MOTION PASSED: 4-0

Vice Mayor Scharff said a reasonable number should be specified for Mitchell Park Library.

Mr. Perez said Staff would come up with a suitable figure and was committed to have the figure in place by the time the item went to the Council.

Chair Shepherd announced there were no more questions and discussion on the LRFF item was concluded.

Chair Shepherd wanted a clear understanding of what the Library Director's vision for the libraries in 2012-13 in terms of staffing needs.

Mr. Perez noted that the last page of the forecast contained names of those who contributed in putting the LRFF together. He said it was a significant project and required a great deal of support. The goal was to have the changes ready for the April 9th Council Meeting. The next Finance Meeting was scheduled for March 6, 2012. The agenda was full and asked the Committee to accept the tentative agenda. Council had requested that the Community Services Division (CSD) Staff come back through the Finance Committee with more information on the Golf Course impacts from the San Francisquito Creek Joint Powers Authority (JPA) work. CSD was leading the effort and have additional information for the Committee to review. Additionally, there was the Water Financial Forecast, Wastewater, and the Refuse Fund Cost-of-Service Study item that have Proposition 218 notification.

Vice Mayor Scharff asked if all this was going to be discussed at the March 6 meeting at 7 p.m., with the AB1234 Ethics Training at 5 p.m.

Mr. Perez said yes.

The group discussed topics that needed to be included in the upcoming meetings that included the Golf Course, Community Development Block Grant (CDBG), Proposition 218 and to determine which subjects would be discussed during which meetings. Upcoming Council Member absentees were also discussed. Meeting dates for consideration were April 10th, 17th and 24th.

Adjournment: 10:21 pm.