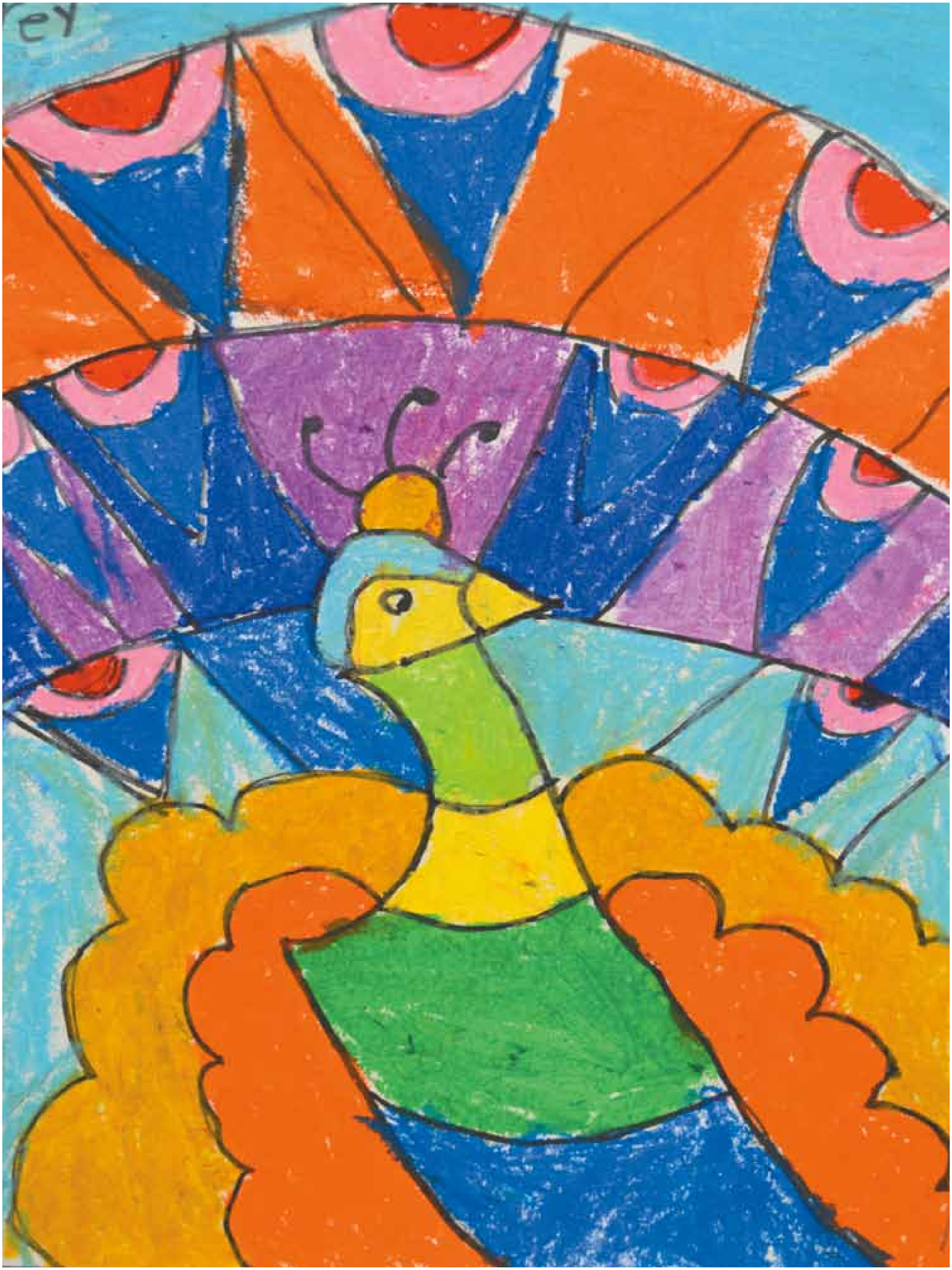
LONG RANGE FINANCIAL FORECAST

FISCAL YEARS
2016
TO
2025

CITY OF
PALO
ALTO



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EXECUTIVE SUMMARY

The Fiscal Year (FY) 2016 to 2025 General Fund Long Range Financial Forecast (LRFF), which marks the beginning of the FY 2016 budget planning process, projects a slight General Fund surplus of $0.5 million in FY 2016. Although economic indicators and rebounding tax revenues reveal that the City of Palo Alto has reached a turning point from the Great Recession, this Forecast reflects financial obligations and rising benefits costs that diminish the positive outlook over the next 10 years.

Despite improving revenue receipts as projected forward, the City continues to face challenges related to the funding of infrastructure, rising benefits costs, and unfunded long-term liabilities. The Infrastructure Plan was recently approved by the City Council and contains $125.8 million in projects recommended by the Infrastructure Committee; however, even with the voter approved increase in the Transient Occupancy Tax (TOT), a funding gap of $7.5 million still exists and the plan does not include any contingencies for potentially higher land acquisition and construction costs. Starting with FY 2016, this Forecast assumes an additional transfer of $4.7 million annually for the estimated annual debt service cost as assumed in the Infrastructure Plan. Since it is not anticipated that debt will be issued until FY 2016, with the first debt service due in FY 2017, the additional transfer of $4.7 million to the Capital Fund will be allocated to address the Infrastructure Plan funding gap.

Since the Great Recession, the City Council has approved various strategies to reduce the costs of salaries and benefits. These strategies include: (1) employees paying their own CalPERS contribution (between 6 percent to 9 percent of salary) except for the members of the Fire Chiefs' Association; (2) sharing the cost of health plan costs at 90/10; (3) creating a second pension tier (and the state implemented a third tier effective January 1, 2013); (4) reducing professional development expenses; (5) eliminating minimum staffing requirements and associated overtime costs in Fire services; (6) cost of living freezes for four years; and (7) terminating the Variable Management Compensation Plan. Continuing with previous actions to curtail the growth of benefit costs, in 2014, as part of approving the agreement with SEIU and the compensation plan for Management and Professional employees, the City Council approved the cost sharing of future health plan costs. Because of the implementation of these various strategies, the growth in salary and benefit costs are not outpacing the growth in revenue; however, over the Forecast period, salary and benefit costs gradually increase in comparison to the total expenditure budget. In FY 2016, salary and benefit costs represent 62 percent of the expenditure budget; in FY 2025, salary and benefit costs represent 65 percent of the budget. During the same period benefit costs as a percentage of total salary and benefit costs increase from 49 percent in FY 2016 to 55 percent in FY 2025.

As reported in the first quarter financial report for FY 2015, as of early November 2014, 28 percent of non-safety (Miscellaneous) employees received Tier 2 (2 percent at 60) and Tier 3 (2 percent at 62) pension benefits, and 14 percent of Safety employees received Tier 2 and Tier 3 pension benefits. The impact of employees hired during the last five years has had little impact on unfunded pension plan liabilities. Per the latest CalPERS valuations for the Miscellaneous and Safety employees, the combined unfunded pension liability amounts to $295.5 million. Adding on the unfunded liability for the retiree healthcare plan in the amount of $143.6 million, the total unfunded liability for all three plans is $439.1 million. In comparison to the most recent valuations available for all three plans, the total unfunded liability has remained approximately the same at $439.7 million. Changes in the actuarial assumptions and policies, which have increased total liabilities, have offset recent substantive market gains.

This Forecast provides a long-term view of the City's General Fund to provide a strategic focus for addressing future funding needs in the FY 2016 Budget and beyond. This Forecast assumes FY 2015 service levels remain the same and includes funding for the City Council's approved enhancements to the Shuttle Service and funding for the Transportation Management Authority. As in past years, the Forecast has been updated based on current information compiled from various sources, in addition to utilizing available tools to project revenues and expenditures. This document facilitates City Council members' and staff's understanding of the long-term impacts of past decisions, and identifies issues that must be addressed in the near and long-term, including the availability of funds. The Forecast is not a prediction or a commitment of resources; rather, it is a reasonable snapshot of the City's future financial condition based on various assumptions and currently available data.

A continuously improving economic climate is noted by the majority of national, state, regional, and local economic indicators. This Forecast assumes a continued, gradual growth of the national economy with positive impacts to the local economy, which is reflected in the estimates of economically sensitive revenues. Consistent with previous forecasts, the methodology for calculating changes for out-years of the Forecast (FY 2017 to FY 2025) are based on a historical analysis of increases using the Compounded Annual Growth Rate (CAGR) with adjustments factored in for known items. By using the historical average growth rate that incorporates the up and down cycles over the past 10 or 20 years, there is no single year in which a downturn is depicted. Instead, past downturns (e.g. dot.com bust and Great Recession) have been factored into the compound growth rate used to forecast future revenue streams. Staff performed a reasonableness test of the results and made appropriate changes to the CAGR analysis.

As shown in the table below, the FY 2016 Forecast Budget anticipates a General Fund surplus of approximately $0.5 million for FY 2016, and surpluses in all out-years of the Forecast except Fiscal Year 2017. During the forecast period, surpluses range between $0.5 million and $3.4 million with an approximate cumulative one-time surplus of $17.2 million. Assuming that the General Fund Budget Stabilization Reserve (BSR) is fully funded at the City Council approved target level of 18.5 percent of General Fund operating expenditures, $11.6 million would have to set aside to maintain the target level. With these funds set aside, the one-time resources projected in this Forecast would decrease by $11.6 million from $17.2 million to $5.6 million.

Long Range Financial Forecast

Fiscal Year 2016-2025

	Adopted 2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Total Revenue	$171,084	$179,637	$186,961	$194,498	$201,233	$208,234	$214,408	$221,070	$228,864	$236,926	$245,129
Total Expenditures	$171,084	$179,155	$187,142	$193,437	$199,825	$205,896	$212,624	$219,358	$226,567	$234,032	$241,765
Net One-Time Surplus/(Shortfall)	$0	$482	($180)	$1,061	$1,408	$2,408	$1,784	$1,712	$2,297	$2,894	$3,364
Cumulative Net Operating Margin (One-Time)											**$17,231**
Net Operating Margin		$0	($180)	$1,061	$347	$1,000	($625)	($72)	$585	$597	$470
Cumulative Net Operating Margin											**$3,185**

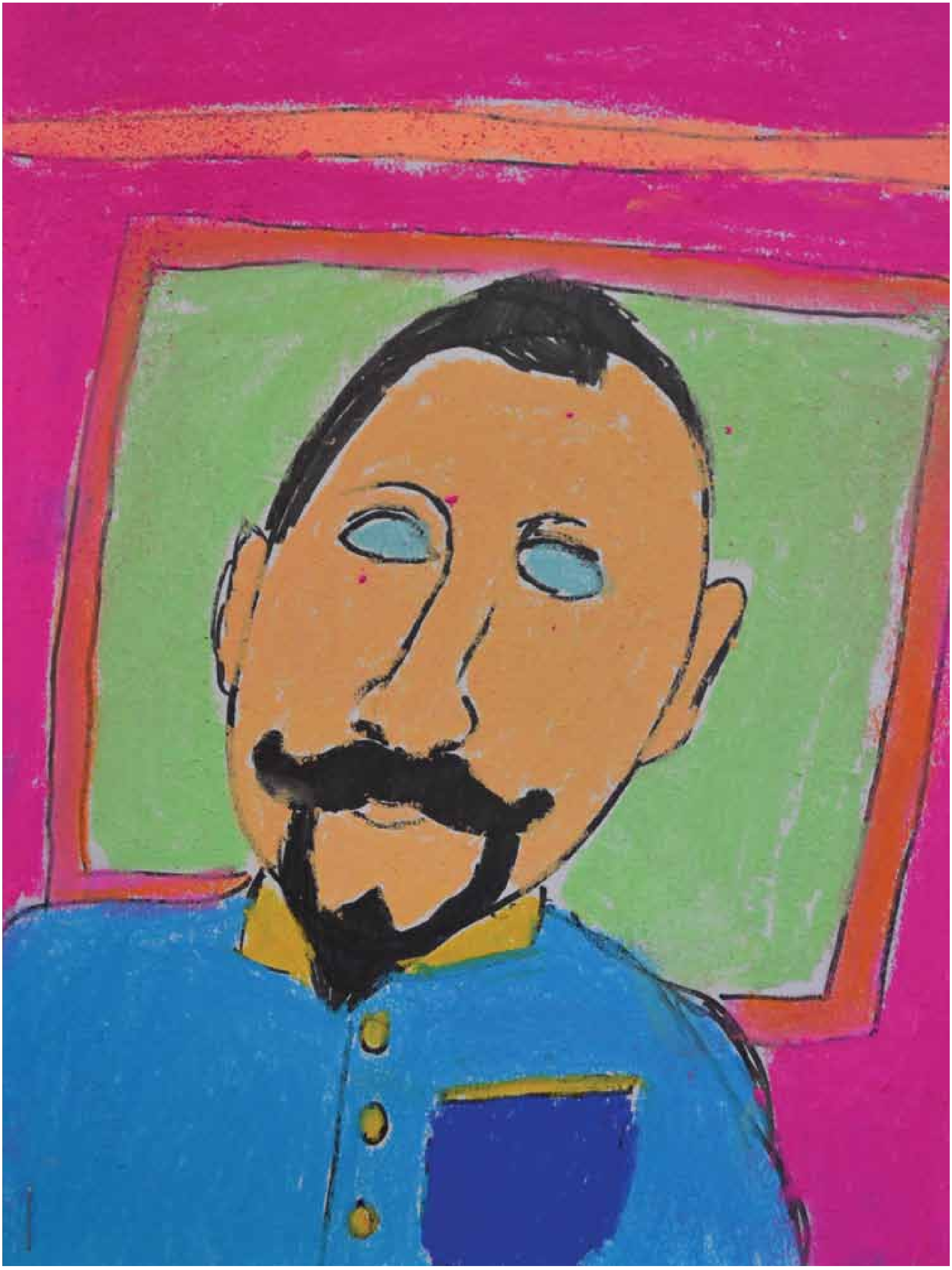
Assumes that the annual shorfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures.

The table includes a calculation for the net operating margin which reflects the year over year change of surpluses and shortfalls. With the net operating margin, it is assumed that each shortfall is addressed completely with ongoing solutions in the year it appears, and that each surplus is completely expended with ongoing expenditures. Based on these assumptions, the cumulative net operating margin, or ongoing surplus, during the forecast period is approximately $3.2 million.

Although this Forecast presents a positive fiscal outlook for the City's General Fund, it does not include the following potential impacts, which can increase or decrease the projected annual surpluses to the FY 2016 Projected Budget and the out-years of the Forecast: (1) ongoing labor negotiations; (2) Cadillac Healthcare Federal Excise Tax; (3) Foothills College Cubberley Lease; (4) potential acquisition of the downtown Palo Alto Post Office; (5) potential termination of the Fire Services Contract with Stanford University; (6) radio infrastructure investments with the Silicon Valley Regional Interoperability Authority; (7) Remaining Infrastructure Plan approved projects and contingency for increased land acquisition and construction costs; (8) future changes to pension plan assumptions by CalPERS; (9) Infrastructure Plan operating budget impacts; and (10) changes in the local, regional, and national economy.

At this time, staff projects $4.3 million in excess revenues and expenditure savings in the General Fund for FY 2015. The FY 2015 projected surplus includes City Council approved budget amendments to date and is driven by a $4.3 million, or 4.6 percent, increase in major tax revenues from the Adopted Budget. This amount does not assume forthcoming recommendations to adjust revenues and expenditures as part of the FY 2015 Midyear Budget Review.

During the next few months, staff will continue to monitor revenues and expenditures based on available information and include these updates in the FY 2016 Proposed Budget scheduled for release late April/early May 2015.



ECONOMIC OUTLOOK

In preparing the FY 2016 to 2025 General Fund Long Range Financial Forecast, key economic indicators and measures available through various publications and reports were reviewed. Overall, the economic outlook for 2016 calls for continued measured optimism even as global economic conditions continue to produce uneven economic growth across regions and sectors.

Thinking Globally

Famed American mathematician and meteorologist Dr. Edward Lornez engineered the strange attractor notion and coined the term, *Butterfly Effect*. According to Lorenz, on any given day a butterfly can flap its wings in China and in New York you get rain instead of sunshine In the age of globalization, where the exotic and chaotic combine to produce 24 hour cable news fodder, economic and political conditions in all corners of the world can have as much of an impact on the local economy as similar factors here at home. As a world renowned hub of technological innovation, and at the heart of the Silicon Valley, Palo Alto is connected to the global economy in immeasurable ways. From Amazon® to Zimride®, the global innovation economy helped drive global growth by 3 percent in 2013, and that momentum is expected to continue through 2015 and beyond.[i]

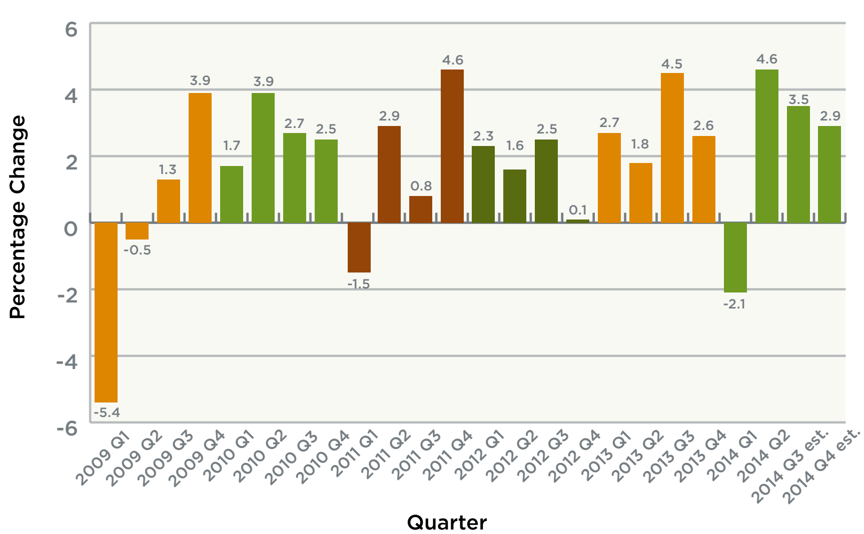
According to the Silicon Valley Bank's *Innovation Economy Global Outlook (2014)*, "across regions, 2 in 3 executives say their company met or beat 2013 revenue targets. UK executives reported the strongest performance, with 77 percent saying they met or beat targets. US executives came in second, with 65 percent, and other innovation economies came in strong with 62 percent meeting or beating revenue targets."[ii] Although the International Monetary Fund (IMF) recently lowered 2014 global growth projections by 0.4 percent to 3.3 percent to reflect a weak first quarter in the US and a less optimistic outlook for emerging markets, stronger growth is expected in advanced economies next year. The IMFs global growth projection for 2015 is 3.8 percent.[iii]

The measured optimism expressed by the IMF is due, in part, to downside risks that include geopolitical factors from Eastern Europe to the Middle East that may have a supply side impact on global oil prices; however, the emerging shale oil boom in the US has been mitigating some of these concerns. The softening of Eurozone economies, most notably Germany, has caused concern that Europe's leading economy is struggling with weakening demand for exports, slowing growth in Asia, and the impacts of Russian trade sanctions. In the US, the Federal Reserve has ended the central bank's long-term bond buying program known as Quantitative Easing which may have an impact on long-term interest rates that affect everything from consumer credit cards to home mortgages while the Bank of Japan and the European Central Bank have ramped up similar programs.

A National View

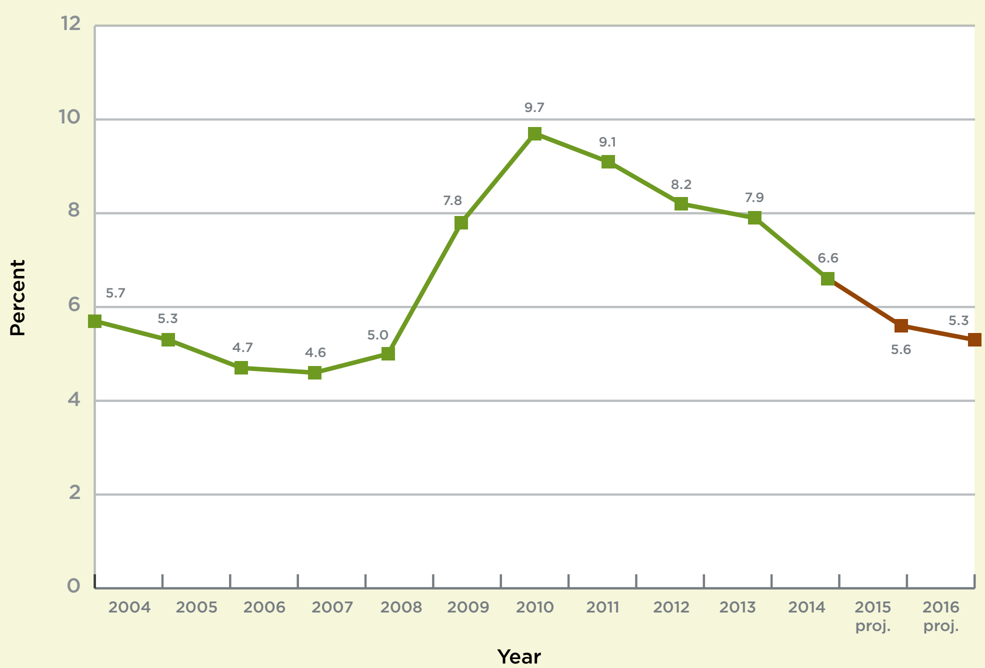
The beginning of 2014 was, as Shakespeare famously wrote in Richard III, "the winter of our discontent." In July 2014, the Bureau of Economic Analysis revised its Q1 2014 Gross Domestic Product (GDP) contraction to -2.1 percent, relative to Q4 2013 when real GDP grew by 2.6 percent, while posting a modest gain of 1.9 percent for all of 2013.[iv] Overall, Q1 2014 was the worst first quarter showing since Q1 2009, amidst the throws of the Great Recession. Economists attributed the sharp decline in output and productivity to unusually cold weather in much of the US in early 2014 that affected everything from auto sales to home construction, and became a significant drag on the economy. As bad as Q1 2014 was, Q2 2014 was, "made glorious summer by this sun of York." The output of goods and services in the US increased at a robust annual rate of 4.6 percent in the second quarter of 2014, primarily driven by significant increases in personal consumption expenditures, exports, private inventory investments, and state and local government spending.[v] According to the UCLA Anderson Forecast, Q3 2014 GDP growth is estimated at 3.5 percent and Q4 2014 growth is projected to be 2.9 percent. For 2015, GDP is projected to grow at annualized rate of 3.1 percent.[vi] The chart below provides a quarterly view of GDP growth from 2009 to present.

GDP Growth by Quarter (2009-Present)



The UCLA Anderson Forecast cites several factors contributing to their favorable outlook for 2015. Leading the way is continued domestic job growth resulting in the precipitous decline of the unemployment rate. As of September 2014, the national unemployment rate (U3) was 5.9 percent. The UCLA Anderson Forecast projects that by the end of 2016, the unemployment rate (U3) will drop to 5.3 percent signaling that the economy is approaching full employment. The following chart provides a multi-year view of the US unemployment rate. While a decrease in the unemployment rate is very positive, it is important to note that the Federal Reserve's highly accommodative monetary policy may be driving job growth too far too fast. As the Dallas Fed president recently noted in the *Economic Letter*, "Fed policymakers successfully 'tapped the breaks' in the middle of three of our longest economic expansions (in the 1960s, 1980s, and 1990s), slowing—but not ending—the unemployment rate's decline. By comparison, there are no instances where the Fed has successfully eased the unemployment rate upward after having overshot full employment: When the economy goes into reverse, it has a pronounced tendency to lurch backward all the way into recession."[vii]

US Unemployment Rate (U3)



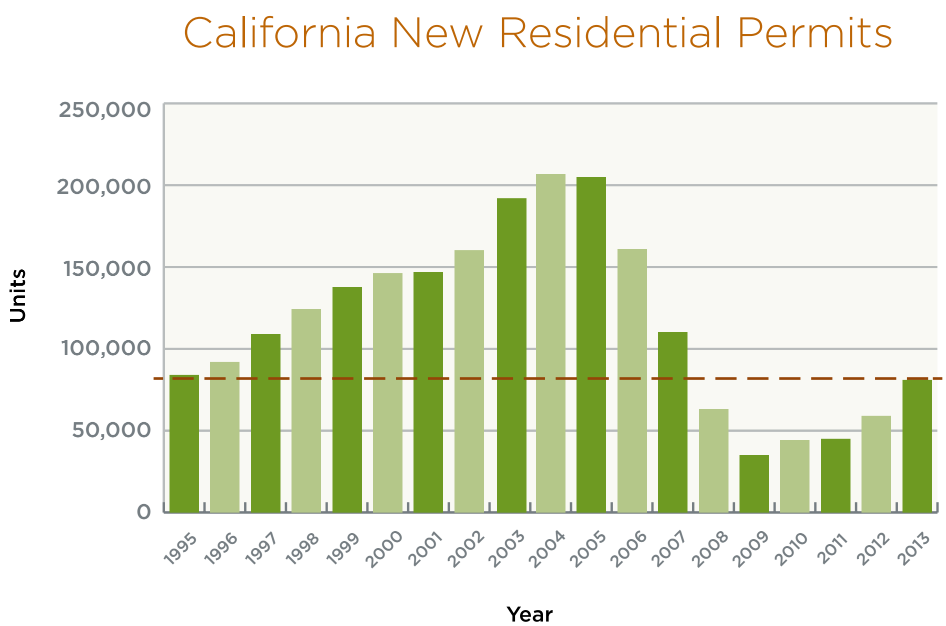
Other factors included in the UCLA Anderson Forecast that will drive growth in 2015 include housing, non-residential construction, and investment in equipment and software. On the housing front, despite the recovery being slower than anticipated, UCLA Anderson is forecasting housing starts to rise from 1.025 million units in 2014 to 1.32 million units in 2015, and 1.47 million units in 2016. According to the US Department of Housing and Urban Development (HUD), privately-owned housing starts in September 2014 were at a seasonally adjusted rate of 1.017 million, in line with the UCLA Anderson Forecast.[viii] However, according to the National Association of Realtors (NAR), current market conditions weakened across all property types in September 2014 compared to August 2014 at a time when the market typically perks up. According to NAR, "confidence about the outlook for the next six months also broadly weakened and is attributed to difficulties in obtaining a mortgage under tighter underwriting standards and the decreased supply of 'affordable' homes."[ix] Because of continued investment in domestic energy production and a revival in commercial construction, non-residential construction will start to rise rapidly in mid-2015. In 2016, investment in non-residential construction is forecast to expand at a robust 8.2 percent. Persistent strength in equipment and software spending will continue to buoy the economy.[x]

Additional macroeconomic data suggests that inflation is on the rise which is good for the broader economy, but is falling below the Federal Open Market Committee's (FOMC) long-run objective of 2 percent. According to the San Francisco Fed, "overall and core consumer prices, as measured by the price index for Personal Consumption Expenditures (PCE), rose 1.5 percent in August 2014 compared with a year earlier," but are being driven lower by falling commodity prices, particularly those in the energy sector.[xi] Nevertheless, the FOMC is projecting PCE inflation to increase by a range of 1.5 to 2.4 percent in 2015 and 1.6 to 2.1 percent in 2016. Regarding interest rates, the FOMC has signaled that due to the improving labor market and rising inflation, the Fed will begin raising interest rates at its March 2015 FOMC meeting. Thereafter, according to the UCLA Anderson Forecast, the Fed will continue to increase the Federal Funds Rate to about 3 percent by the end of 2016.[xii]

California Dreaming

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us," wrote Charles Dickens in his acclaimed tome *A Tale of Two Cities*. Much can be said about the state of California's economy as well—depending upon where you live. As a whole, California's economy has out-performed the nation in terms of job growth and production. According to the Bureau of Labor Statistics (BLS), California's unemployment rate (U3) dropped from 9.0 percent in July 2013 to 7.4 percent in July 2014, exceeding the UCLA Anderson Forecast (2013) by nearly a full percentage point (8.2 percent). California's Gross State Product (GSP) grew at annualized rate of 2.0 percent in 2013[xiii] and is projected to grow by 2.1 percent for 2014. While the data suggests that a California comeback is in the offing, the distribution of growth among the state's regions remains uneven. It is not by happenstance that the state's two municipal bankruptcies, Stockton and San Bernardino, are located in interior regions while California's coastal communities are enjoying an economic renaissance.

Although the economic outlook for California is generally positive, according to the UCLA Anderson Forecast, even though the total number of jobs is now higher than ever before, the state remains below its potential in output and employment. California's personal income growth, after adjusting for inflation, is expected to grow by 4.4 percent in 2015 and 4.6 percent in 2016.[xiv] California's new home permits, as shown in the following chart, continue to bounce back from their 2009 recessionary lows, showing continued improvement in new home construction, but are far below their pre-recession levels. For 2013, new residential permits were roughly equal to 1995 levels. According to the Zillow Home Value Index, "the median home value in California is $430,700. California home values have gone up 11.5 percent over the past year (August 2013 to August 2014), and Zillow predicts they will rise 5.8 percent within the next year. The median price of homes currently listed in California is $424,900 while the median price of homes sold is $409,550. The median rent price in California is $1,895."[xv]



Looking forward, while there are many facets of California's economy that are encouraging, it is important to be cognizant of downside risks to California's economy. The UCLA Anderson Forecast cites a host of new labor, healthcare, and environmental related policies that could become a drag on the state's growth. In addition, the housing market, although showing strength, has been slow to takeoff despite rising occupancy and rental rates, and is largely attributable to the lack of housing supply as previously mentioned. According to the UCLA Anderson Forecast, "though these risks exist, the fundamentals of California [and the United States] suggest that the most likely evolution of California's economy is one of more of the same—slow, steady, and unexceptional growth."[xvi]

Palo Alto Possible

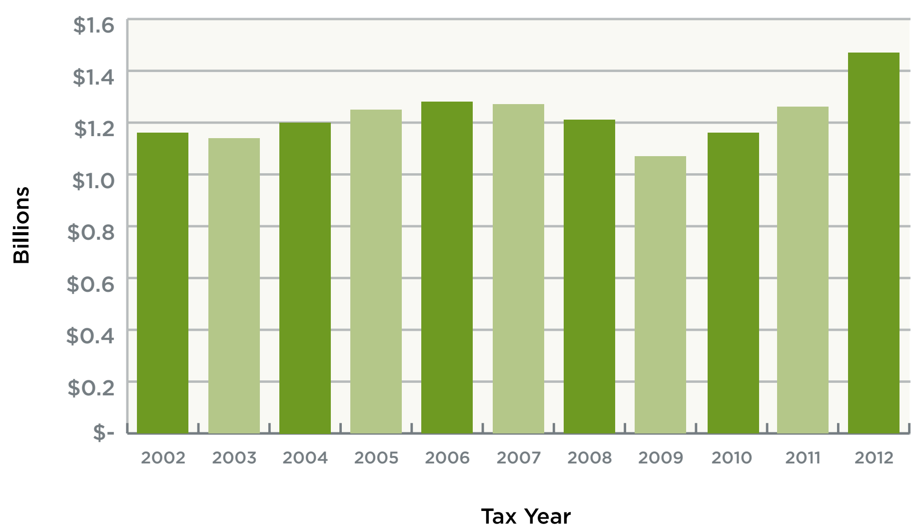
In 2010, the Knight Foundation, an organization dedicated to supporting transformational ideas that promote quality journalism, advance media innovation, engage communities, and foster the arts, teamed up with Gallup polling to survey 43,000 people in 26 cities to answer two very important questions: what makes a community a desirable place to live and what draws people to stake their future in it?[xvii] "The study found that the most important factors that create emotional bonds between people and their community were not jobs and the economy, but rather 'physical beauty, opportunities for socializing, and a city's openness to all people' that made the difference."[xviii] While many of Palo Alto's traditional economic indicators of growth and prosperity—which are highlighted below—continue to shine, the future for our City should also include those factors that provide Palo Alto residents, businesses, and visitors with a community of enduring value. Viewed through that lens, the outlook for Palo Alto is exceptional.

This year, the City launched *Our Palo Alto*, a comprehensive outreach effort that is designed to build civic capacity and community engagement. It is organized into three main areas:

- **Ideas:** creating opportunities for community conversations beyond City Hall in new and creative ways.
- **Action:** continuing work on important issues that impact the community such as traffic and parking.
- **Design:** the update of our Comprehensive Plan, the land use blueprint for the City.

Our Palo Alto is intended to have a long lasting impact by generating civic conversations across our community, in neighborhoods, businesses, community centers, and schools. Our hope is that these conversations will bring people together, to deepen understanding, and to expand the voices that actively participate in our community life and shape the civic decisions of the City.

Taxable Retail & Food Services Sales



In a more traditional sense, most economic indicators point to an improving business environment in Palo Alto. The unemployment rate (U3) in Palo Alto ticked up slightly in July 2014 to 3.1 percent, up from 2.8 percent in June 2014, but down from the July 2013 rate of 3.8 percent and the recessionary high of 6.3 percent in July 2009.[xix] According to the California Board of Equalization (BOE), total taxable retail and food service sales in Palo Alto totaled $1.47 billion in 2012, surpassing the pre-recession high of $1.28 billion in 2006.[xx] Adjusted for inflation, the 2006 figure totals approximately $1.462 billion in 2012 dollars which is slightly lower than BOEs total for that year, suggesting that Palo Alto retail and service sales outperformed expectations, albeit slightly. Finally, home values in Palo Alto continue to reach new highs. According to the Zillow Home Value Index, “the median home value in Palo Alto is $2.02 million. Palo Alto home values have gone up 12.1 percent over the past year (August 2013 to August 2014) and Zillow predicts they will rise 5.9 percent within the next year. The median rent price in Palo Alto is $3,671 which is higher than the San Jose Metro median of $2,750.”[xxi]

GENERAL FUND LONG RANGE FINANCIAL FORECAST

The FY 2016-2025 General Fund LRFF projects a General Fund surplus of $0.5 million for FY 2016. During this forecast period, the operating margin (shortfalls and surpluses) ranges between negative $0.2 million in FY 2017 and $3.4 million in FY 2025 with an approximate cumulative one-time net surplus of $15.9 million (see table on next page).

In accordance with City Council policy, the General Fund Budget Stabilization Reserve (BSR) is maintained at the range of 15 to 20 percent of General Fund operating expenditures, with a target of 18.5 percent. Based on the 18.5 percent target, the BSR would have to increase from $33.1 million in FY 2016 to $44.7 million in FY 2025. Over the Forecast period, $11.6 million would have to be set aside to achieve the 18.5 percent BSR target by FY 2025, reducing the net one-time resources projected in this Forecast from $17.2 million to $5.6 million.

The operating margin reflects the variance between the projected General Fund revenues and expenditures for each year of the forecast or the annual surplus or deficit. With the operating margin, the year over year change in surpluses and deficits, it is assumed that each shortfall is addressed completely with ongoing solutions in the year it appears and that each surplus is completely expended with ongoing expenditures. During the Forecast period, the net operating margin fluctuates between negative $0.2 million and positive $1.1 million. Although this Forecast projects healthy revenue growth, the revenue growth is barely keeping pace with the projected expenditure growth. Further, the City Council approved Infrastructure Plan is not yet fully funded and does not contain any contingency for higher land acquisition or construction costs; and based on the latest valuation reports, the City's pension and retiree healthcare trust funds have a combined unfunded liability in the amount of $439.1 million.

Base Long Range Financial Forecast

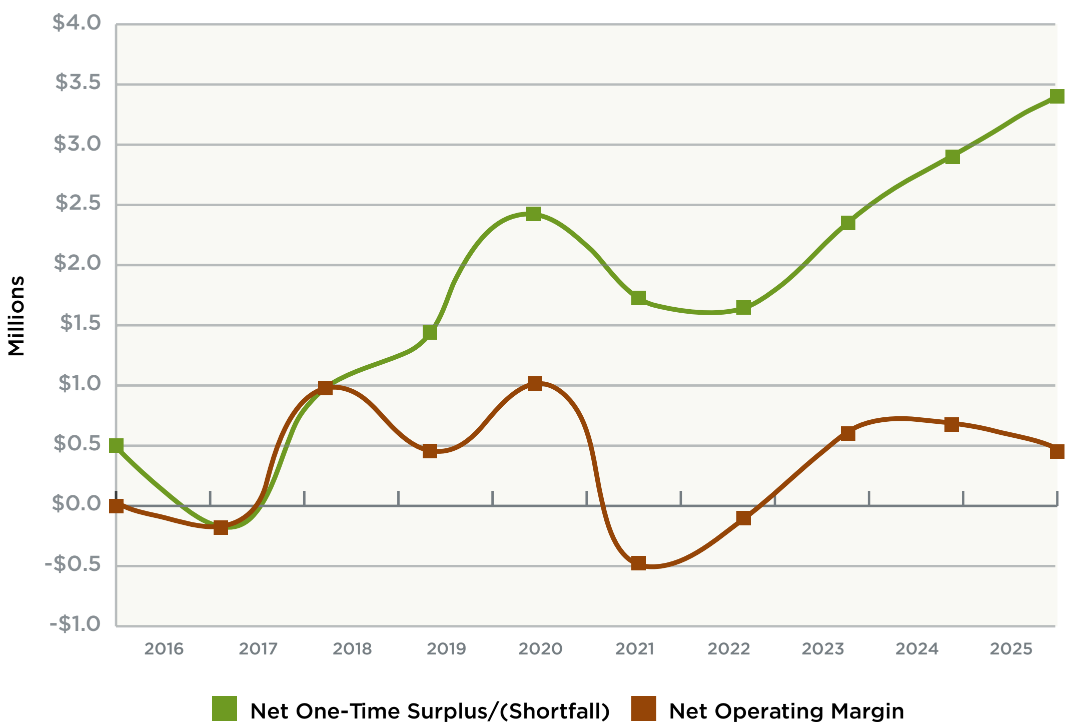
Fiscal Year 2016-2025

	Adopted 2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Total Revenue	$171,084	$179,637	$186,961	$194,498	$201,233	$208,234	$214,408	$221,070	$228,864	$236,926	$245,129
Total Expenditures	$171,084	$179,155	$187,142	$193,437	$199,825	$205,896	$212,624	$219,358	$226,567	$234,032	$241,765
Net One-Time Surplus/(Shortfall)	$0	$482	($180)	$1,061	$1,408	$2,408	$1,784	$1,712	$2,297	$2,894	$3,364
Cumulative Net Operating Margin (One-Time)											**$17,231**
Net Operating Margin		$0	($180)	$1,061	$347	$1,000	($625)	($72)	$585	$597	$470
Cumulative Net Operating Margin											**$3,185**

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

The graph below provides a representation of the operating and net operating margin of the base model as described above.

General Fund Operating Margin



It should be noted that this Forecast, as outlined in the following sections of this report, does not include the following potential impacts to the FY 2016 Projected Budget and the out-years of the Forecast:

1. **Labor negotiations:** The City is currently in negotiations with the Palo Alto Police Officers Association (PAPOA) and the International Fire Fighters Association (IAFF). Any

agreements reached between the City's bargaining units and the City will be incorporated into future budgets and forecasts, as applicable.

2. **Cadillac Healthcare Federal Excise Tax:** Beginning 2018, a 40 percent excise tax will be imposed on the value of health insurance benefits that exceed a certain threshold. It is expected that this tax will be included in the cost of the health care premiums. CalPERS plans to design healthcare premiums to stay below the threshold and discussions are in the preliminary stage.
3. **Foothill College Cubberley Lease:** In November 2014, the City Council authorized extension of the lease between the City and the Palo Alto Unified School District (PAUSD) at the Cubberley Community Center site for an additional five years and to update the financial terms to eliminate the Covenant Not to Develop (approximately $1.9 million annually) and reallocate these funds to the capital investment of the Center's aging infrastructure. Foothill College represents a significant portion of the current tenant lease income (approximately $1.0 million annually) of the site and the College is planning to move operations currently housed at Cubberley to a new Sunnyvale campus. Although the forecast assumes the investment in the Center's infrastructure, the Forecast does not assume lost revenue from Foothill College relocating to a new campus. Per the lease agreement with the school district, any loss in lease revenue from Foothill College will be equally shared between the City and PAUSD.
4. **Acquisition of the downtown Palo Alto Post Office:** The City may acquire the downtown Palo Alto Post Office with the plan to relocate staff from leased facilities. The acquisition would be financed through issuance of debt with the annual debt service paid through lease cost savings. If the Palo Alto Post Office is acquired, it would require substantial improvements while the City pays the annual debt service, and during that time the City would also have to continue paying for leasing existing facilities. Staff is reviewing potential strategies that would reduce the impact to the General Fund in the short-term.
5. **Fire Services Contract with Stanford University:** The term of the fire response service contract between the City and Stanford is through September 30, 2026; however, at Stanford's request, the two parties have been in negotiations over the past two years to restructure the contract. On October 8, 2013, the City received a Notice of Termination letter from Stanford with the intent to terminate the contract with the City no sooner than one year and no later than two years from the date of the notice. In order to plan for a possible termination of services, the City requested that Stanford inform the City of the final termination date at least three months in advance to allow for a structured potential reduction in force in the City's Fire Department. On November 20, 2013, Stanford issued a Request for Proposal (RFP) for Delivery of Fire Department Services for the campus, to which the City responded to by the submission deadline of January 31, 2014. This Forecast assumes the continuation of the contract, because staff believes that the City of Palo Alto is best suited to provide Fire Protection Services to Stanford. For FY 2016 the City is budgeted to receive approximately $8.4 million in revenue from Stanford for fire response services and emergency dispatch services.
6. **Radio Infrastructure Investment with the Silicon Valley Regional Interoperability Authority (SVRIA):** The SVRIA oversees a number of initiatives to enhance radio and data interoperability in Santa Clara County and the South Bay Region, and the most ambitious project is the build-out of the Silicon Valley Regional Communications System (SVRCS)

at an estimated cost of $35.5 million. It is envisioned that both public safety and local government users such as Public Works, City Utilities, and Park Rangers will migrate to this 700 MHz trunked radio system. In addition to a portion of the infrastructure costs, each participating agency will be responsible for the purchase of portable and mobile radios to replace their legacy UHF and VHF radios. If the City chooses to participate in the SVRCS project, the City's total proportional infrastructure costs are estimated to be $2.5 million, of which $1.65 million would be paid by the General Fund and the remainder by several enterprise funds. The radio replacement costs are estimated to be $1.1 million, of which $837,500 would be paid by the General Fund and the remainder by several enterprise funds. The total implementation cost to the General Fund would be $2.5 million, and the remaining $1.1 million would be paid by several Utilities and Public Works enterprise funds. Participation in this county-wide investment will be evaluated as part of future budget processes.

7. **In June 2014, the Infrastructure Plan was approved by the City Council and contains $125.8 million in projects recommended by the Infrastructure Committee.** However, even with the voter approved increase in the Transient Occupancy Tax, a funding gap of $7.5 million still exists and the plan does not include any contingencies for potentially higher land acquisition and construction costs. Starting with FY 2016, this Forecast assumes an additional transfer of $4.7 million annually for the estimated annual debt service cost as assumed in the Infrastructure Plan. Since it is not anticipated that debt will be issued until FY 2016 with the first debt service due in FY 2017, the additional transfer of $4.7 million to the Capital Fund will be allocated to address the Infrastructure Plan funding gap.
8. **During the last two years, the CalPERS Board approved actuarial mortality assumptions changes and lowered the assumed interest earnings assumption from 7.75% to 7.5%.** This Forecast does not include additional future changes to pension plan assumptions by CalPERS.However, the Forecast does include continuous incremental pension cost increases for the Forecast period.
9. **Infrastructure Plan operating budget impacts:** In June 2014, the City Council approved the Infrastructure Project Funding Proposal which includes $125.8 million in projects recommended by the Infrastructure Committee. This Forecast does not assume ongoing operating impacts as a result of the Infrastructure Plan. Future forecasts will include operating cost impacts as the specific projects are designed.
10. **Changes in the local, regional, and national economy:** This Forecast assumes a steadily growing local economy. Any changes may have positive or negative impacts on economically sensitive revenues such as Sales Tax and the Transient Occupancy Tax.

At this time, staff projects a $4.3 million General Fund budget surplus for FY 2015. This surplus assumes City Council authorized budget amendments to date and includes higher revenue estimates based on actual receipts in FY 2015 totaling $4.3 million, or a 4.7 percent increase over the Adopted Budget. This amount does not assume forthcoming recommendations to adjust revenues and does not include expenditure increases that may be recommended as part of the FY 2015 Midyear Budget Review.

Compared to FY 2015 Projected Budget, in FY 2016, the upward revenue trend continues with a $3.0 million, or 3.1 percent, tax revenue increase. This revenue increase, together with a $1.0 million contribution from the Golf Course Operating Loss Reserve, significantly offsets the $3.9 million, or 3.6 percent, increase in salary and benefits. Please note that the City Council established the Golf Course Operating Loss Reserve in the amount of $0.6 million in August 2014. As part of the FY 2015 Midyear Budget Review, staff will bring forward a recommendation to increase the reserve amount by approximately $0.4 million to $1.0 million. It is anticipated that the one-time FY 2016 decrease in revenues due to the Golf Course closure is $1.0 million.

A $0.2 million budget shortfall is expected in FY 2017. This shortfall is driven by lower estimates for Utilities Users' Tax as explained in the revenue section of this report and a net $1.2 million increase in operating costs due to the reopening of the Golf Course.

The next section of the report discusses the analysis and assumptions of major revenue and expenditure categories. Consistent with the 2015-2024 LRFF, the methodology for calculating changes for out-years of the Forecast (FY 2017 to FY 2025) are based on a historical analysis of increases using the Compounded Annual Growth Rate (CAGR) with adjustments factored in for known items. Staff performed a reasonableness test of the results.

REVENUES

City of Palo Alto tax revenues turned in another solid performance in FY 2014. This trend is expected to continue into FY 2015 and FY 2016. The fundamental economic drivers of low unemployment, robust business activity, demand for residential and commercial property, and strong incomes in the Silicon Valley region are propelling tax receipts upward.

Long Range Financial Forecast

Fiscal Year 2016-2025

Revenue & Other Sources	Adopted 2015	Projected 2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Sales Taxes	$25,957	$29,238	$27,454	$28,333	$29,245	$30,199	$31,201	$32,250	$33,256	$34,280	$35,308	$36,332
Property Taxes	31,927	32,556	34,343	36,270	38,313	40,479	42,783	45,149	47,577	50,051	52,614	55,245
Transient Occupancy Tax	14,156	15,901	17,640	18,526	19,505	20,136	20,799	21,464	22,166	22,921	23,710	24,471
Documentary Transfer Tax	7,514	6,500	6,852	7,233	7,657	8,104	8,583	9,192	9,848	10,568	11,351	12,151
Utility Users Tax	11,285	10,895	11,805	12,054	12,503	12,926	13,343	13,666	14,034	14,416	14,812	15,229
Other Taxes and Fines	2,164	2,164	2,165	2,222	2,279	2,339	2,399	2,462	2,526	2,591	2,659	2,728
Subtotal: Taxes	93,003	97,254	100,259	104,638	109,502	114,183	119,108	124,183	129,407	134,827	140,454	146,156
Charges for Services	14,814	15,931	15,356	17,793	18,957	19,462	19,978	20,507	21,042	21,590	22,153	22,730
Stanford Fire & Dispatch Services	8,199	8,199	8,402	8,621	8,845	9,075	9,311	9,553	9,801	10,056	10,318	10,586
Permits and Licenses	7,804	7,738	8,005	8,213	8,427	8,646	8,871	9,101	9,338	9,581	9,830	10,085
Return on Investments	685	877	894	912	931	952	973	996	1,020	1,049	1,081	1,115
Rental Income	14,254	14,230	14,288	14,528	14,746	14,972	15,242	14,348	13,819	14,169	14,528	14,896
From Other Agencies	453	453	333	337	341	345	349	354	358	363	367	372
Charges to Other Funds	10,647	10,647	10,997	11,282	11,575	11,876	12,184	12,500	12,824	13,157	13,498	13,849
Other Revenue	1,060	1,289	1,508	1,562	1,602	1,643	1,686	1,729	1,774	1,820	1,867	1,916
Total Non-Tax Revenue	57,916	59,364	59,783	63,248	65,424	66,971	68,594	69,088	69,976	71,785	73,642	75,549
Operating Transfers-In	18,433	18,528	18,592	19,076	19,572	20,080	20,602	21,138	21,688	22,252	22,830	23,424
BSR Contribution (One-Time)	1,732	1,732										
Golf Operating Loss Reserve Liquidation			1,004									
Total Source of Funds	**$171,084**	**$176,878**	**$179,637**	**$186,962**	**$194,498**	**$201,233**	**$208,304**	**$214,408**	**$221,070**	**$228,864**	**$236,926**	**$245,129**

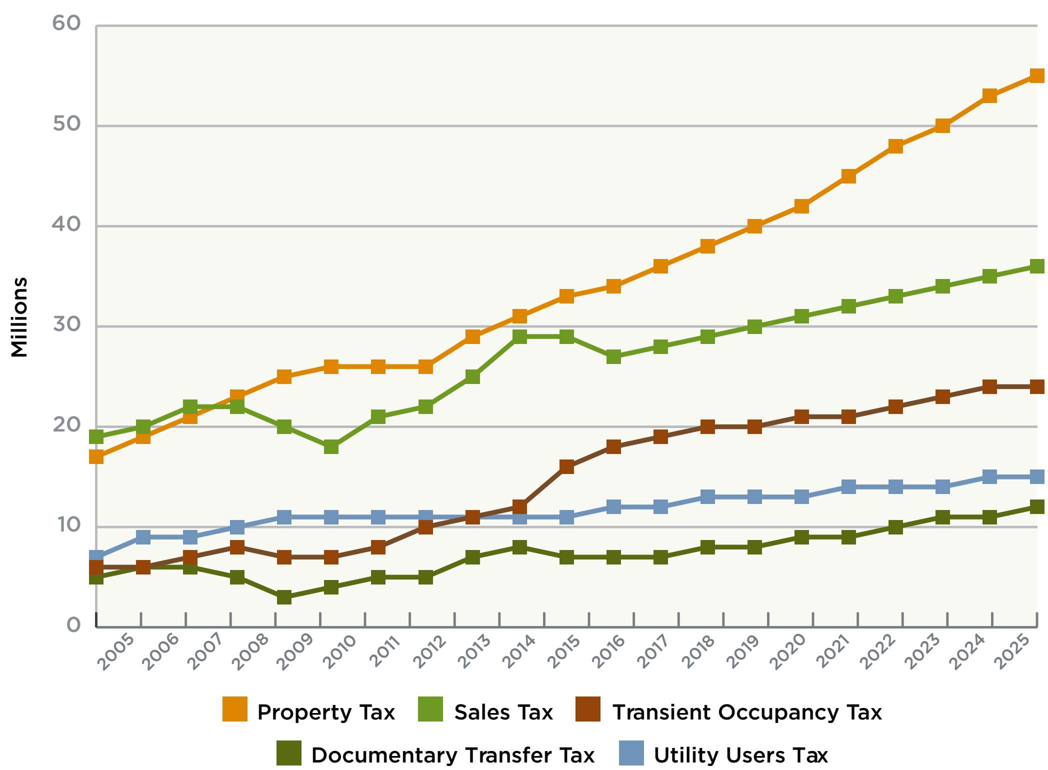
Revenue & Other Sources	Adopted 2015	Projected 2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Sales Taxes	-11.8%	12.6%	5.8%	3.2%	3.2%	3.3%	3.3%	3.4%	3.1%	3.1%	3.0%	2.9%
Property Taxes	4.4%	2.0%	7.6%	5.6%	5.6%	5.7%	5.7%	5.5%	5.4%	5.2%	5.1%	5.0%
Transient Occupancy Tax	15.5%	12.3%	24.6%	5.0%	5.3%	3.2%	3.3%	3.2%	3.3%	3.4%	3.4%	3.2%
Documentary Transfer Tax	-7.7%	-13.5%	-8.8%	5.6%	5.9%	5.8%	5.9%	7.1%	7.1%	7.3%	7.4%	7.0%
Utility Users Tax	2.5%	-3.5%	4.6%	2.1%	3.7%	3.4%	3.2%	2.4%	2.7%	2.7%	2.7%	2.8%
Other Taxes and Fines	1.4%	0.0%	0.1%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Subtotal: Taxes	-0.6%	4.6%	7.8%	4.4%	4.6%	4.3%	4.3%	4.3%	4.2%	4.2%	4.2%	4.1%
Charges for Services	-10.9%	7.5%	3.7%	15.9%	6.5%	2.7%	2.7%	2.6%	2.6%	2.6%	2.6%	2.6%
Stanford Fire & Dispatch Services	11.4%	0.0%	2.5%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Permits and Licenses	13.4%	-0.8%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Return on Investments	-44.1%	28.0%	30.5%	2.0%	2.1%	2.3%	2.2%	2.4%	2.4%	2.8%	3.1%	3.1%
Rental Income	1.2%	-0.2%	0.2%	1.7%	1.5%	1.5%	1.8%	-5.9%	-3.7%	2.5%	2.5%	2.5%
From Other Agencies	-50.8%	0.0%	-26.6%	1.2%	1.2%	1.2%	1.3%	1.3%	1.3%	1.3%	1.3%	1.3%
Charges to Other Funds	-3.3%	0.0%	3.3%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Other Revenue	-11.1%	21.6%	42.2%	3.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Total Non-Tax Revenue	-2.3%	2.5%	3.2%	5.8%	3.4%	2.4%	2.4%	0.7%	1.3%	2.6%	2.6%	2.6%
Operating Transfers-In	-7.5%	-7.5%	0.9%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
BSR Contribution (One-Time)		0.0%	-100.0%									
Golf Operating Loss Reserve Liquidation				-100.0%								
Total Source of Funds	**-1.0%**	**3.4%**	**1.6%**	**4.1%**	**4.0%**	**3.5%**	**3.5%**	**2.9%**	**3.1%**	**3.5%**	**3.5%**	**3.5%**

The tables above highlight the annual revenue estimates and year over year increases for this Forecast. Compared to FY 2015 projected, FY 2016 revenues are estimated to increase by $2.8 million, or approximately 1.6 percent. This includes $1.0 million in one-time sources set aside in FY 2015 for the Golf Course Operating Loss Reserve. Excluding one-time sources, ongoing revenues in FY 2016 are estimated to increase by $3.5 million, or 2.0 percent, from FY 2015 yearend projections. Based on the economic analysis presented in the previous section of this report, revenue estimates, which are primarily linked to the performance of the regional and local economy, are reflective of increased consumer spending, continued rise in home prices, and the opening of hotels. The upward trend of the City's tax revenues is expected to continue over the next 10 years. These tax revenues have significantly improved since the beginning of the Great Recession. The table above illustrates the steady growth projected for the General Fund's revenue streams, by percentage, from FY 2016 through FY 2025.

During the 2013 Finance Committee discussions, it was recommended that staff consider use of a historical annual growth rate derived for each tax revenue source to project future revenue streams. This methodology was used in the final forecast presented for FY 2015 to 2024 and has been used in this forecast as well. The Compound Annual Growth Rates (CAGR) utilized in this Forecast is cited in each revenue section.

It is worth noting that in past forecasts a recession and fall-off in economically sensitive revenues was assumed once every nine years. While it is not staffs' intent to predict the exact timing of the recession, its inclusion in the forecast is to send a signal that a cyclical event, whereby revenues can drop dramatically, will inevitably occur. By using the historical average growth rate that incorporates the up and down cycles over the past 10 or 20 years, there is no single year in which a downturn is depicted. Instead, past downturns (e.g. dot-com bust and Great Recession) are factored into the compound growth rate used to forecast future revenue streams.

Top Five General Fund Tax Revenues



The graph above depicts a historical and projected view of the five major General Fund tax revenues. It includes 10 years of actual revenue history; the projections for the remainder of FY 2015 based on actual data available for the first five months of the fiscal year; as well as the projections for FY 2016 and the subsequent years of the Forecast, based on current available data and application of the CAGR methodology. The following section is a detailed discussion of General Fund Tax revenue and other major revenue sources by category.

Sales Tax

Sales taxes have rebounded from a low of $17.9 million in FY 2010 to a new high of $29.4 million in FY 2014. Results in FY 2014 are a consequence of one-time, exceptional receipts from a single vendor. The FY 2015 projected figure is due to a planned adjustment of the sales tax accrual period, which was discussed with the Finance Committee as part of the approval of the FY 2014 Comprehensive Annual Financial Report. The FY 2016 projection then returns the General Fund to a more representative level.

TABLE 1: SALES TAX REVENUE BY FISCAL YEAR

(MILLIONS)

Fiscal Year	2011	2012	2013	2014	2015[1]	2016[2]
Revenue	$22.6	$22.0	$25.6	$29.4	$29.2	$27.5

Sales tax revenue is showing continued positive growth. Restaurant and electronic sales are trending higher and auto sales in key, older dealerships are rising. The state has terminated its "triple flip" program so the City will receive more timely payments of its sales tax receipts. This primarily affects cash flow, but will result in slightly better interest earnings for the General Fund.

While overall sales tax revenue growth is continuing a positive trend from recessionary lows, there are some potential risks that could affect the current trend. First, the breakup of Hewlett Packard (HP) into two companies could potentially eliminate tax-generating segments of HP's business. The split is expected to occur next year. Recent news also indicates that Internet retail sales are anticipated to increase by over 15 percent (over prior year) during the critical holiday sales season. This trend will continue to exert downward pressure on sales tax growth, a key source that constitutes approximately 15 percent of General Fund revenue.

The CAGR applied to the period FY 2016 through FY 2025 is 2.8 percent which is in line with historical growth rates.

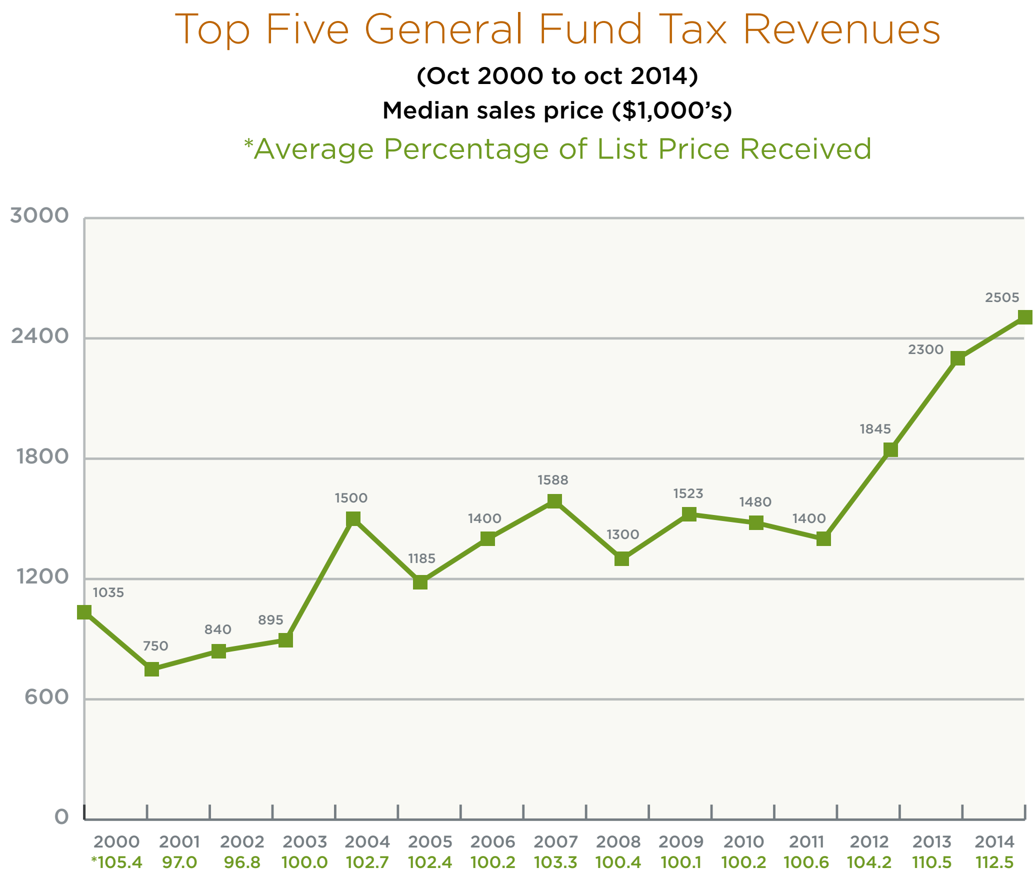
Property Tax

Since the end of the Great Recession, property values and revenues have risen at a strong rate. Beginning in FY 2013, receipts have risen by a robust $2.0 million each year. Contributing factors to this exceptional rise in property tax revenue include: single family home sales that have exceeded asking prices; a healthy commercial property market; and the unleashing of latent property values from the sale of long held homes that were "shielded" from assessed value appreciation by Proposition 13.

[1] Projections based on fiscal year-to-date results, expected growth, and potential risks.

[2] Revenues are expected to drop in Fiscal Year 2016 as a consequence of one-time receipts and accrual changes (per an outside audit recommendation) in Fiscal Year 2015

The following chart is taken from a realtor (Alain Pinel) web site. It depicts the astonishing takeoff in median Palo Alto home prices since Calendar Year 2011.



The City's property tax estimate for FY 2015 is based on information received from quarterly meetings with the Santa Clara County Assessor's Office. The estimate includes appeals on record with the Assessor's Office, additions to the roll, and movements in assessed values. Projections beyond FY 2015 are based on historical growth rates. The CAGR used in this 10 year forecast equals 5.4 percent.

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

TABLE 2: PROPERTY TAX REVENUE BY FISCAL YEAR

(MILLIONS)

Fiscal Year	2011	2012	2013	2014	2015[3]	2016
Revenue	$25.7	$26.5	$28.7	$30.6	$32.6	$34.3

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

- There are 8,600 residential properties in Palo Alto under $600,000 in Assessed Value. These properties turn over at a rate of 570 annually.
- Approximately 3 percent of residential parcels will increase in Assessed Value by an average 63 percent. All other properties will increase by the historical average of 7 percent.
- Per the 2013-201414 Assessor's Roll, average Assessed Value of residential properties in Palo Alto equal $944,000.

Transient Occupancy Tax (TOT)

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

TABLE 3: TRANSIENT OCCUPANCY TAX BY FISCAL YEAR

(MILLIONS)

Fiscal Year	2011	2012	2013	2014	2015[4]	2016
Revenue (millions)	$8.1	$9.7	$10.8	$12.3	$15.9	$17.6
Average Daily Room Rate	$147	$165	$182	$208	$198	n/a
Average Occupancy (percent)	73%	79%	80%	79%	84%	n/a

[3] Projected revenue based on county year to date data and trends.
[4] Projected revenue based on trend and Fiscal Year 2015 year to date data. Average Daily Room Rate and Occupancy are year-to-date through October 2014.

This forecast includes estimated revenues for all of the new hotels built, being constructed, or planned in the City. The Epiphany has opened and it is expected that two Hilton hotels will open towards the end of FY 2015. The Westin Annex and a new hotel on the Ming's restaurant site are not expected to open until FY 2017. The voter approved TOT rate increase from 12 to 14 percent will take effect on January 1, 2015 and is expected to generate approximately $2.7 million in revenue in FY 2016. This forecast includes revenue from new hotels and the 2 percent TOT rate increase and a corresponding $4.7 million transfer to infrastructure to support the Infrastructure Plan that was recently adopted by Council.

The CAGR applied to the period FY 2016 through FY 2025 is 4.4 percent which is in line with historical growth rates.

Documentary Transfer Tax (DTT)

The Documentary Transfer Tax continued to outperform expectations by reaching $8.1 million in FY 2014 as compared to an average of $5.6 million over the prior three fiscal years. This average was affected by the Great Recession and likely caused a burst of property transactions (due to improving prices and low interest rates) in FY 2014. There were an unusually high number of high value commercial property sales in FY 2014.

TABLE 4: DOCUMENTARY TRANSFER TAX BY FISCAL YEAR

(MILLIONS)

Fiscal Year	2011	2012	2013	2014	2015[5]	2016
Revenue	$5.2	$4.8	$6.8	$8.1	$6.5	$6.9

Through October 2014, Documentary Transfer Tax receipts are running 40 percent below the prior year period. As a result, the Forecast includes lower expectations for FY 2015. As stated in prior forecasts, this revenue source is somewhat unpredictable given that the volume and mix of commercial and residential transactions can vary significantly from year to year. The CAGR applied to the period FY 2016 through FY 2025 is 6.5 percent.

Utility Users Tax (UUT)

The Utility Users Tax forecast incorporates two changes approved by voters in November 2014. The telephone UUT rate has been reduced from 5.0 percent to 4.75 percent and the large utility user discount (which stepped down tax rates for water, gas, and electric usage) was eliminated.

These changes will be implemented in the next few months and according to state codes. On an annual basis, the changes will reduce telephone revenues by an estimated $0.16 million while ending the large utility user discount will raise utility related revenues by $0.55 million.

[5] Projected revenue based on county year to date data and trends.

Receipts anticipated from the UUT are based on the Utilities Department's five-year revenue and rate projections. These estimates could change as the department discusses its proposed rate plan with the Utilities Advisory Commission and the City Council during the annual budget process.

Telephone receipts went down slightly from FY 2013 to FY 2014 and a lower level is expected in FY 2015 based on the rate decrease. Unfortunately, there is little data available from telecommunications providers to offer more informed projections.

Other Taxes & Fines

Staff anticipates that revenues in this category will remain flat in FY 2016 at $2.2 million. The largest source of revenue in this category is derived from parking violations revenue, which staff estimates will also hold flat in FY 2016 at $1.7 million. Additional revenue in this category, such as traffic violations, administrative citations, and library fines and fees, are projected to grow annually by 2.6 percent over the 10 year forecast.

Charges for Services

For FY 2016, total one-time revenues in this category will decrease by $0.6 million or 3.6 percent to $15.4 million from a FY 2015 projection of $16.0 million. The decline is largely attributable to the Golf Course Reconfiguration Project (decrease of $1.0 million) which is scheduled to begin in the spring of 2015 and continue through FY 2016. It is important to note that the one-time revenue decrease from the Golf Course closure is scheduled to be offset with the liquidation of the Golf Course Operating Loss Reserve. In August 2014, the City Council established the Golf Course Operating Loss Reserve in the amount of $0.6 million. As part of the FY 2015 Midyear Budget Review, staff will bring forward a recommendation to increase the reserve amount by approximately $0.4 million to $1 million.

Ongoing, this Forecast assumes a revenue increase of $0.3 million for Community Services Department classes and camps to align with historical trends. In addition, Charges for Services revenue was increased by 3.6 percent to account for general salary and benefit increase included in the Forecast. These figures do not include Charges for Services revenue for Stanford Fire & Dispatch which is explained in further detail below.

Stanford Fire & Dispatch Services

The City has two separate agreements with Stanford University to provide fire response services and emergency dispatch services. As part of these agreements, Stanford is charged 30.3 percent of the Fire Department's net cost and 16 percent of the Police Department's Communication and Dispatch Division to reimburse the City for Stanford's proportional share of these services. The FY 2016 Forecast assumes a reimbursement of $8.4 million, which is a 3.5 percent increase from the FY 2015 adopted amount of $8.1 million.

The term of the fire response service contract between the City and Stanford is through

September 30, 2026; however, at Stanford's request, the two parties have been in negotiations over the past two years to restructure the contract. On October 8, 2013, the City received a Notice of Termination letter from Stanford with the intention to terminate the contract with the City no sooner than one year and no later than two years from the date of the notice. In order to plan for a possible termination of services, the City requested that Stanford inform the City of the final termination date at least three months in advance to allow for a structured potential reduction in force in the City's Fire Department. On November 20, 2013, Stanford issued a Request for Proposal (RFP) for Delivery of Fire Department Services for the campus, which the City responded to by the submission deadline of January 31, 2014. The FY 2016 Forecast assumes the continuation of the contract, because staff believes that the City of Palo Alto is best suited to provide Fire Protection Services to Stanford. A modest annual increase of 2.6 percent has been built into the outer years to account for increasing salary and benefit costs based on currently available information.

Permits and Licenses

Revenue from permits and licenses has experienced consistent growth over the past several years, primarily due to increased development activity around Palo Alto. Based on year-to-date estimates, FY 2015 revenues are projected to decrease by 0.8 percent from the adopted budget revenue estimate. Staff fully anticipates meeting or exceeding FY 2015 revenue estimates for this category based upon current activity levels. In FY 2016, revenues in this category are expected to increase by an additional $0.3 million, or 3.5 percent, from the FY 2015 projected level. The Planning and Community Environment and Development Services departments are currently undertaking a fee study to review the appropriateness of planning and development fees. Staff is expecting the study to be concluded in early 2015 and will evaluate changes in planning and development fees and corresponding revenue estimates as part of the FY 2016 budget process.

Return on Investment

Interest earnings continue to be depressed as a consequence of the Federal Reserve's loose monetary and interest policies. Expectations for earnings from investments are around $0.9 million which is a 1.9 percent increase from FY 2015 yearend projections.

Rental Income

The largest source of rental income comes from the City's Enterprise Funds and the Cubberley Community Center. Compared to the FY 2015 Adopted Budget, rental income will remain flat at $14.3 million. An appraisal of all General Fund properties that may result in additional rental income will be completed in January 2015. For this forecast period, starting with FY 2017, a 2.6 percent growth was assumed for all rental properties, except for the Refuse Fund rent which is assumed until FY 2021 as approved by the City Council to account for the closing costs related to the Middlefield Well landfill site.

Revenue from Other Agencies

Included in this category is funding from Community Services Outreach theatre programs, reimbursements from the Palo Alto Unified School District (PAUSD) for School Resource Officers, and state and federal grants, if received. Many of these revenue streams are difficult to predict and are dedicated often to specific purposes. In this category revenues over the past five fiscal years have ranged from $0.1 million to $0.4 million. This forecast assumes $0.3 million for FY 2016 with a growth rate of 1 percent in subsequent years due to the unpredictability of this funding source.

Charges to Other Funds

Approximately 87 percent of this category is General Fund administrative cost plan charges to the Enterprise and Internal Service Funds. The FY 2016 projected amount is $11.0 million, an increase of 3.3 percent, from the FY 2015 Adopted Budget. The increase is primarily attributable to increased salary and benefit costs in the internal support departments. The forecast includes increases ranging between 2.6 to 3.6 percent each year based primarily on assumed increases in salary and benefit costs.

Other Revenues

Major revenue sources in this category are reimbursements for the Shuttle program (e.g. City of East Palo Alto), Animal Services charges to Los Altos and Los Altos Hills, reimbursements from PAUSD for its share of Cubberley and athletic field maintenance, donations from non-profits to City libraries, and miscellaneous revenues. Revenues for this category are estimated to increase by 17 percent in FY 2016, mostly due to $0.4 million in increased revenue from partner agencies for the Shuttle program. The FY 2016 projected revenue for this category is $1.5 million, with a 3.6 percent annual increase forecasted for FY 2017 and 2.6 percent annual increases through FY 2025.

Operating Transfers In

Operating Transfers In include the equity transfer from the Electric and Gas funds as well as transfers from the University Ave Parking Permit Fund. In accordance with a methodology approved by Council in June 2009, the equity transfer is calculated by applying a rate of return to the capital asset base of the Electric and Gas funds. This rate of return is based on PG&E’s rate of return on equity as approved by the California Public Utilities Commission (CPUC). The equity transfer from the Electric and Gas funds are projected to increase from $17.1 million in FY 2015 to $17.3 million in FY 2016. Using the Utility Department’s projections from the Electric and Gas Five Year Financial Forecasts, as approved by the City Council in spring 2014, the equity transfer is projected to increase slightly in FY 2016 (0.9 percent) and then increase annually by 2.6 percent over the rest of the forecast period. Overall Operating

Transfers are estimated to increase from a projected FY 2015 yearend estimate of $18.6 million to $19.1 million in FY 2016, a 0.5 percent increase year over year.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EXPENDITURES

As part of developing the FY 2016 Forecast expenditure budget, the General Fund expenditure categories have been adjusted by removing FY 2015 Adopted Budget one-time expenditures and updating major cost elements such as salary and benefits costs. The tables below display the General Fund expense forecast. Compared to FY 2015 projected, FY 2016 expenditures are estimated to increase by $6.7 million, or 3.9 percent, primarily due to increased salary and benefits, an increased transfer to infrastructure, and allocated charges costs from Enterprise Funds and Internal Service Funds.

Long Range Expenditure Forecast

Fiscal Year 2016-2025

Expenditures & Other Uses	Adopted 2015	Projected 2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Salary	$64,238	$64,188	$65,084	$67,156	$69,046	$70,807	$72,558	$74,339	$76,158	$78,024	$79,940	$81,909
Benefits	42,727	42,598	45,563	48,809	51,676	54,645	57,734	60,954	64,311	67,816	71,477	75,305
Subtotal: Salary & Benefits	106,965	106,786	110,647	115,965	120,723	125,453	130,292	135,294	140,469	145,840	151,417	157,214
Contract Services	16,028	17,496	14,261	15,338	15,660	16,061	16,449	16,846	17,282	17,731	18,191	18,662
Supplies & Material	3,433	3,475	3,464	3,554	3,646	3,740	3,837	3,936	4,038	4,143	4,251	4,362
General Expense	5,058	5,069	4,727	4,829	4,934	5,041	5,151	5,265	5,380	5,500	5,621	5,747
Cubberley Lease	6,446	6,446	5,736	5,908	6,085	6,268	6,446	6,649	6,849	7,054	7,266	7,484
Debt Service	428	428	431	432	432	431	-	-	-	-	-	-
Rents & Leases	1,356	1,365	1,391	1,427	1,464	1,502	1,541	1,581	1,622	1,664	1,708	1,752
Facilities & Equipment	556	556	486	499	512	525	539	553	567	582	597	613
Allocated Charges	15,080	15,047	15,589	15,883	16,294	16,721	17,159	17,609	18,067	18,537	19,019	19,513
Total Non Sal/Ben Before Transfers	48,385	49,882	46,085	47,870	49,027	50,290	51,121	52,438	53,807	55,211	56,653	58,133
Operating Transfers-Out	2,076	2,276	3,735	4,281	4,315	4,355	4,390	4,425	4,232	4,272	4,312	4,354
Transfer to Infrastructure	13,659	13,659	18,688	19,026	19,372	19,728	20,093	20,467	20,851	21,245	21,649	22,063
Total Use of Funds	$171,084	$172,603	$179,155	$187,142	$193,437	$199,825	$205,896	$212,624	$219,358	$226,567	$234,032	$241,765

Expenditures & Other Uses	Adopted 2015	Projected 2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Salary	27.0%	-0.1%	1.4%	3.2%	2.8%	2.6%	2.5%	2.5%	2.4%	2.5%	2.5%	2.5%
Benefits	-11.6%	-0.3%	7.0%	7.1%	5.9%	5.7%	5.7%	5.6%	5.5%	5.4%	5.4%	5.4%
Subtotal: Salary & Benefits	8.1%	-0.2%	3.6%	4.8%	4.1%	3.9%	3.9%	3.8%	3.8%	3.8%	3.8%	3.8%
Contract Services	11.8%	9.2%	-18.5%	7.6%	2.1%	2.6%	2.4%	2.4%	2.6%	2.6%	2.6%	2.6%
Supplies & Material	-2.2%	1.2%	-0.3%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
General Expense	17.7%	0.2%	-6.8%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%
Cubberley Lease	-11.3%	0.0%	-11.0%	3.0%	3.0%	3.0%	2.8%	3.1%	3.0%	3.0%	3.0%	3.0%
Debt Service	84.5%	0.0%	0.7%	0.3%	0.0%	-0.3%	-100.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Rents & Leases	10.2%	0.7%	1.9%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Facilities & Equipment	23.0%	0.0%	-12.5%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Allocated Charges	-1.8%	-0.2%	3.6%	1.9%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Total Non Sal/Ben Before Transfers	3.6%	3.1%	-7.6%	3.9%	2.4%	2.6%	1.7%	2.6%	2.6%	2.6%	2.6%	2.6%
Operating Transfers-Out	54.0%	9.6%	64.1%	14.6%	0.8%	0.9%	0.8%	0.8%	-4.4%	0.9%	1.0%	1.0%
Transfer to Infrastructure	-20.7%	0.0%	36.8%	1.8%	1.8%	1.8%	1.8%	1.9%	1.9%	1.9%	1.9%	1.9%
Total Use of Funds	4.2%	0.9%	3.8%	4.5%	3.4%	3.3%	3.0%	3.3%	3.2%	3.3%	3.3%	3.3%

Salary and Benefits

The table above depicts the salaries and benefits costs for the next ten years. Over the Forecast period, the salaries and benefits cost gradually increase in comparison to the total expenditure budget. In FY 2016, salaries and benefits costs represent 62 percent of the expenditure budget; in FY 2025, the salaries and benefits cost represent 65 percent of the budget. In the same period, though, the benefits cost as a percentage of total salaries and benefits costs increase from 49 percent in FY 2016 to 55 percent in FY 2025. Over the Forecast period, salaries compounded growth is 26 percent versus a compounded growth in benefits costs of 59 percent. The following sections describe the assumed increases in salary and benefits costs and depict the reasons for the more rapidly increasing benefits versus salaries costs.

Salary

The Forecast is consistent with the City's change in salary budget methodology that was implemented as part of the FY 2015 Adopted Budget. As such, positions are budgeted at actual rate of pay including benefits as of fall 2014. Then, by position, salary costs are updated in accordance with applicable Memoranda of Understanding (MOU) between the City and its labor groups and the Management and Professional Personnel and Council Appointees Compensation Plan. The Forecast also assumes merit increases for Management and Professional employees as well as general salary increases for all labor groups consistent with the existing MOUs. Any other assumed general salary increases are assumed for planning purposes only and do not signify a commitment of future salary increases.

A majority of the programmed salary increases for FY 2016 were approved by the City Council, as any changes to employees' salaries and benefits are part of the meet-and-confer process with the City's labor groups. However, the City is currently in negotiations with the

Palo Alto Police Officers Association (PAPOA) and the International Association of Fire Fighters (IAFF), Local 1319. These pending negotiations with PAPOA and IAFF may impact the salary costs for the FY 2016 Budget. Any such impacts will be included, as necessary, in the development of the FY 2016 Proposed Budget, which is scheduled for release to the City Council late April/early May 2015.

Benefits

Pension

The forecast includes the pension rates from CalPERS as of the June 30, 2013 valuation for the City's Miscellaneous and Safety plans. As stated in these valuations (Attachments A and B), these valuations include the CalPERS approved actuarial mortality assumption changes; the smoothing and amortization policies as discussed with the Finance Committee in December 2013 (CMR 4310); as well as the initial set of employees who receive the Tier 3 or Public Employees' Pension Reform Act (PEPRA) pension benefit level. Further, per the valuations, the FY 2016-2017 rates, and thereafter, reflect the 18 percent investment return for FY 2014.

As shown in the table below, the FY 2016 pension contribution rates for the Miscellaneous and Safety plans increased from the current year. For the Miscellaneous Plan, the pension contribution rate increased by 1.6 percentage points from the FY 2015 rate of 26.1 percent to a FY 2016 rate of 27.7 percent. For the Safety Plan, the pension contribution rate increased by 2.4 percentage points from the FY 2015 rate of 39.5 percent to a FY 2016 rate of 41.9 percent. Per the attached valuations, the table below shows the pension contribution rates from FY 2016 through FY 2020. Thereafter, for the purpose of this Forecast, the pension contribution rates continue to escalate by 1.4 percent for the Miscellaneous Plan and 2.4 percent for the Safety Plan.

TABLE 5: PENSION RATES BY PLAN (FISCAL YEAR)

Pension Plans	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Miscellaneous	26.1%	27.7%	29.9%	31.4%	33.0%	34.6%	36.2%	37.8%	39.4%	41.0%	42.6%
Safety	39.5%	41.9%	45.1%	47.5%	49.9%	52.3%	54.7%	57.1%	59.5%	61.9%	64.3%

As indicated in the table on the next page, the unfunded pension liability and funding status for Miscellaneous and Safety (see pg. 6 of Miscellaneous and Safety Valuations for further detail) plans have improved slightly from the last valuation. For the Miscellaneous Plan, the unfunded liability was reduced by $12.3 million from $202.6 million to $190.3 million, and the funded ratio improved by 3.6 percentage points from 64.8 percent to 68.4 percent. Similarly, for the Safety Plan, the unfunded liability was reduced by $6.8 million from $112.0 million to $105.2 million, and the funded ratio improved by 3.1 percentage points from 65.8 percent to 68.9 percent. Despite these improvements, the cumulative unfunded liability for both pension plans amounts to $295.6 million and will require continuous higher pension payments to CalPERS during this Forecast and beyond.

TABLE 6: UNFUNDED PENSION LIABILITY BY PLAN

	Miscellaneous Plan		Safety Plan	
	June 30, 2012	June 30, 2013	June 30, 2012	June 30, 2013
1. Present Value of Projected Benefits	$662,770,685	$690,227,166	$382,313,961	$392,560,445
2. Normal Accrued Liability	$576,182,013	$602,540,178	$327,608,300	$338,666,499
3. Market Value of Assets	$373,592,926	$412,227,784	$215,605,457	$233,417,363
4. Unfunded Liability [(2) - (3)]	$202,589,087	$190,312,394	$112,002,843	$105,249,136
5. Funded Ratio [(3) / (2)]	64.8%	68.4%	65.8%	68.9%

Retiree Healthcare

This Forecast includes the Annual Required Contribution (ARC) per the May 2014 actuarial valuation based on information as of June 30, 2013, (accepted by the City Council on June 9, 2014) for the City's retiree healthcare plan. The City's total ARC is increasing approximately 3.4 percent annually; however, based on the valuation report, over the next 10 years the City's Retiree Healthcare fund is projected to move towards a "pay as you go" model instead of continuing to pre-fund future retiree healthcare needs due to increasing healthcare benefit payments to current and future retirees. As a result of this shift during the Forecast period, less of the ARC pays towards pre-funding future benefits and rather for benefits of current and future retirees.

The City's Retiree Healthcare Trust fund is administered by the California Employers' Retiree Benefit Trust, a division of CalPERS. As of August 31, 2014, the City's Retiree Healthcare funded ratio stands at 35.1% and the projected unfunded liability as of June 30, 2013 per the City's actuary is $143.6 million. Staff is evaluating an increase to the ARC with budget surpluses that become available as part of the closing of the annual budget in order to prefund the healthcare liability and increase the funded ratio.

Healthcare

As a result of the new labor agreement between the City and the Service Employees International Union (SEIU), the City's contribution towards the medical costs for SEIU employees changed from a 90 percent contribution from the City and a 10 percent contribution from the employee to a flat contribution from the City and the employee contributing towards the remaining medical plan premium. This change took effect in March 2014, and it will also be implemented for Management and Professional employees effective January 1, 2015. All other labor groups eligible for medical benefits will remain on the 90/10 contribution structure until new labor agreements are reached with the City and the affected bargaining groups. This Forecast assumes an annual health care cost inflator of 8 percent for the labor groups on the 90/10 medical benefit structure, and a 4 percent annual health care cost inflator for the labor groups on the flat rate contribution structure. Consistent with the previous forecast and with historical trends, the 2016-2025 LRFF assumes a 4 percent increase for dental and vision costs for outer years.

Contract Services

The FY 2015 Adopted Budget included $16.0 million to fund contract services of which approximately $2.8 million was for one-time items that include $1.0 million for a Cubberley Reserve; $1.0 million for a Shuttle Reserve, $0.4 million for the Our Palo Alto community engagement process; and $0.4 million for other activities such as a consultant led fee study for the Planning & Community Environment and Development Services departments and data analytic support for People Strategy & Operations. In addition, the FY 2015 Adopted Budget assumed that the Golf Course would be closed during the fiscal year; however, due to the delay in the Golf Course Reconfiguration project, the Golf Course is now scheduled to remain open through February 2015 resulting in additional contract expenses of $0.6 million. Additional City Council approved actions during the course of FY 2015 that are attributed to the 9.2 percent increase in year-end Contract Services projections from the adopted budget include $0.1 million for the Climate Action Plan and an additional $0.2 million for the East Palo Alto Shuttle Route, which was offset with revenue from the City of East Palo Alto. For FY 2016, the Forecast assumes that the Golf Course will be closed during the entire fiscal year and will resume operations in early FY 2017, adding an additional $0.8 million of contract services in FY 2017.

When adjusting for one-time expenditures included in the FY 2015 Adopted Budget, the FY 2016 base budget for Contract Services is $13.2 million. For the FY 2016 Forecast Budget year, $0.8 million has been added for additional Shuttle service expenses offset with revenue from the City of East Palo Alto as approved by the Council on June 23, 2014, in addition to $0.2 million for continued Transportation Management Authority development as approved by the Council in August 2014.

In the out years of the Forecast, 2.6 percent of annual growth for contract services is assumed. This is aligned to the 20 year historical average of the San Francisco Metropolitan Statistical Area Consumer Price Index – All Urban Consumers of 2.6 percent.

Supplies & Materials

The category for Supplies and Materials remains flat at $3.5 million in the FY 2016 Forecast Budget from the current year projection. For the out years of the Forecast, it is assumed that costs will increase based on the 2.6 percent annual CPI increase.

General Expense

This category includes costs for travel and meetings, telephone and non-city utilities, contingency accounts, subsidies and grants provided through the Human Resource Allocation Process, and debt service payments for the Master Lease-Purchase Agreement related to the Golf Course. In this category, the Forecast projects a 6.8 percent decrease from $5.0 million in FY 2015 to $4.7 million in FY 2016. The decrease is due to a reduction of $0.3 million in one-time election costs. For the remaining years of the forecast, this category assumes annual increases between 2.5 and 2.7 percent. These figures do not include General Expenses for the Cubberley Lease which is explained in further detail below.

Cubberley Lease

In the FY 2015 Adopted Budget, $6.4 million was appropriated for Cubberley Lease payments with an additional $1.0 million set-aside in reserve pending the outcome of lease negotiations with the Palo Alto Unified School District (PAUSD). As a result of negotiations with PAUSD, $1.9 million will be set-aside annually in a Cubberley Reserve Fund for future infrastructure improvements. As part of the lease agreement, the City Council approved creation of a fund for Cubberley infrastructure improvements. Therefore, the $1.9 million is classified as an Operating Transfer Out which is discussed in further detail below. With the Cubberley reserve funds set aside, the FY 2016 Forecast Budget includes $5.7 million for Cubberley Lease payments, up $0.2 million or 3.0 percent from FY 2015, but in accordance with the new lease agreement with PAUSD.

In accordance with the lease agreement, the Forecast assumes a 3.0 percent annual CPI increase for the lease payments to the Palo Alto Unified School District (PAUSD) for the Cubberley facility. Also, the lease agreement period is five years; however, for planning purposes in this Forecast, it is assumed that the agreement will continue during the Forecast period.

Rents & Leases

Rents and Lease expenses for FY 2016 are estimated to increase by $26,000 from the FY 2015 projected level of $1.3 million. The largest expense in this category is $1.0 million for the Development Services Center. From FY 2017 onwards, this expense is expected to increase by 2.6 percent per year.

Facilities & Equipment

Facilities and Equipment expenses for FY 2016 are projected to decrease by 12.5 percent, which is attributable to decreased Golf Course operating expenses; however, projected expenses in this category of $0.5 million will remain fairly consistent in FY 2016 and beyond. Consistent with the 20-year CPI for the San Francisco San Jose Metropolitan Statistical Area, the forecast assumes a 2.6 percent annual increase starting in FY 2017.

Allocated Charges

Allocated charges represent expense allocations by the City's enterprise and internal services funds for services and products they provide to General Fund departments. In FY 2016, these charges are estimated at $15.6 million including utilities usage (25.8 percent or $4.0 million), liability insurance (8.3 percent or $1.3 million), technology costs (36.5 percent, or $5.7 million), vehicle equipment and replacement costs (23.7 percent or $3.7 million), and other costs (5.7 percent, or $0.9 million). The FY 2016 charges of the forecast updates the revenue and expense for these cost plans based on the most current information available at the time of Forecast development. Growth of 2.6 percent is anticipated in the outer years, which is based on the average annual expense growth over the forecast period.

Operating Transfers Out

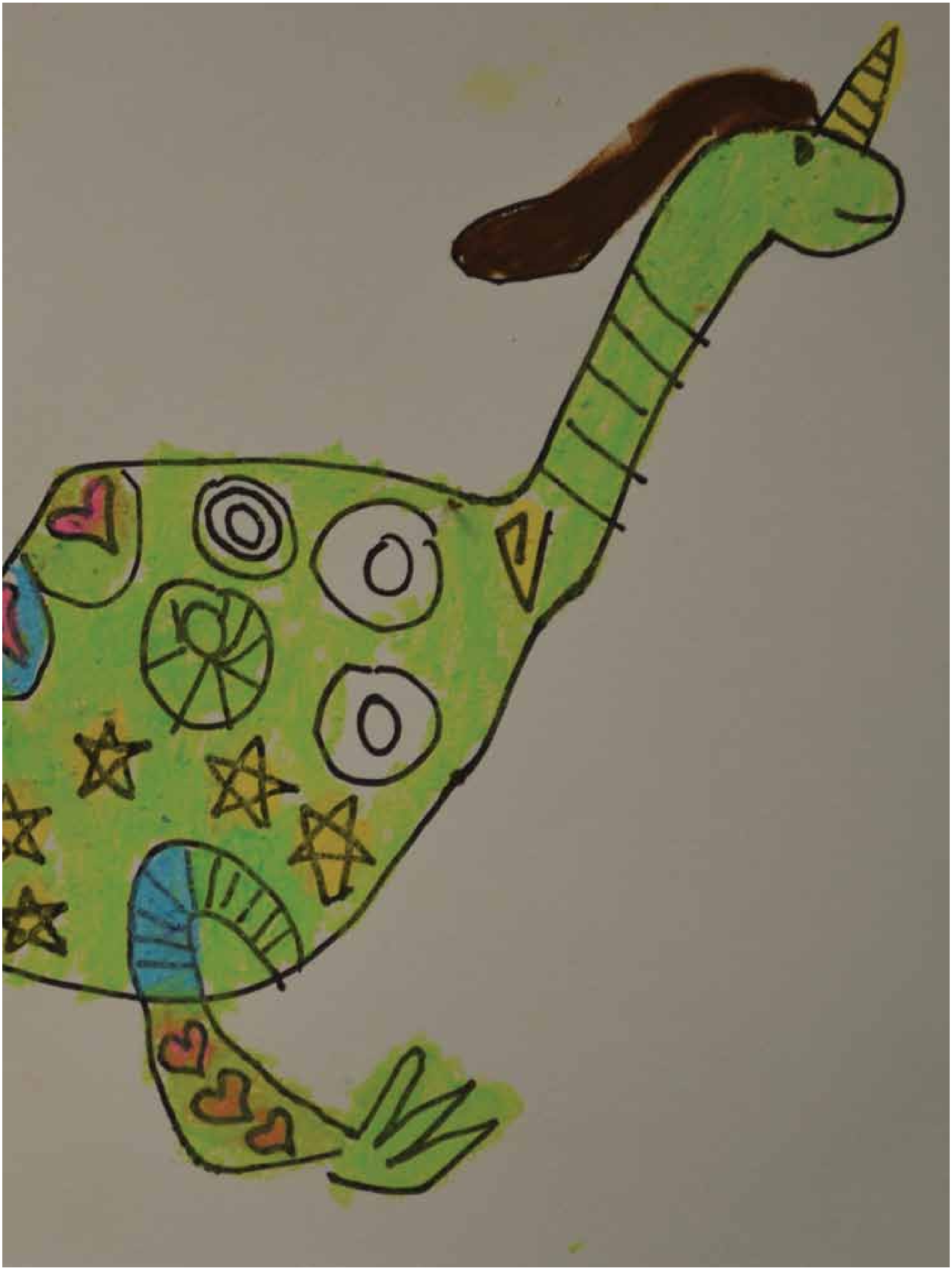
Operating Transfers Out include transfers from the General Fund to the Debt Service Fund, Technology Fund, and Airport Fund. Fiscal Year 2015 yearend projected transfers out total $2.3 million, an increase of $0.2 million compared to the FY 2015 Adopted Budget amount. The one-time increase in the amount transferred to the Airport Fund is for legal services related to the August 2014 takeover of the airport by the City from Santa Clara County. In FY 2016, a $1.5 million increase in this expense category is assumed due to operating transfers of $1.9 million for the Cubberley Infrastructure Fund offset with the elimination of one-time transfers.

In FY 2017, the anticipated issuance of debt related to the golf course reconfiguration will increase the total amount for the FY 2017 Forecast Budget by $0.5 million to $4.2 million.

A $0.3 million transfer to the Airport Fund from the General Fund is included in FY 2016 projected amounts, which represents the same figure assumed in the FY 2015 LRFF. While the City has taken over operations of the Airport from Santa Clara County, it is anticipated that the Airport Fund will have to rely on General Fund transfers to cover its operating expenses for a number of years. As such, this transfer continues throughout the Forecast.

Transfer to Infrastructure

In FY 2015, the adopted transfer to the Capital Project Fund is $13.7 million. The transfer for FY 2016 is significantly higher at $18.7 million. The increase is attributable to two factors. The primary driver of the increase is transfers associated with the City Council approved Infrastructure Plan. A significant portion of the plan was reliant upon increased Transient Occupancy Tax (TOT) receipts, both from the addition of new hotels in Palo Alto, as well as a two percent increase in the tax (from twelve percent to fourteen percent), which was approved by Palo Alto voters in November 2014. The Infrastructure Plan assumes that these new revenues will be available to support debt service costs associated with the build-out of infrastructure improvements included in the plan ($2.5 million related to the new hotels and $2.2 million from the tax increase for the Forecast period). Secondly, the annual transfer amount is increased by the CPI, 2.6 percent for FY 2016. Increases of 2.6% are assumed for the remaining years of the forecast as well.



ALTERNATIVE GENERAL FUND LONG RANGE FINANCIAL FORECAST

CalPERS Investment Return Analysis

The CalPERS valuations submitted to the City provide a three year analysis of alternative investment return scenarios. This alternative Forecast model builds on the information provided by CalPERS assuming an annual investment return of 2.8 percent versus 7.5 percent starting with FY 2018. At this time, the CalPERS Board approved an annual investment return target of 7.5 percent. Based on the information provided by CalPERS, this alternative Forecast model keeps the incremental annual increase of the City's pension contribution of 2.9 percentage points for the Miscellaneous Plan and 4.7 percentage points for the Safety Plan constant after Fiscal Year 2020 (see table below).

TABLE 7: PENSION RATES BY PLAN (FISCAL YEAR) WITH A LOWER ASSUMED INVESTMENT RETURN

Pension Plans	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Miscellaneous	26.1%	27.7%	29.9%	31.9%	34.5%	37.4%	40.3%	43.2%	46.1%	49.0%	51.9%
Safety	39.5%	41.9%	45.1%	48.3%	52.3%	57.0%	61.7%	66.4%	71.1%	75.8%	80.5%

Based on these higher annual pension rates, pension costs would increase by a total of $34.0 million over the forecast period, compared to the base model. The General Fund annual surplus in Fiscal Year 2018, the first year impacted by the higher rates, would be reduced from

$1.1 million in the base model to $0.7 million, a 36 percent reduction. This trend would continue through Fiscal Year 2025 as the projected General Fund surplus of $3.4 million in Fiscal Year 2025 would become a General Fund deficit of $5.4 million. During the Forecast period, the net operating margin fluctuates between positive $0.6 million and negative $5.4 million. This model does not project any additional revenue growth compared to the base model, which is the main reason expenditures begin to outpace revenue in Fiscal Year 2021 and this gap continues to grow through Fiscal Year 2025.

Long Range Revenue Forecast - CalPERS Investment Return Alternate Model

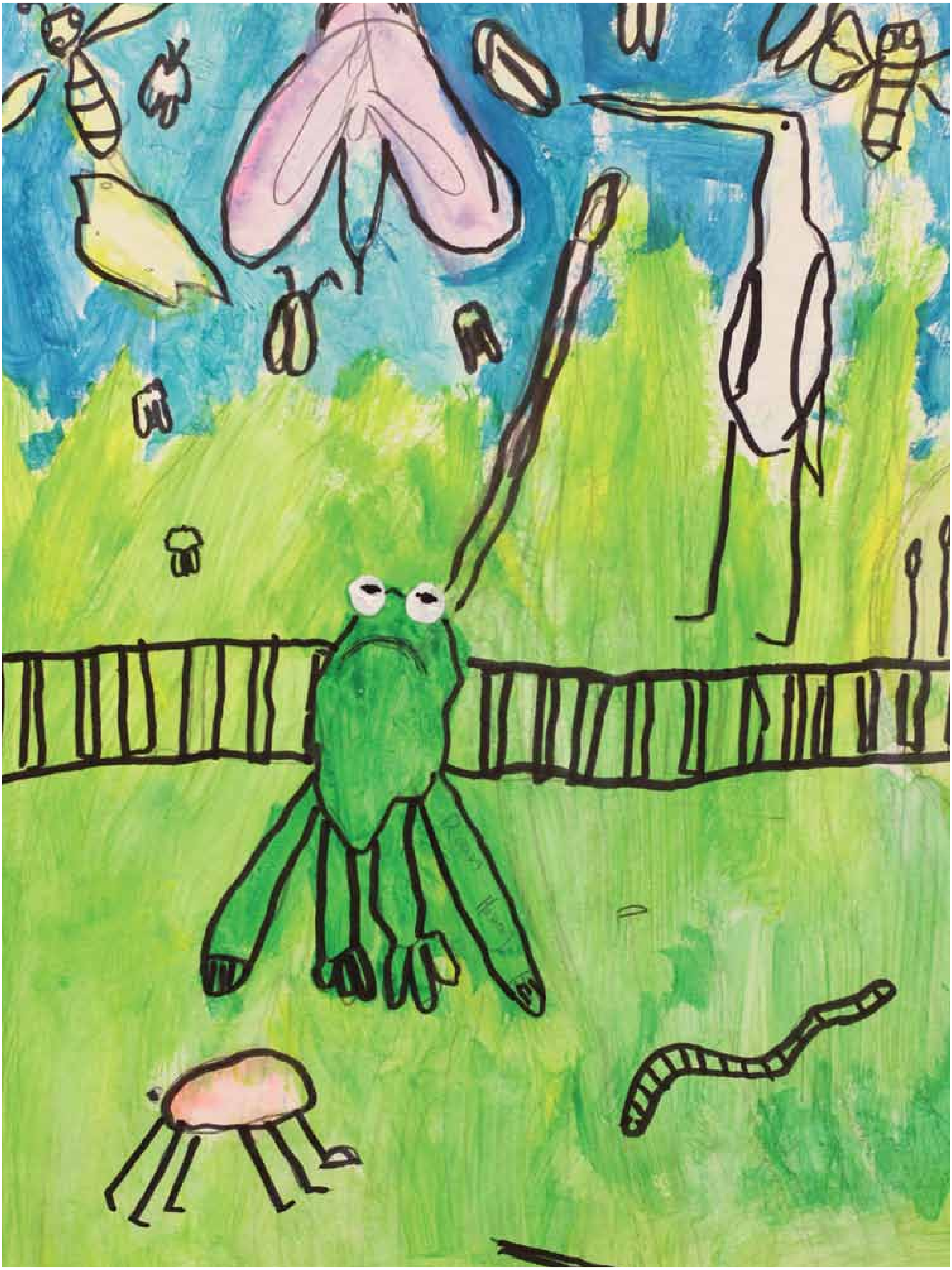
Fiscal Year 2016-2025

	Projected 2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Total Revenue	$176,878	$179,637	$186,962	$194,498	$201,233	$208,304	$214,408	$221,070	$228,864	$236,926	$245,129
Total Expenditures	$172,603	$179,155	$187,142	$193,816	$200,991	$208,179	$216,078	$224,039	$232,532	$241,342	$250,481
Net One-Time Surplus/(Shortfall)	$4,275	$482	($180)	$682	$242	$125	($1,670)	($2,968)	($3,669)	($4,415)	($5,352)
Cumulative Net Operating Margin (One-Time)											**($16,772)**
Net Operating Margin	$0	$0	($180)	$682	($440)	$565	($1,670)	($2,968)	($3,669)	($4,415)	($5,352)
Cumulative Net Operating Margin											**($17,447)**

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

Major Tax Revenue Sensitivity Analysis

As discussed in this Forecast, FY 2016 total tax receipts are estimated to generate approximately $100.3 million. This assumes an average tax receipts annual growth of 3.1% from FY 2015 yearend projections to FY 2016. The year over year assumed growth in total tax revenues is between 3.1% and 4.6% for the Forecast period. All other assumptions remaining the same, if tax revenue receipts growth falls short by one percentage point from 2.1% to 3.6% in FY 2016, the loss in revenue would be approximately $1.0 million; however, a year over year loss of one percentage point in annual revenue growth would result in a cumulative one-time revenue loss of approximately $47.2 million through the forecast period.



CONCLUSION

This Forecast projects a slight General Fund surplus of $0.5 million for FY 2016 and, except for a slight budget shortfall in FY 2017, reflects a generally positive outlook over the next 10 years.

Economic indicators demonstrate that the local business environment is rebounding; however, substantial financial obligations and added uncertainties may diminish the General Fund surplus over the next 10 years.

The City Council approved Infrastructure Plan needs to be fully funded and contingencies for land acquisition and constructions costs need to be planned for. As the City's unfunded pension and retiree medical liabilities have increased to $439.1 million, the City could be well positioned if additional funds were contributed to the pension and retiree healthcare trust funds to reduce the unfunded liabilities. This Forecast assumes the Fiscal Year 2015 service level and supports the City Council's plans for enhancements to the Shuttle Service and funding for the Transportation Management Authority.

While the City is addressing these short-term and long-term issues, the City needs to continue reviewing its operations and service delivery options. Over the last few years, the City has outsourced services to the private sector and entered into negotiations with the non-profit sector for public-private partnerships. In November, the City Council approved a letter of intent with the Friends of the Palo Alto Junior Museum and Zoo with the goal to rebuild the current facility and to enter into a 40 year lease for the Friends to operate the Junior Museum and Zoo. While the City further explores alternative service delivery models with the goal to reduce staff levels and related unfunded pension and retiree healthcare liabilities, the City will also review cost recovery levels of services currently provided to the community. In early 2015, staff intends to bring forward a policy framework for City Council discussion and input, which will guide staff in setting appropriate fees for various services based on the values of our community.

The City is currently updating its Comprehensive Plan. During recent discussions with the City Council, staff was directed to assess the fiscal impacts of the simplified planning scenarios that will be used to analyze policy choices that will have to be made as part of the update. Once the Council approves the Comprehensive Plan update with its inherent policy choices, revenue assumptions for future Forecasts will be aligned with the new Comprehensive Plan.

During the next two months, staff will continue to monitor revenue sources as well as update revenues and expenditures, as applicable, based on newly available information. This updated information will be reflected in the FY 2016 Proposed Budget, which is scheduled to be released to the City Council late April/early May 2015.

ENDNOTES

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x. UCLA Anderson Forecast, *Op. Cit*.
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xvii. Knight Foundation, Soul of the Community, *What Makes People Happy With Their Communities?*, Accessed October 2014
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xix. United States Bureau of Labor Statistics (BLS), *Palo Alto Unemployment Rate*, Accessed October 2014
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xxi. Zillow, Palo Alto Home Prices & Values, Zillow Value Home Index, Accessed October 2014

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Americans with disabilities act statement

In compliance with Americans with Disabilities Act (ADA) of 1990, this document may be provided in other accessible formats.

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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 charger in 1909. The City has long been known for its innovative people and its exploration of ideas that have changed the world. In Palo Alto, our history has always been about the future.

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