



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

December 3, 2002

Honorable City Council
Attn: Finance Committee
Palo Alto, California

Analysis of the Long Range Financial Plan

Summary

Dramatic declines in sales and transient occupancy taxes and double-digit increases in benefit costs are just a few of the most salient factors affecting Palo Alto's financial future. A sustained economic downturn means continuing uncertainty and additional challenges ahead. The purpose of a Long Range Financial Plan (LRFP) is to identify long-term opportunities, problems and strategies.

We have reviewed the current plan and believe it is reasonable, given what is known today about the City's financial condition. The plan includes a base forecast that shows the implications of not acting now to address projected deficits. It outlines a strategy for reducing those deficits by cutting forecasted expenditures by 3 percent in 2003-04 and by another 2 percent in 2004-05.

The details of our review follow, along with three specific recommendations:

RECOMMENDATION #1: In light of continuing economic uncertainties, we recommend staff brief the Finance Committee about the General Fund's budget-to-actual status (for revenues and expenditures) on a quarterly basis.

RECOMMENDATION #2: To simplify tracking infrastructure funds, we recommend staff assess the feasibility of (1) moving the Infrastructure Reserve from the General Fund to the Capital Projects Fund, and (2) retaining unspent project funds in the Capital Projects Fund.

RECOMMENDATION #3: To facilitate City Council discussion of long-term infrastructure priorities, we recommend that during the upcoming budget process staff provides the City Council with a list of the identified Infrastructure Management Plan (IMP) projects including estimated, budgeted, and actual costs for each project.

Discussion and Analysis

The purpose of our review was to provide an independent assessment of the feasibility and completeness of the LRFP. We prepared this analysis at the request of the City Council and in accordance with the City Auditor's 2002-03 Work Plan. We reviewed the previous LRFP (CMR:355:01, September 2001), verified that the major revenue and expenditure categories were

complete, reviewed spreadsheet calculations, compared historical trends to forecast, obtained samples of methodologies from other jurisdictions, and reviewed best practices.

Using this information, we provided input to staff as they prepared the 2002 LRFP that is being presented to the Finance Committee in December 2002 (CMR:444:02). Staff has incorporated many of our comments in the current version of the LRFP.

The Plan Meets Best Practices in Public Budgeting

The National Advisory Council on State and Local Budgeting (NACSLB) recommends long range planning as a key component of recommended budget practices:

A government should have a financial planning process that assesses the long-term financial implications of current and proposed policies, programs, and assumptions and that develops appropriate strategies to achieve its goals.... The planning process results in the preparation of a financial plan consisting of various components such as an analysis of financial trends, an assessment of problems or opportunities facing the jurisdiction and actions needed to address these issues; and a long-term forecast of revenues and expenditures that uses alternative economic, planning, and policy assumptions.... A financial plan is not a forecast of what is certain to happen but rather a device to highlight significant issues or problems that must be addressed if goals are to be achieved.¹

In our opinion, the City's Long Range Financial Plan meets these best practices for long range planning. It provides policy-makers with a vehicle to look forward ten years. Staff plans to continue updating the forecast annually.

Completeness and Feasibility of Revenue Assumptions

The model calculates the forecast using estimated year-to-year growth rates; a change in any one of these factors would significantly affect the forecast. The model is comprised of a number of linked spreadsheets including historical totals and forecasts for major revenue and expenditure categories in the General Fund. It incorporates staff's judgment as to projected rates of growth for each of the categories described above, and applies year-to-year rates of change to each category. The growth factors are shown in Exhibit 3 of LRFP so that assumptions are clear.

It is prudent for policy makers to remember the forecast could easily be off by several percentage points in either direction – especially over the long term. Some jurisdictions present forecasts as single point estimates; some include various scenarios; and some bracket their forecast within a range of uncertainty (e.g. plus or minus 2 percent). Whether staff chose to present a single point estimate, several scenarios, or a range of uncertainty, it is important to emphasize that forecasting is more art than science.

Continuing economic uncertainties and projected deficits make periodic monitoring essential. The LRFP forecasts \$125.4 million in General Fund sources of funds in 2003-04 with average annual increases of about 4.6 percent through 2012-13. It forecasts \$131.8 million in General Fund uses of funds in 2003-04 (before reductions) with average annual increases of about 5 percent through

¹ National Advisory Council on State and Local Budgeting, *Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting* (Chicago, IL: Government Finance Officers Association, 1998)

2012-13 in the base case, or 4.7 percent in the reduced scenario. Under both forecasts, the City faces a \$463,000 deficit in current fiscal year.

RECOMMENDATION #1: In light of continuing economic uncertainties, we recommend staff brief the Finance Committee about the General Fund's budget-to-actual status (for revenues and expenditures) on a quarterly basis.

Completeness and Feasibility of Expenditure Assumptions

The plan identifies major funding challenges and specifies those issues that were not included in the forecast. Chapter 3 of the LRFP outlines a number of items that are not funded in the forecast. In general, we agree that those items either (1) cannot be reasonably estimated, or (2) have not been formally approved by the City Council. For example, the City pays for employee and retiree medical premiums on an annual basis, and the LRFP includes projected growth in these premiums; but the forecast does not include pre-funding the future cost of retiree medical benefits at this time. It should be noted that some jurisdictions include allowances for some types of commitments in their forecasts. For example, an allowance for a project for which the Council has expressed an informal 'commitment', but for which there is neither a formal estimate or approval; or an allowance for the operating cost of capital projects.

The model assumes year-end savings. The City historically spends less than its operating budget. For example, between 1992-93 and 2000-01, actual expenditures were 5 to 7 percent less than the adjusted budget. The forecast assumes year-end operating savings of at least \$2 million per year to fund the Infrastructure Reserve, as well as additional savings and/or surplus revenues of \$1.5 million to maintain the Budget Stabilization Reserve. Based on the City's history of spending less than budget, this is reasonable. However, revenue monitoring and disciplined spending will become more critical as budgets get tighter (see recommendation #1 above).

The Forecast Continues Funding for Infrastructure

The forecast continues the \$100 million pay-as-you-go commitment to infrastructure. The City began setting aside funds in the Infrastructure Reserve in 1996-97, and began constructing Infrastructure Management Plan (IMP) projects in 1999-00. The 2002 LRFP shows \$59.4 million in IMP capital project costs from 2003 to 2013. This is in addition to more than \$20 million already spent or in process, and \$30.2 million set aside in the Infrastructure Reserve, for a total of approximately \$109.6 million from 1996-97 through 2012-13 (not including associated staffing costs).

Infrastructure funding transfers can be simplified. Long-term infrastructure planning is a key City Council priority. The LRFP shows a number of transfers to account for the flow of infrastructure funding, including transfers in and out of the General Fund, Capital Projects Fund, Infrastructure Reserve, and Budget Stabilization Reserve. In tracing these transfers, we also noted that when a capital project is completed, any funds remaining on that project are returned to the originating fund (e.g. General Fund). In our opinion, these transfers unnecessarily complicate the accounting for infrastructure funding.

RECOMMENDATION #2: To simplify tracking infrastructure funds, we recommend staff assess the feasibility of (1) moving the Infrastructure Reserve from the General Fund to the

Capital Projects Fund, and (2) retaining unspent project funds in the Capital Projects Fund.²

Monitoring the Infrastructure Program. Staff identified an infrastructure backlog in the late 1990s and proposed \$100 million in funding to reduce the backlog over 10 years starting in 1999-00. This 10-year period would theoretically end in 2008-09. The LRFP assumes that IMP funding will be required through the entire term of the LRFP (through 2012-13) because of inflation and the addition of new IMP projects. Other new infrastructure projects are discussed, but no funding is identified.

RECOMMENDATION #3: To facilitate City Council discussion of long-term infrastructure priorities, we recommend that during the upcoming budget process staff provides the City Council with a list of the identified IMP projects including estimated, budgeted, and actual costs for each project.

Conclusion

By addressing potential shortfalls proactively, Palo Alto has kept its budget balanced and its reserves whole. Staff has prepared a long-range plan that identifies revenue and expenditure gaps, and has proposed a reasonable strategy to address those gaps. We commend staff on their efforts to bring the City's long-range financial condition into focus and would like to thank the Administrative Services Department for their cooperation and assistance during this review.

Respectfully submitted,

/s/

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City Auditor

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² The Infrastructure Reserve and the Budget Stabilization Reserve are both designations of fund balance within the General Fund.