City of Palo Alto

City Council Staff Report

(ID # 11954)

Meeting Date: 2/8/2021 **Report Type: Action Items**

Title: Review the Potential Financial Scenarios and Direction to Staff on Development of the Fiscal Year (FY) 2022 Budget, Review and Accept the FY 2022 Budget Development Guidelines, and Review and Accept the FY 2022 - 2031 Long Range Financial Forecast

Council Priority: Economic Recovery & Transition

From: City Manager

Lead Department: Administrative Services

RECOMMENDATION

Staff recommends that the City Council accept the Fiscal Year 2022 to 2031 General Fund Long Range Financial Forecast (Attachment A) and annual Budget Development Guidelines (Attachment C), and that the City Council select a financial scenario to be used for planning and issuance of the FY 2022 Proposed budgets to be considered by the City Council and Finance Committee in May/June 2021.

EXECUTIVE SUMMARY

The Fiscal Year (FY) 2022 to 2031 General Fund Long Range Financial Forecast (LRFF), typically marks the beginning of the FY 2022 annual budget process. This year, adapting to the current fiscal environment due to an ongoing pandemic, staff has included in this LRFF three items for the City Council's consideration and direction to staff:

- FY 2022 Financial Balancing Scenarios for Council deliberation and direction to staff in preparing the FY 2022 Proposed Budget
- Accept the Base Case LRFF, including a discussion of revenue and expense modeling assumptions, to aid in long range financial planning
- Accept the FY 2022 Budget Development Guidelines to inform the budget process

This continues the multiple conversations with City Council to discuss the changing financial impacts of COVID-19.

The three financial balancing scenarios for the City Council's review include a two to three year, three to five and five to ten economic recovery where major tax revenues are modeled to reflect the impact of the COVID-19 pandemic and illustrate the financial outlook under several different recovery levels.

Staff presented a preliminary one-year outlook of this LRFF at the December 15, 2020 Finance Committee meeting (CMR 11844). The Finance Committee directed staff to include a scenario that reflects more conservative estimates for Sales Tax and Transient Occupancy Tax (TOT) and a scenario that maintains transfers to infrastructure and salaries at current year (FY 2021) levels.

Included in this report is a revised Base Case financial forecast assumes a three to five-year economic recovery (Scenario B) and projects a General Fund gap of $6.8 million in FY 2022. Annual gaps, where expenses outpace forecasted revenue growth range from a shortfall in FY 2026 of $17.6 million that decreases to a $13.0 million shortfall in FY 2031. The Base Case reflects staff's best estimate given the information available at the time of this report and considers economic outlooks by UCLA Anderson and other resources. The forecast will be refined as new information becomes available and is intended to provide a preliminary forecast that can help gauge future policy or funding decisions and assumes that the world continues to change and unfold in line with current expectations.

Of important note, the LRFF assumes that the significant reductions taken in the FY 2021 Adopted Budget continue throughout the forecast period. A more detailed discussion of these reductions is included later on in this document. The budgetary gaps projected in this forecast suggest that it will again be necessary to prioritize spending and consider additional service reductions over the next four to five fiscal years to ensure continued financial stability. More detailed guidelines or Budget Policies to inform the development of the FY 2022 Budget (Attachment C) and potential financial balancing strategies to resolve the anticipated budgetary gap are discussed at the end of this document.

Looking forward, the City continues to face several pressures from the financial impacts of the COVID-19 shelter in place orders to fund the 2014 Council approved Infrastructure Plan projects (including the new public safety building) and the growing costs of pension benefits and labor costs due to the current labor market and cost of living around Palo Alto. The continued policy direction from the City Council regarding proactively addressing the pension obligations, including the direction to assume a lower discount rate in calculating pension costs, is contained in the Base Case forecast model. The City will continue to face critical choices in order to balance short- and long-term revenue projections based on the current economic situation and unknown impacts of the COVID-19 pandemic.

Included in this report and subsequent documents are the following:

- FY 2021 Adopted Budget reductions recap and discussion of the current financial and economic climate.
- FY 2022 Financial Balancing Scenarios including a) $4 million reduction; b) $7 million reduction; and c) $11 million reduction (details in Attachment A)
- Base Case LRFF Forecast (Attachment A) and discussion of revenue and expense modeling assumptions (Attachment B)
- Alternative LRFF Forecast Scenarios that maintains transfers to infrastructure and salaries at current year (FY 2021) levels
- FY 2022 Budget Development Guidelines to inform the budget process (Attachment C)

Palo Alto serves a diverse community with a broad range of unique services that adds to the significant complexity of managing a balanced budget and healthy long-range financial outlook. The demands and conflicts emerging from our vibrant economy have heightened the intensity of the “Palo Alto Process”. New analyses and data generation demands require deep dives into complex problem-solving within an engaged public process across a wide range of issues. These forecast figures present staff with the challenge of prioritizing the growing needs of the City with the long-term fiscal sustainability of these needs.

BACKGROUND

The Office of Management and Budget (OMB) produces a ten-year General Fund Long Range Financial Forecast (LRFF) annually. The LRFF reflects staff’s best estimates on the projected revenues and expenditures over the next ten years based on the information that is currently available. It is important to note that the LRFF is a planning document and is separate and distinct from the development of the City’s annual Operating and Capital Budgets. There are assumptions and parameters modeled in the LRFF and these assumptions are revised and refined as more information becomes available through the budget development process.

The LRFF contains a comprehensive review of the costs to provide current City Council approved service levels, including current contracts, updates to salaries and benefits based on the current population of employees, and the current labor contracts in effect.

Since the great recession, the City has approved many strategies to mitigate rising costs, especially the rising increase in salaries and benefits. Strategies that have been used include: a second pension tier, employees sharing in health plan cost increases, and shifting from employer-paid member contributions to employee pick-up of a portion of the employer share for pensions. Since 2016, rounds of negotiations with bargaining units have resulted in employees not only paying their full portion of CalPERS contributions but also beginning a cost-sharing program wherein employees contribute a certain percentage of the City’s required employer pension contribution. These strategies have helped to create the financial capacity to invest proactively in the City’s Pension Trust, supporting the City’s commitments to employees while ensuring fiscal sustainability. Most recently, concessions were achieved with the deferral of salary increases in FY 2021 in the majority of units, excluding SEIU.

The City Council continues to invest in the community and approved significant improvements in June 2014 with the Infrastructure Plan (IP) in the original amount of $125.8 million with most current cost estimate of approximately $260.5 million. The largest of the IP projects in terms of cost, the New Public Safety Building budgeted at $118.0 million and as this report was developed, is planned for consideration by the City Council on February 1, 2021 (CMR 11752). The estimated annual debt service costs associated with the bond funding for the project is a long-term cost that will be evaluated by the City Council before awarding the construction contract (CMR 11665). A status report of the General Capital Improvement Fund for FY 2021 was reviewed by the City Council on January 25, 2021 (CMR 11808). This report includes a review of the potential impacts to the five-year capital improvement plan due to unknown financial impacts in the current fiscal environment.

FY 2021 Adopted Budget Reductions

Important to recall are the actions that the Palo Alto City Council lead as it boldly recognized the financial impacts of the pandemic and worked to address it. The City Council provided direction on May 4, 2020 (CMR 11315) to assume a conservative revenue estimate, a loss of $39 million in General Fund tax revenues, in the development of the FY 2021 budget. This reflected the severity of the current public health emergency and its impacts on the City's financial status. The City Council reviewed the FY 2021 Proposed Operating Budget along with CMRs 11322 and 11376 and other at places materials over the course of a series of public budget hearings that took place May 11 through May 13, 2020 and provided tentative approvals, changes, and areas for further follow up. The City Council adopted a balanced budget that incorporated all feedback and changes from the budget hearings in CMR 11330 on June 22, 2020. Approximately half of the expense reductions were executed through service reductions in General Fund departments. Those adjustments are summarized below and outlined in detail in CMR 11330. The base case scenario in this forecast assumes that these service reductions persist in FY 2022 and throughout the ten-year timeframe.

Public Safety: FY 2021 adjustments included an increase of $1.55 million in program revenues and a reduction of $7.3 million in expenses in the General Fund, including 33.27 full-time and 2.28 part-time staffing freezes. These actions included suspensions of specialized police units such as the traffic enforcement and investigation units to maintain minimal police patrol services and shift the priority of police services to urgent calls, lowering capacity to respond to nonurgent calls. Limited officer training, promotional testing, uniform purchases and eliminated or changed to full cost recovery non-essential programming such as school resource officers. Curtailed dispatch, communication, and emergency preparedness services, as well as emergency incident response and training and work to adopt fees to increase revenue for first responder and ambulance subscription.

Community & Library Services: FY 2021 reductions included $0.3 million in program revenues and $4.9 million in expenses in the General Fund, including 16.1 full-time and 21.02 part-time staffing freezes. These actions reduced library hours at all branches, keeping neighborhood libraries (Children's, Downtown, and College Terrace) open three days a week and full-service branches (Mitchell Park and Rinconada) open six days per week. This includes greater cost-recovery through changes in service delivery, charges for services, and/or limiting operating hours for facilities such as the new Junior Museum and Zoo (JMZ), community centers, open space preserves, the Children's Theatre, and the Art Center. These actions also reduced or eliminated programming such as special events, art exhibits, human services activities, and teen programs.

Planning, Transportation, and Infrastructure: FY 2021 reductions included $2.1 million in program revenues and $6.1 million in expense in the General Fund, including 8.25 full-time and 1.44 part-time staffing freezes. Included were actions to reduce administration, code enforcement, front counter support, and inspection services. Understanding that this could delay services to the development community, the building inspection and plan review team was reorganized to minimize the impacts to lead times for inspections, progress on the Energy Reach Code, and the ability to meet next day inspections. The Crosstown and Embarcadero shuttle programs were eliminated, and the delivery of this service redesigned to reduce costs. Additionally, funding for tree trimming and vehicle replacement was reduced for one year and rate changes in various utility enterprise funds were suspended for the coming year(s).

Internal Services & Council Appointed Officers: FY 2021 reductions included $2.9 million in operating expenses in the General Fund, including 5.9 full-time and 0.96 part time staffing freezes. Internal Services departments include the Information Technology, Human Resources, and Administrative Services Departments as well as the Council and appointed officers (City Manager, City Attorney, City Auditor and City Clerk). Reductions in these areas align with the changes in services, increasing timeframes for assistance and review in areas such as recruitments, procurements, performance reporting, and risk management. Technology solutions will be constrained to only essential contracts and systems and support equipment needs as majority of our workforce continues to work from home. The City Council, Innovation and Special Events, and Human Recourses contingency accounts were eliminated in FY 2021 on a one-time basis.

The Economy

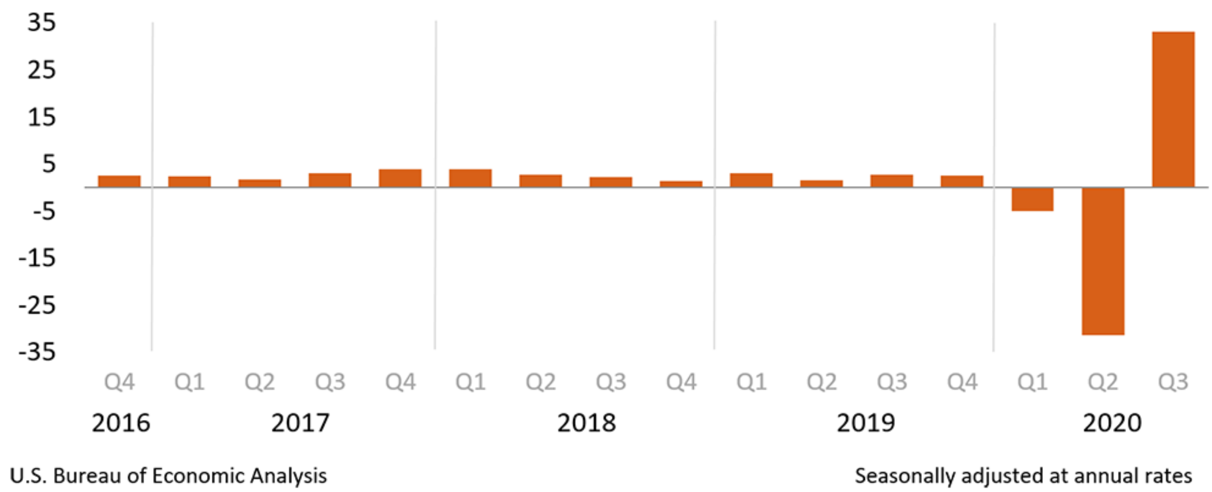
National, state, regional and local economic indicators show promising third calendar quarter results and economic recovery relies on continued resumption of economic activity, a viable vaccine, and containing the spread of COVID-19. As of the development of this report, fourth calendar quarter economic indicators were not yet available; the data below presents information as of the third calendar quarter of 2020. The full economic effects of the COVID-19 pandemic and its recent resurgence is difficult to predict and becomes less certain as the new round of virus spread has led to activity restrictions in Santa Clara County and across the Bay Area, state and nation. Although Federal stimulus packages have contributed to the positive economic indicators at the end of the third quarter, two more months have passed without a new federal stimulus package as some income and business supports will expire by year end with more restrictive shelter in place orders. More restaurants and other small businesses in

Palo Alto have closed either temporarily or permanently. While there has been positive news in the last few months regarding a coronavirus vaccine, major benefits seen from the vaccine administration are not expected until the next fiscal year when distribution is widespread. Staff will continue to monitor short-term economic trends and report back to council as new information is available.

According to the US Bureau of Economic Analysis, the U.S. economy's national gross domestic product (GDP) grew by 33.1 percent in the third calendar quarter of 2020 following a record plunge of 31.4 percent in the second quarter. The increase in the third quarter reflects a surge in personal spending as efforts to reopen businesses and resume activities that were postponed or restricted due to the COVID-19 pandemic continue. The national consumer price index (CPI), as of the third calendar quarter has grown 0.2 percent and trails behind larger increases in July and August, respectively 0.6 percent and 0.4 percent. The following graphs depict the GDP and unemployment trends over the past few years.

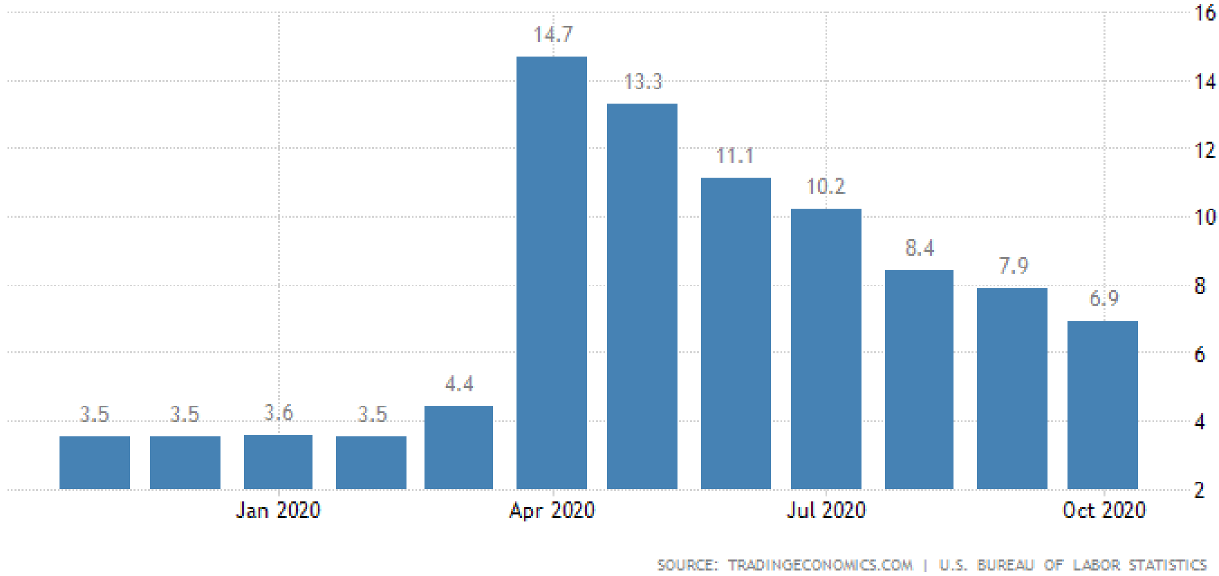
Table 1:

Real GDP: Percent change from preceding quarter



The nation's unemployment rate fell to 7.9 percent in the third calendar quarter, compared to a record high of 14.7 percent at the onslaught of the pandemic in April. It is expected that unemployment will remain above the pre-pandemic levels, averaging around 3.5 percent, as the labor market recovers from COVID-19 shock and signs of economic slowdown surrounding the winter resurgence of virus infections. In the California labor market, the end of October unemployment rate of 9.3 percent marks the first month since March 2020 that the State's unemployment rate was below 10 percent and the fifth straight month it fell below the all-time unemployment rate high of 16.4 percent in April and May of 2020. The improved unemployment rates are driven by job gains in the leisure, hospitality and accommodation; food services; arts, and entertainment and professional, scientific, and technical services. These trends are still far from pre-COVID employment levels and may change in the coming month with uncertainty of COVID-19 statistics over the winter months. Bay Area job growth has been led by the Peninsula and for the past several years. The unemployment rate for the San Francisco Peninsula improved to 6.5 percent in October 2020 compared to 7.7 percent in September 2020. At the national level, job gains in leisure and hospitality, professional and business services, retail, and construction are positive; these gains heavily rely on health orders and their impact on business.

Table 2: U.S. Unemployment Rate



DISCUSSION

While mindful of the unprecedented circumstances the City continues to face, this staff report provides additional details to inform the City Council and to gain further direction for staff for the development of the FY 2022 Proposed budgets. The scenarios outlined in this staff report reflect the tough budget decisions the City continues to face. In addition, following these scenarios is a Base case long-range ten-year forecast. As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document.

For example, General Fund revenues may exceed or fall below expectations based on changes in economic or non-economic conditions. Various cost elements can also vary from year to year.

This Forecast, along with the alternative revenue scenarios, allows City Council to discuss both the short-term and long-term financial status of current service levels in the General Fund. It also informs daily policy decisions on both long-term goals and ongoing challenges. In addition, it provides the potential dollar and percent service reduction impacts associated with each model. Staff is seeking Council guidance on which financial model to use in development of the FY 2022 Proposed Budget.

FY 2022 Financial Balancing Scenarios

Depending on the length and depth of this current public health emergency, the ongoing severity of the financial ramifications remain unknown. For modeling purposes, the base case assumes a moderately paced recovery with the recession continuing through FY 2027 and economically sensitive tax revenues reaching pre-COVID levels towards the end of the 10-year forecast. Based on revised information, potential timelines, travel and the recovery of the local economy, staff has prepared two alternative scenario models that reflect the range of impact if the economy experiences recovery at an earlier, moderate, and slower rate for the City's economically sensitive tax revenues – property tax, sales tax, and TOT.

Staff has provided these scenarios for the City Council to discuss and provide guidance to staff on which scenario to use to prepare the FY 2022 Proposed Budget. Inevitably, the scenario chosen will directly correlate with the level of service impacts that may be felt on top of those service impacts already felt in the FY 2021 Adopted Budget. Ultimately it is estimated that in addition to the $39 million loss in major tax revenues projected in FY 2021, these scenarios reflect additional deficits ranging between $4 million and $11 million in FY 2022. This would reflect a total reduction in service and capital investments of up to $50 million, or 22 percent of the City's pre-pandemic General Fund. Below are options to consider as direction to staff for potential FY 2022 budget balancing actions:

a) Build a FY 2022 Proposed Budget assuming Scenario A, assuming a $4 million overall General Fund reduction
b) Build a FY 2022 Proposed Budget assuming Scenario B or the Base Forecast, including a $7 million General Fund reduction
c) Build a FY 2022 Proposed Budget assuming Scenario C, assuming a $11 million overall General Fund reduction

The financial balancing scenario that is selected will correlate with the level of service impacts that may be felt. These scenarios will assist staff in primarily preparing the FY 2022 Proposed Budget and five-year capital plan.

The focus of the balancing scenarios is to guide the FY 2022 budget process. Staff has used the Scenario B as the Base Forecast to model the full, 10-year timeline that is typical for long range financial planning. While the economy changes as the world adjusts to the COVID-19 pandemic and its financial impacts, staff will continue to produce a LRFF annually in subsequent budget processes, including continual updates throughout the year. Modeling in the long term is important for planning longer term investments, including capital, debt obligations, and other liabilities.

The following tables summarize the Annual One-Time Surplus/(Gap) and Net Operating Margin for the three financial balancing scenarios for FY 2022-2026 and a comparison of the FY 2022 major tax revenue for each model. Throughout each scenario, the projected net operating gaps are driven by growth in the cost to deliver current services outpacing expected revenue growth over the next five years. Details of the scenarios can be found in Attachment A.

Table 3: Financial Balancing Scenarios – Annual One-Time Surplus/(Gap) and Net Operating Margins for FY 2022 to 2026

	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	Cumul. Surplus/(Gap)
Balancing Scenario A								
Net One-Time Surplus/(Gap)	($476)	$1,678	($3,124)	($7,719)	($7,522)	($8,737)	($9,187)	
Net Operating Margin		**1,678**	**(3,124)**	**(4,595)**	**197**	**(1,215)**	**(450)**	***(9,187)***
Balancing Scenario B (Base Case)								
Net One-Time Surplus/(Gap)	(476)	562	(6,790)	(12,684)	(13,488)	(15,806)	(17,558)	
Net Operating Margin		**562**	**(6,790)**	**(5,894)**	**(804)**	**(2,318)**	**(1,752)**	***(17,558)***
Balancing Scenario C								
Net One-Time Surplus/(Gap)	(476)	(700)	(10,617)	(17,476)	(19,041)	(22,807)	(25,927)	
Net Operating Margin		**(700)**	**(10,617)**	**(6,859)**	**(1,565)**	**(3,766)**	**(3,120)**	***(25,927)***

Scenario A: This scenario assumes an economic recovery in which revenues rebound to pre-COVID levels within two to three years. This recovery is heavily reliant on resumption of travel to the region and return to pre-COVID level daytime population (e.g. return to in-person work for office and education employees). This scenario assumes strong consumer confidence in the economy and society feeling safe to resume to normal, pre-COVID activities.

Scenario B: This scenario assumes a shelter in place order through this spring/early summer, with an economic recessionary period slowing growth once the order is lifted. This scenario also reflects impacts related to longer term social distancing requirements to continue. In this scenario, revenue levels return to pre-COVID levels in FY's 2025 and 2026. This scenario most closely aligns with staff's research and review of economic forecasts, including the UCLA Anderson forecast.

Scenario C: This scenario assumes extended impacts associated with prolonged COVID-19 social restrictions, with revenue not returning to pre-COVID levels within the next five years. In FY 2026, total major tax revenues of $126 million are $7.0 million short of pre-COVID levels of $133 million. This reflects the net impact of property tax growth offset by the substantially lower levels of sales tax and TOT. Specifically, for sales tax and TOT, in the fifth year, FY 2026, these revenues remain approximately 10 and 45 percent below FY 2019 actuals, respectively. Annually, major tax revenues are between $7 to $29 million less than pre-COVID levels over the next five years.

As outlined in the May 2020 discussion of COVID-19 fiscal scenarios (CMR 11315), the FY 2021 Proposed Budget estimated the same major tax revenues at $145.7 million, which is nearly $40 million higher than the FY 2021 Adopted Budget of $107.2 million. The below table continues this fiscal scenario planning and compares major tax revenues estimates for Scenarios A, B, and C for FY 2022 against pre-COVID actual revenue levels in FY 2019 and the FY 2021 projections. Scenario A anticipates year-over-year growth of 10 percent, or $10 million in additional revenues. Scenario B estimates year-over-year growth of 5 percent, or an additional $5.2 million in revenues. Scenario C assumes no growth from current year projections.

Table 4: Comparison of FY 2022 Tax Revenue Detail for Financial Balancing Scenarios

Major Tax Revenues	Actual 2019	Actual 2020	Adopted 2021	as of 12/31 Projected 2021	Scenario A 2022	chg vs FY19	chg vs FY21P	Scenario B (Base) 2022	chg vs FY19	chg vs FY21P	Scenario C 2022	chg vs FY19	chg vs FY21P
Sales Taxes	$ 36,508	$ 30,563	$ 20,500	$ 25,030	$ 30,420	*-17%*	*22%*	$ 28,034	*-23%*	*12%*	$ 25,920	*-29%*	*4%*
Property Taxes	47,327	51,089	52,000	53,173	51,988	*10%*	*-2%*	51,228	*8%*	*-4%*	50,223	*6%*	*-6%*
Transient Occupancy Tax	24,937	18,553	14,900	4,830	10,170	*-59%*	*111%*	8,428	*-66%*	*74%*	6,626	*-73%*	*37%*
General Purpose	*16,245*	*11,568*	*8,344*	*2,740*	*3,051*	*-81%*	*11%*	*2,529*	*-84%*	*-8%*	*1,988*	*-88%*	*-27%*
Infrastructure	*8,692*	*6,985*	*6,556*	*2,090*	*7,119*	*-18%*	*241%*	*5,899*	*-32%*	*182%*	*4,638*	*-47%*	*122%*
Documentary Transfer Tax	6,923	6,903	4,700	6,875	7,135	*3%*	*4%*	7,137	*3%*	*4%*	7,013	*1%*	*2%*
Utility Users Tax	16,402	16,140	15,100	14,080	14,370	*-12%*	*2%*	14,370	*-12%*	*2%*	14,327	*-13%*	*2%*
Subtotal: Major Tax Revenue	**$132,097**	**$123,249**	**$107,200**	**$103,988**	**$114,083**	***-14%***	***10%***	**$109,197**	***-17%***	***5%***	**$104,109**	***-21%***	***0%***
Change from FY 2019 Actual					$ (18,014)	*-14%*		$ (22,900)	*-17%*		$ (27,988)	*-21%*	
Change from FY 2021 Prior to COVID					$ (31,643)	*-22%*		$ (36,529)	*-25%*		$ (41,617)	*-29%*	
Change from FY 2021 Projected					$ 10,095	*10%*		$ 5,209	*5%*		$ 121	*0%*	
One-Time Net Surplus/(Gap)					**($3,124)**			**($6,790)**			**($10,617)**		

Note: Prior to the onset of the COVID-19 pandemic, the FY 2021 Proposed Budget originally estimated $145.7M in receipts for these major tax revenues, a decline of $41.7M from current FY 2021 projections.

Financial Balancing Scenario A: Two-Three Year Economic Recovery

This alternative scenario depicts a cumulative net operating gap of $9.2 million over the next five fiscal years. Considering the service and capital investment reductions taken in the FY 2021 Adopted Budget, if the $9.2 million cumulative net operating gap is balanced through service reductions, this scenario would result in approximately 20 percent, or $48.2 million, overall budget reduction between FY 2021 and FY 2026. Within five years, this alternative scenario estimates that tax revenues will exceed pre-COVID levels by approximately $15 million, or 12 percent, with sales tax exceeding pre-COVID levels by 9 percent ($3 million) and TOT revenues falling short by 14 percent (-$3 million). Overall, major tax revenues will increase by 6.4 percent, from $107.2 million in the FY 2021 Adopted Budget, to $114.1 million in FY 2022.

Table 5: Financial Balancing Scenario A – Two-Three Year Economic Recovery

	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026
Total Revenue	**$209,515**	**$196,474**	**$194,271**	**$201,418**	**$211,957**	**$224,563**	**$232,809**	**$241,142**
		-6.2%	*-1.1%*	*3.7%*	*5.2%*	*5.9%*	*3.7%*	*3.6%*
Total Expenditures	**$227,016**	**$196,950**	**$192,593**	**$204,542**	**$219,676**	**$232,085**	**$241,546**	**$250,329**
		-13.2%	*-2.2%*	*6.2%*	*7.4%*	*5.6%*	*4.1%*	*3.6%*
Net One-Time Surplus/(Gap)	**($17,501)**	**($476)**	**$1,678**	**($3,124)**	**($7,719)**	**($7,522)**	**($8,737)**	**($9,187)**
Cumulative Net Operating Margin (One-Time)								**($36,290)**
Net Operating Margin			**$1,678**	**($3,124)**	**($4,595)**	**$197**	**($1,215)**	**($450)**
Cumulative Net Operating Margin								**($9,187)**

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

<u>Financial Balancing Forecast B: Three-Five Year Economic Recovery</u>

Scenario B is discussed later in this report and is modeled 10 years for the LRFF. This scenario is based on staff's economic research that recovery will occur over a three to five-year period, with major tax revenue returning to pre-COVID in FY 2025. In FY 2026, total tax revenues will exceed pre-COVID levels by 3 percent, or approximately $5 million. At the end of the five years, assuming that the annual budget shortfalls are balanced through service reductions, this scenario would result in approximately a cumulative 25 percent, or $56.6 million, overall budget reduction between FY 2021 and FY 2026.

Table 6: Financial Balancing Scenario B – Three-Five Year Economic Recovery

	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026
Total Revenue	**$209,515**	**$196,474**	**$193,045**	**$196,532**	**$205,162**	**$216,193**	**$223,168**	**$229,605**
		-6.2%	*-1.7%*	*1.8%*	*4.4%*	*5.4%*	*3.2%*	*2.9%*
Total Expenditures	**$227,016**	**$196,950**	**$192,483**	**$203,322**	**$217,846**	**$229,681**	**$238,974**	**$247,163**
		-13.2%	*-2.3%*	*5.6%*	*7.1%*	*5.4%*	*4.0%*	*3.4%*
Net One-Time Surplus/(Gap)	**($17,501)**	**($476)**	**$562**	**($6,790)**	**($12,684)**	**($13,488)**	**($15,806)**	**($17,558)**
Cumulative Net Operating Margin (One-Time)								**($66,327)**
Net Operating Margin			**$562**	**($6,790)**	**($5,894)**	**($804)**	**($2,318)**	**($1,752)**
Cumulative Net Operating Margin								**($17,558)**

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

<u>Financial Balancing Forecast C: Five-Ten Year Economic Recovery</u>

The most conservative of the alternative scenarios assumes $26.0 million cumulative net operating gap. Selecting this financial balancing scenario would cumulatively result in approximately $65 million, approximately 30 percent overall budget reductions between FY 2021 through FY 2026. This alternative revenue scenario assumes that major tax revenues will increase by 2.9 percent, from $107.2 million in the FY 2021 Adopted Budget, to $104.1 million in FY 2022. Although sales tax nearly reaches pre-COVID levels in FY 2026, TOT revenues fall below pre-COVID levels by nearly $11 million, or 42 percent. More conservative growth of economically sensitive revenues is assumed with the five-year CAGR for FY 2022 through 2026 being 1.9 percent for tax revenues. It is likely that this scenario is very pessimistic and result in an extreme impact to service levels.

Table 7: Financial Balancing Scenario C – Five-Ten Year Economic Recovery

	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026
Total Revenue	**$209,515**	**$196,474**	**$191,603**	**$191,444**	**$198,479**	**$207,816**	**$213,849**	**$218,757**
		-6.2%	*-2.5%*	*-0.1%*	*3.7%*	*4.7%*	*2.9%*	*2.3%*
Total Expenditures	**$227,016**	**$196,950**	**$192,303**	**$202,061**	**$215,955**	**$226,857**	**$236,656**	**$244,684**
		-13.2%	*-2.4%*	*5.1%*	*6.9%*	*5.0%*	*4.3%*	*3.4%*
Net One-Time Surplus/(Gap)	**($17,501)**	**($476)**	**($700)**	**($10,617)**	**($17,476)**	**($19,041)**	**($22,807)**	**($25,927)**
Cumulative Net Operating Margin (One-Time)								**($95,869)**
Net Operating Margin			**($700)**	**($10,617)**	**($6,859)**	**($1,565)**	**($3,766)**	**($3,120)**
Cumulative Net Operating Margin								**($25,927)**

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

Budget Balancing Options for Consideration

In conclusion, the City Council has several options to consider on how to continue to address the financial impacts of COVID-19 and proactively plan for a shelter in place order extension and other impacts, and a recessionary recovery, while maintaining flexibility due to the significant number of unknowns still before us. Below are a few options to consider as direction to the staff regarding potential FY 2022 budget balancing actions:

1) Build a FY 2022 proposed budget assuming Scenario A with a Tier 2 plan that balances Scenario B
2) Build a FY 2022 proposed budget assuming Scenario B
3) Build a FY 2022 proposed budget assuming Scenario B with a Tier 2 plan that balances no less than 50 percent of Scenario C
4) Build a FY 2022 proposed budget assuming Scenario B for FY 2022 and direct staff to reassess Scenarios A, B, and C in Fall 2021 with the Finance Committee for changes in economic conditions
5) Build a FY 2022 proposed budget assuming Scenario C

The significant unknowns that the City is facing in terms of the duration and type of shelter in place restrictions continues to be a moving target, as noted above with the recent easing of the State's Regional Stay at Home Order and related County Shelter in Place restrictions could have a positive impact on the City's economy in the shorter term. The changes continue to be swift and being able to react in a nimble way, while prioritizing our ability to reengage services and serve this community continues to be a high priority.

FY 2022-2031 Long Range Financial Forecast: Base Case

The Base Case LRFF projects General Fund financials over the next ten years based on current City Council approved service levels (the "Base Case"). The following table displays the projected General Fund revenues and expenditures over the next decade and the total cumulative gap. In addition to the cumulative gap, the incremental surplus or shortfall (assuming each preceding surplus or shortfall is addressed completely with ongoing solutions in the year it appears) for each year of the forecast is included. Because it is the City's goal to remain in balance on an ongoing basis, the incremental figure is useful in that it shows the additional surplus and/or shortfall attributed to a particular fiscal year. To the extent that a shortfall is not resolved, or a surplus is not expended on an ongoing basis, it is important to understand that the remaining budget gap or surplus will carry over to the following year.

The hard work of the City in FY 2021 to proactively balance the budget due to estimated financial impacts from the COVID-19 pandemic is reflected in the base case; however, due to the continued public health crisis most of the major revenue categories remain well below previously forecasted levels. Although services were reduced in the FY 2021 budget, expenditures continue to increase at a rate faster than revenue through the ten-year forecast. To ensure financial stability critical choices over the next four to five years must continue to be made to prioritize spending and services the City wishes to deliver.

Throughout the next 10 years, Base Forecast does not restore the approximately $20 million in service reductions that are outlined in the FY 2021 Adopted Budget Reductions section of this report. In addition, other Citywide balancing items, including the base capital transfer, are incrementally restored over a five-year period (additional details for this can be found in the Capital Improvement Fund Update and Status, CMR 11808). The $20 million in service reductions represent 10 percent of the General Fund budget when compared to the pre-COVID service levels in the FY 2020 Adopted Budget. If the $6.8 million budget gap in the FY 2022 Forecast were to be solved with further service reductions, the overall dollar and percent reduction to services will total $27 million, or approximately 12 percent, over two fiscal years. Considering all balancing solutions, service and infrastructure investment reductions will total nearly $46 million, or approximately 20 percent.

The FY 2021 budget balancing strategy also included reductions in the General Fund's capital investment, concessions in the Management and Professional employee group, and adjustments to contributions to the City's Internal Service Funds. The General Fund's base transfer towards capital investments continues to be held flat in the FY 2022 Forecast year. Four-year restoration of the $10.7 million reduction of the base transfer begins in FY 2023 with this investment returning pre-COVID levels in FY 2026, not adjusted for inflation.

When compared to FY 2021 Adopted Budget, revenue estimates in FY 2022 remain flat; fluctuations in major tax revenues for FY 2021 are discussed in the following sections of this report. Expenditures increase by approximately 3.4 percent in FY 2022 compared to the FY 2021 Adopted Budget. The gap reflected in FY 2022 is mainly the result of increases to Salary and Benefit costs including the restoration of concessions taken by Management/Professional employees and the City's Public Safety labor Groups (Police Officers Association, Police Management Association, International Association of Fire Fighters, Fire Chief's Association) in FY 2021.

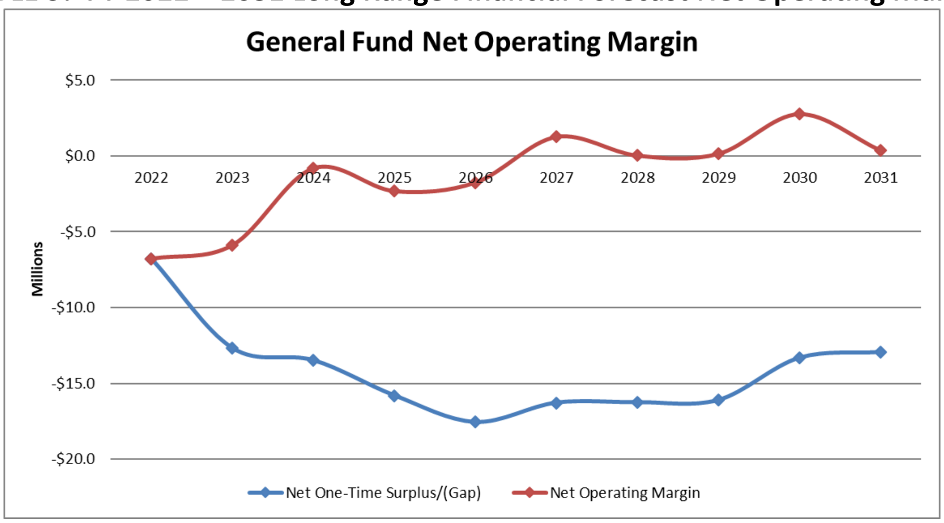
Although the Forecast anticipates gaps ranging from $11.9 million to a slight budget shortfall in the tenth year of $0.3 million, the short- and long-term impacts from the current public health crisis are still unknown. Further information and analysis of the constantly changing fiscal impacts from the health crisis will continue to inform the development of the FY 2022 Budget to proactively plan for changes and ensure a structurally balanced budget.

TABLE 8: FY 2022 – 2031 Long Range Financial Forecast

	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
Total Revenue	$196,474	$193,045	$196,532	$205,162	$216,193	$223,168	$229,605	$235,821	$242,126	$248,722	$255,479	$261,330
		-1.7%	*1.8%*	*4.4%*	*5.4%*	*3.2%*	*2.9%*	*2.7%*	*2.7%*	*2.7%*	*2.7%*	*2.3%*
Total Expenditures	$196,949	$192,483	$203,322	$217,846	$229,681	$238,974	$247,163	$252,106	$258,383	$264,833	$268,808	$274,273
		-2.3%	*5.6%*	*7.1%*	*5.4%*	*4.0%*	*3.4%*	*2.0%*	*2.5%*	*2.5%*	*1.5%*	*2.0%*
Net One-Time Surplus/(Gap)	($475)	$562	($6,790)	($12,684)	($13,488)	($15,806)	($17,558)	($16,285)	($16,257)	($16,111)	($13,329)	($12,943)
Cumulative Net Operating Margin (One-Time)												($141,251)
Net Operating Margin		$0	($6,790)	($5,894)	($804)	($2,318)	($1,752)	$1,273	$28	$146	$2,782	$386
Cumulative Net Operating Margin												($12,943)

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

TABLE 9: FY 2022 – 2031 Long Range Financial Forecast Net Operating Margin



Budget Stabilization Reserve

The City's Budget Stabilization Reserve (BSR) serves as the primary General Fund reserve. By policy, the BSR is maintained in the range of 15 to 20 percent of General Fund operating expenditures, with a target of 18.5 percent. Any reduction to the reserve below 15 percent requires City Council approval. At the discretion of the City Manager, any BSR balance above 18.5 percent may be transferred to the Infrastructure Reserve (IR), which was established to provide funding for maintenance and rehabilitation of the City’s capital assets. The BSR is used to fund unanticipated one-time costs as opposed to ongoing or recurring operating expenditures. The City's intent is to fund ongoing programs and services with ongoing dollars. Maintaining the BSR at 18.5 percent also provides flexibility to the City do deal with unforeseen issues that may arise. Furthermore, establishing, and following, sound fiscal reserve policies has been a strong factor in the City being rated AAA by rating agencies. Based on revenue and expense assumptions in this forecast, where expense levels outpace revenue growth, maintaining the 18.5 percent BSR target will not be achieved over the length of the 10-year forecast without further cost reductions.

Finance Committee Requested Alternative Forecast

Transfers to Infrastructure and Salaries Remain at Current Year (FY 2021) Levels

Per direction by the Finance Committee at the December 15, 2020 Committee meeting, this alternative scenario assumes two changes to expense assumptions. First, that the base transfer from the General Fund to the Capital Fund to support infrastructure investments is held at the same level in FY 2022 as in the FY 2021 Adopted Budget; this removes the general CPI that is applied to this transfer. Second, salaries remain at the same level in FY 2022 as the FY 2021 Adopted Budget, regardless of current terms in labor contracts. In addition, furloughs taken by the City's Management group sunset in FY 2021 however, all salaries remain flat. This model assumes the same rates of increase for employee benefits as the base model, including healthcare costs, pension benefits, proactive pension contributions as per the City's Pension Fund Policy and contract with CalPERS. This alternative forecast assumes that wage increases resume beginning in FY 2023, including step increases, merit increases, and negotiated wage adjustments in place. Additional general wage adjustments of 2.0 percent are included in each year of the Forecast for all employees in years when there is not a MOA in effect. This is consistent with prior Council direction to use the 2.0 percent increase as a forecasting model, not as a commitment to future negotiations.

Table 10: Alternative Forecast – Transfers to Infrastructure and Salaries Remain at Current Year Levels

	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026
Total Revenue	**$209,515**	**$196,474**	**$193,045**	**$196,532**	**$205,162**	**$216,193**	**$223,168**	**$229,605**
		-6.2%	*-1.7%*	*1.8%*	*4.4%*	*5.4%*	*3.2%*	*2.9%*
Total Expenditures	**$227,016**	**$196,950**	**$192,483**	**$199,666**	**$215,383**	**$227,348**	**$236,730**	**$244,522**
		-13.2%	*-2.3%*	*3.7%*	*7.9%*	*5.6%*	*4.1%*	*3.3%*
Net One-Time Surplus/(Gap)	**($17,501)**	**($476)**	**$562**	**($3,134)**	**($10,221)**	**($11,155)**	**($13,562)**	**($14,917)**
Cumulative Net Operating Margin (One-Time)								**($52,989)**
Net Operating Margin			**$562**	**($3,134)**	**($7,087)**	**($934)**	**($2,406)**	**($1,356)**
Cumulative Net Operating Margin								**($14,917)**

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

FY 2022 Budget Development Guidelines

As discussed earlier in this document, the LRFF represents the initial steps of the FY 2022 budget development process. In the FY 2019 – FY 2028 Long Range Financial Forecast presented in December 2018, staff included budget development guidelines based on the trends that were identified and the anticipated fiscal condition of the City. Due to the clear overlap of projecting the City's fiscal condition over the next ten years and the need to shape service level expectations over the same time period, staff recommends that the inclusion of Budget Development Guidelines be incorporated into the Long Range Financial Forecast on an ongoing basis.

As the City and the County move through different phases of recovery from the COVID-19 pandemic, the City adapts operations to best support and serve the community. County Public Health Orders and State Public Health restrictions impact both the cost of delivering City services and the revenues that pay for them (both taxes and fees). Often, staff finds that it takes increased resources to deliver the same quantity of service in modified ways to ensure the safety of the community and employees This year, the FY 2022 Budget Development Guidelines are detailed in Attachment C. They are meant to reflect the anticipated fiscal condition of the City and to provide high-level budgetary direction to the organization. These guidelines will shape and inform the annual financial planning and the allocation of resources across the organization, especially in the General Fund. Further, strategic work is underway focused on a Community and Economic Recovery Strategy. On November 30, 2020 (CMR 11790) the City Council held a study session to discuss and consider areas of focus to inform and build a Palo Alto specific recovery strategy. Key to the City Council's and staff's fiscal and recovery planning is the important work underway to understand the fiscal implications of possible recovery scenarios. This includes the potential for City actions to affect economic recovery and associated impacts on City revenues. This, in turn, affects the level and nature of services the City can deliver to the community.

When the Fiscal Sustainability Workplan (CMR 10267) was approved by the City Council on April 22, 2019 drafting a budget development policy was listed as part of the "Newly proposed or potential activities proposed to be completed". The inclusion of Budget Development Guidelines in this, and future years', Long Range Financial Forecast represents staff's recommended method of addressing this referral. Pairing Budget Development Guidelines with the Long Range Financial Forecast links the anticipated fiscal condition of the organization with the necessary context regarding service delivery prioritization and resource allocation that will be further explored through the process. Including the Budget Development Guidelines with the Long Range Financial Forecast ensures that the City is able to proactively address anticipated changes in its fiscal condition through the budget process.

Conclusion

The FY 2022 – 2031 Long Range Financial Forecast provides context to proactively approach the budget constraints faced by the City over the next 10 years. Specifically, financial impacts of the COVID-19 pandemic and health orders have significantly restrained consumer spending, resulting in weakened job market, and uncertainty of how and when the economy will rebound. Although economic indicators in the past month show some promise, the surge in COVID-19 infections in the late fall reverted cities in Santa Clara County to a more restrictive "purple tier." Positive economic trends and containment of the virus hinge of the viability of an effective vaccine and society's ability to adapt while ensuring safety.

The financial balancing scenario that is selected will have a direct impact to the level of service impacts that may be felt. All three financial balancing scenarios assume the continuation of service reductions taken in the FY 2021 Adopted Budget as well as no additional incoming resources to sustain the current expense levels through the length of the forecast. As the fiscal year progresses and as trends for this year materialize, prioritizing spending and services the City wishes to continue will be paramount in the City's financial stability.

STAKEHOLDER ENGAGEMENT

The LRFF represents the beginning of the Fiscal Year 2022 budget development process. As in previous years, the City Council discussion of LRFF will provide guidance to staff in the budget development process. It is anticipated that conversations with City Council and the community will occur through public budget hearings in Spring 2021. Staff will continue to bring forward updates regarding the City's financial outlook as new information becomes available.

RESOURCE IMPACT

Financial implications from this report and input from the City Council will be considered in the City Manager's development of the Fiscal Year 2022 budget.

ENVIRONMENTAL IMPACT

This report is not a project for the purposes of the California Environmental Quality Act. Environmental review is not required.

Attachments:

- Attachment A: Long Range Financial Forecast Base Forecast and Financial Balancing Scenarios
- Attachment B: FY 2022 - 2031 Long Range Financial Forecast Revenue & Expense Assumptions
- Attachment C: FY 2022 Budget Development Guidelines

FY 2022-2031 General Fund Long Range Financial Forecast Revenue Table

Base Forecast

Revenue & Other Sources	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	CAGR 10 Years
Sales Taxes	$30,563	$20,500	$25,030	$28,034	$30,557	$32,543	$34,170	$35,366	$36,604	$37,555	$38,532	$39,534	$40,562	7.1%
Property Taxes	51,089	52,000	53,173	51,228	52,124	54,844	57,038	59,320	61,693	64,160	66,727	69,396	72,172	3.3%
Transient Occupancy Tax														
General Purpose	11,568	8,344	2,740	2,529	2,950	4,300	4,601	4,924	5,194	5,444	5,699	5,979	6,278	-2.8%
Infrastructure	6,985	6,556	2,090	5,899	8,849	11,628	12,442	13,312	14,045	14,719	15,411	16,166	16,974	10.0%
Documentary Transfer Tax	6,903	4,700	6,875	7,137	7,246	7,451	7,701	7,965	8,245	8,543	8,853	9,195	9,553	7.4%
Utility Users Tax	16,140	15,100	14,080	14,370	14,801	15,263	15,767	16,240	16,646	17,062	17,488	17,925	18,374	2.0%
Other Taxes and Fines	1,172	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	0.0%
Subtotal: Taxes	124,422	109,125	105,913	111,122	118,452	127,954	133,644	139,052	144,352	149,408	154,635	160,120	165,838	4.3%
Charges for Services	23,557	25,418	25,418	24,934	25,087	25,629	25,928	26,235	26,552	26,878	27,214	27,560	27,878	0.9%
Permits and Licenses	8,038	8,336	8,336	8,273	8,717	9,015	9,310	9,484	9,597	9,828	10,139	10,330	9,280	1.1%
Return on Investments	1,419	1,100	883	852	816	789	808	831	855	880	906	936	966	-1.3%
Rental Income	16,037	16,022	16,022	15,534	15,935	16,347	16,772	17,210	17,662	18,127	18,605	19,096	19,600	2.0%
From Other Agencies	1,529	551	551	551	508	508	508	508	508	508	508	508	508	-0.8%
Charges to Other Funds	11,099	11,992	11,992	11,364	11,743	12,042	12,285	12,368	12,375	12,573	12,788	12,998	13,325	1.1%
Other Revenue	2,848	2,571	2,571	2,539	2,540	2,541	2,541	2,542	2,543	2,544	2,545	2,546	2,546	-0.1%
Total Non-Tax Revenue	64,526	65,990	65,773	64,048	65,345	66,871	68,153	69,179	70,092	71,338	72,704	73,973	74,104	1.2%
Operating Transfers-In	20,568	21,359	21,359	21,362	21,365	21,368	21,371	21,374	21,377	21,380	21,383	21,386	21,389	0.0%
BSR Contribution (One-Time)														
Total Source of Funds	$209,515	$196,474	$193,045	$196,532	$205,162	$216,193	$223,168	$229,605	$235,821	$242,126	$248,722	$255,479	$261,330	

Revenue & Other Sources	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
Sales Taxes		-32.9%	22.1%	12.0%	9.0%	6.5%	5.0%	3.5%	3.5%	2.6%	2.6%	2.6%	2.6%
Property Taxes		1.8%	2.3%	-3.7%	1.7%	5.2%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Transient Occupancy Tax													
General Purpose		-27.9%	-67.2%	-7.7%	16.6%	45.8%	7.0%	7.0%	5.5%	4.8%	4.7%	4.9%	5.0%
Infrastructure		-6.1%	-68.1%	182.2%	50.0%	31.4%	7.0%	7.0%	5.5%	4.8%	4.7%	4.9%	5.0%
Documentary Transfer Tax		-31.9%	46.3%	3.8%	1.5%	2.8%	3.4%	3.4%	3.5%	3.6%	3.6%	3.9%	3.9%
Utility Users Tax		-6.4%	-6.8%	2.1%	3.0%	3.1%	3.3%	3.0%	2.5%	2.5%	2.5%	2.5%	2.5%
Other Taxes and Fines		64.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Subtotal: Taxes		-12.3%	-2.9%	4.9%	6.6%	8.0%	4.4%	4.0%	3.8%	3.5%	3.5%	3.5%	3.6%
Charges for Services		7.9%	0.0%	-1.9%	0.6%	2.2%	1.2%	1.2%	1.2%	1.2%	1.2%	1.3%	1.2%
Permits and Licenses		3.7%	0.0%	-0.8%	5.4%	3.4%	3.3%	1.9%	1.2%	2.4%	3.2%	1.9%	-10.2%
Return on Investments		-22.5%	-19.7%	-3.5%	-4.2%	-3.3%	2.4%	2.8%	2.9%	2.9%	3.0%	3.3%	3.2%
Rental Income		-0.1%	0.0%	-3.0%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
From Other Agencies		-63.9%	0.0%	0.0%	-7.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Charges to Other Funds		8.1%	0.0%	-5.2%	3.3%	2.5%	2.0%	0.7%	0.1%	1.6%	1.7%	1.6%	2.5%
Other Revenue		-9.7%	0.0%	-1.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Non-Tax Revenue		2.3%	-0.3%	-2.6%	2.0%	2.3%	1.9%	1.5%	1.3%	1.8%	1.9%	1.7%	0.2%
Operating Transfers-In		3.8%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
BSR Contribution (One-Time)													
Total Source of Funds		-6.2%	-1.7%	1.8%	4.4%	5.4%	3.2%	2.9%	2.7%	2.7%	2.7%	2.7%	2.3%

FY 2022-2031 General Fund Long Range Financial Forecast Expense Table

ATTACHMENT A

Base Forecast

Expenditures & Other Uses	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	CAGR 10 Years
Salary	$72,958	$67,421	$67,421	$70,649	$72,862	$74,708	$76,559	$78,175	$79,814	$81,445	$83,075	$84,936	$86,317	2.5%
Benefits	60,257	57,121	$ 57,121	62,420	65,545	68,078	70,444	71,265	71,347	72,611	73,874	75,253	76,623	3.0%
Subtotal: Salary & Benefits	133,216	124,541	124,541	133,069	138,407	142,786	147,003	149,441	151,161	154,055	156,949	160,189	162,940	2.7%
Contract Services	25,360	21,953	21,953	20,710	21,220	22,147	22,747	23,365	24,003	24,658	25,334	26,031	26,748	2.0%
Supplies & Material	2,710	2,975	2,975	3,027	3,102	3,194	3,289	3,387	3,488	3,592	3,699	3,809	3,922	2.8%
General Expense	9,755	9,079	9,079	7,526	7,597	7,684	7,774	8,424	9,164	10,080	11,023	9,156	9,200	0.1%
Rents & Leases	1,520	1,862	1,862	1,913	1,966	2,021	2,079	2,139	2,200	2,262	2,326	2,393	2,461	2.8%
Facilities & Equipment	462	427	427	435	446	459	473	487	501	516	531	547	563	2.8%
Allocated Charges	21,771	18,311	18,311	19,310	21,129	21,634	22,042	22,478	22,949	23,421	23,987	24,443	24,871	3.1%
Total Non Sal/Ben Before Transfers	61,579	54,607	54,607	52,921	55,459	57,139	58,403	60,280	62,304	64,529	66,900	66,378	67,764	2.2%
Operating Transfers-Out	8,049	4,334	4,334	4,428	4,458	4,489	4,520	4,556	4,588	4,625	4,662	4,695	4,733	0.9%
Transfer to Infrastructure - Base	17,187	6,911	6,911	7,006	10,673	13,640	16,607	19,575	20,009	20,455	20,912	21,381	21,862	12.2%
Transfer to Infrastructure - TOT	6,985	6,556	2,090	5,899	8,849	11,628	12,442	13,312	14,045	14,719	15,411	16,166	16,974	10.0%
Total Use of Funds	$227,015	$196,949	$192,483	$203,322	$217,846	$229,681	$238,974	$247,163	$252,106	$258,383	$264,833	$268,808	$274,273	3.4%

Expenditures & Other Uses	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
Salary		-7.6%	0.0%	4.8%	3.1%	2.5%	2.5%	2.1%	2.1%	2.0%	2.0%	2.2%	1.6%
Benefits		-5.2%	0.0%	9.3%	5.0%	3.9%	3.5%	1.2%	0.1%	1.8%	1.7%	1.9%	1.8%
Subtotal: Salary & Benefits		-0.2%	-0.2%	6.8%	4.0%	3.2%	3.0%	1.7%	1.2%	1.9%	1.9%	2.1%	1.7%
Contract Services		-13.4%	0.0%	-5.7%	2.5%	4.4%	2.7%	2.7%	2.7%	2.7%	2.7%	2.8%	2.8%
Supplies & Material		9.8%	0.0%	1.7%	2.5%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
General Expense		-6.9%	0.0%	-17.1%	0.9%	1.1%	1.2%	8.4%	8.8%	10.0%	9.3%	-16.9%	0.5%
Rents & Leases		22.5%	0.0%	2.7%	2.8%	2.8%	2.8%	2.9%	2.9%	2.8%	2.8%	2.9%	2.8%
Facilities & Equipment		-7.7%	0.0%	1.9%	2.5%	2.9%	3.1%	3.0%	2.9%	3.0%	2.9%	3.0%	2.9%
Allocated Charges		-15.9%	0.0%	5.5%	9.4%	2.4%	1.9%	2.0%	2.1%	2.1%	2.4%	1.9%	1.8%
Total Non Sal/Ben Before Transfers		3.1%	3.1%	-3.1%	4.8%	3.0%	2.2%	3.2%	3.4%	3.6%	3.7%	-0.8%	2.1%
Operating Transfers-Out		-46.2%	0.0%	2.2%	0.7%	0.7%	0.7%	0.8%	0.7%	0.8%	0.8%	0.7%	0.8%
Transfer to Infrastructure - Base		-59.8%	0.0%	1.4%	52.3%	27.8%	21.8%	17.9%	2.2%	2.2%	2.2%	2.2%	2.2%
Transfer to Infrastructure - TOT		-6.1%	-68.1%	182.2%	50.0%	31.4%	7.0%	7.0%	5.5%	4.8%	4.7%	4.9%	5.0%
Total Use of Funds		-13.2%	-2.3%	5.6%	7.1%	5.4%	4.0%	3.4%	2.0%	2.5%	2.5%	1.5%	2.0%

FY 2022-2031 General Fund Long Range Financial Forecast Revenue Table
Financial Balancing Scenario A

Revenue & Other Sources	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	CAGR 5 Years
Sales Taxes	$30,563	$20,500	26,000	$30,420	$34,070	$36,455	$38,278	$39,618	2.7%
Property Taxes	51,089	52,000	53,173	51,988	52,898	55,643	58,425	61,785	1.7%
Transient Occupancy Tax	-	-							
General Purpose	11,568	8,344	2,885	3,051	3,559	5,189	5,553	5,941	6.9%
Infrastructure	6,985	6,556	2,200	7,119	10,679	14,032	15,014	16,065	8.5%
Documentary Transfer Tax	6,903	4,700	6,875	7,135	7,246	7,450	7,700	7,965	1.1%
Utility Users Tax	16,140	15,100	14,081	14,370	14,870	15,630	16,390	17,290	1.9%
Other Taxes and Fines	1,172	1,925	1,925	1,925	1,925	1,925	1,925	1,925	0.0%
Subtotal: Taxes	124,422	109,125	107,139	116,008	125,247	136,324	143,285	150,589	2.6%
Charges for Services	23,557	25,418	25,418	24,934	25,087	25,629	25,928	26,235	0.5%
Permits and Licenses	8,038	8,336	8,336	8,273	8,717	9,015	9,310	9,484	1.4%
Return on Investments	1,419	1,100	883	852	816	789	808	831	-0.2%
Rental Income	16,037	16,022	16,022	15,534	15,935	16,347	16,772	17,210	1.0%
From Other Agencies	1,529	551	551	551	508	508	508	508	-0.8%
Charges to Other Funds	11,099	11,992	11,992	11,364	11,743	12,042	12,285	12,368	0.9%
Other Revenue	2,848	2,571	2,571	2,539	2,540	2,541	2,541	2,542	0.0%
Total Non-Tax Revenue	64,526	65,990	65,773	64,048	65,345	66,871	68,153	69,179	0.8%
Operating Transfers-In	20,568	21,359	21,359	21,362	21,365	21,368	21,371	21,374	0.0%
BSR Contribution (One-Time)									
Total Source of Funds	$209,515	$196,474	$194,271	$201,418	$211,957	$224,563	$232,809	$241,142	

Revenue & Other Sources	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026
Sales Taxes		-32.9%	26.8%	17.0%	12.0%	7.0%	5.0%	3.5%
Property Taxes		1.8%	2.3%	-2.2%	1.8%	5.2%	5.0%	5.8%
Transient Occupancy Tax								
General Purpose		-27.9%	-65.4%	5.8%	16.7%	45.8%	7.0%	7.0%
Infrastructure		-6.1%	-66.4%	223.6%	50.0%	31.4%	7.0%	7.0%
Documentary Transfer Tax		-31.9%	46.3%	3.8%	1.6%	2.8%	3.4%	3.4%
Utility Users Tax		-6.4%	-6.7%	2.1%	3.5%	5.1%	4.9%	5.5%
Other Taxes and Fines		64.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Subtotal: Taxes		-12.3%	-1.8%	8.3%	8.0%	8.8%	5.1%	5.1%
Charges for Services		7.9%	0.0%	-1.9%	0.6%	2.2%	1.2%	1.2%
Permits and Licenses		3.7%	0.0%	-0.8%	5.4%	3.4%	3.3%	1.9%
Return on Investments		-22.5%	-19.7%	-3.5%	-4.2%	-3.3%	2.4%	2.8%
Rental Income		-0.1%	0.0%	-3.0%	2.6%	2.6%	2.6%	2.6%
From Other Agencies		-63.9%	0.0%	0.0%	-7.9%	0.0%	0.0%	0.0%
Charges to Other Funds		8.1%	0.0%	-5.2%	3.3%	2.5%	2.0%	0.7%
Other Revenue		-9.7%	0.0%	-1.2%	0.0%	0.0%	0.0%	0.0%
Total Non-Tax Revenue		2.3%	-0.3%	-2.6%	2.0%	2.3%	1.9%	1.5%
Operating Transfers-In		3.8%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
BSR Contribution (One-Time)								
Total Source of Funds		-6.2%	-1.1%	3.7%	5.2%	5.9%	3.7%	3.6%

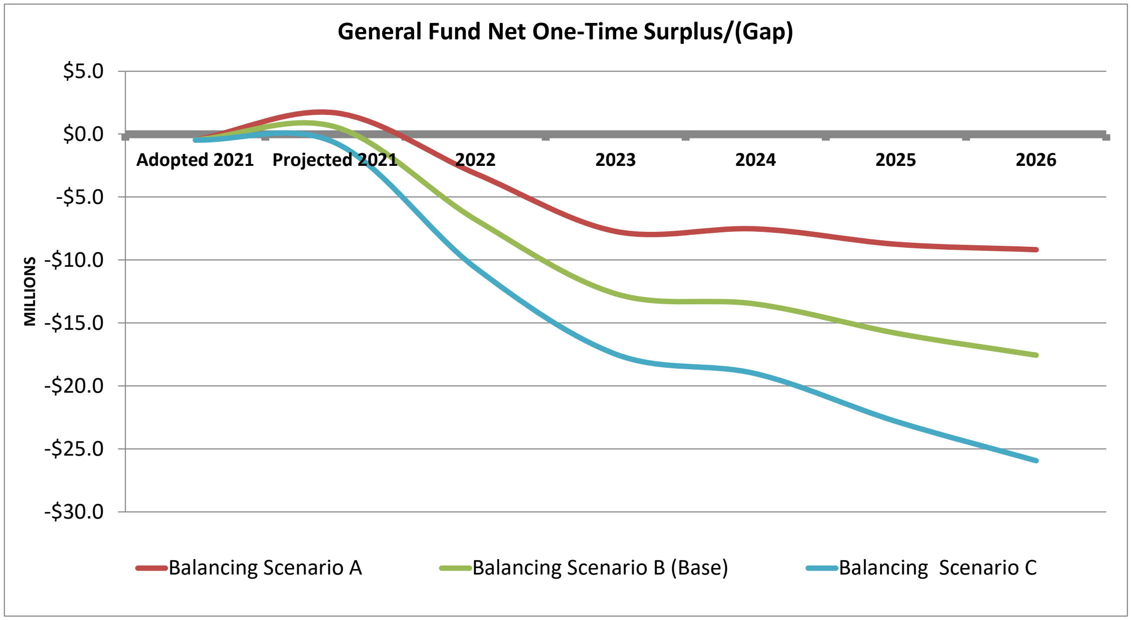
FY 2022-2031 General Fund Long Range Financial Forecast Revenue Table
Financial Balancing Scenario C

Revenue & Other Sources	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	CAGR 5 Years
Sales Taxes	$30,563	$20,500	24,000	$25,920	$27,734	$29,676	$30,863	$31,943	2.1%
Property Taxes	51,089	52,000	53,173	50,223	51,102	53,788	55,133	56,511	1.2%
Transient Occupancy Tax	-	-							
General Purpose	11,568	8,344	2,508	1,988	2,319	3,256	3,745	4,007	7.3%
Infrastructure	6,985	6,556	1,910	4,638	6,958	8,804	10,124	10,833	8.9%
Documentary Transfer Tax	6,903	4,700	6,875	7,013	7,188	7,368	7,515	7,665	0.9%
Utility Users Tax	16,140	15,100	14,080	14,327	14,543	14,760	15,020	15,320	0.7%
Other Taxes and Fines	1,172	1,925	1,925	1,925	1,925	1,925	1,925	1,925	0.0%
Subtotal: Taxes	124,422	109,125	104,471	106,034	111,769	119,577	124,325	128,204	1.9%
Charges for Services	23,557	25,418	25,418	24,934	25,087	25,629	25,928	26,235	0.5%
Permits and Licenses	8,038	8,336	8,336	8,273	8,717	9,015	9,310	9,484	1.4%
Return on Investments	1,419	1,100	883	852	816	789	808	831	-0.2%
Rental Income	16,037	16,022	16,022	15,534	15,935	16,347	16,772	17,210	1.0%
From Other Agencies	1,529	551	551	551	508	508	508	508	-0.8%
Charges to Other Funds	11,099	11,992	11,992	11,364	11,743	12,042	12,285	12,368	0.9%
Other Revenue	2,848	2,571	2,571	2,539	2,540	2,541	2,541	2,542	0.0%
Total Non-Tax Revenue	64,526	65,990	65,773	64,048	65,345	66,871	68,153	69,179	0.8%
Operating Transfers-In	20,568	21,359	21,359	21,362	21,365	21,368	21,371	21,374	0.0%
BSR Contribution (One-Time)									
Total Source of Funds	$209,515	$196,474	$191,603	$191,444	$198,479	$207,816	$213,849	$218,757	

Revenue & Other Sources	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026
Sales Taxes		-32.9%	17.1%	8.0%	7.0%	7.0%	4.0%	3.5%
Property Taxes		1.8%	2.3%	-5.5%	1.8%	5.3%	2.5%	2.5%
Transient Occupancy Tax								
General Purpose		-27.9%	-69.9%	-20.7%	16.6%	40.4%	15.0%	7.0%
Infrastructure		-6.1%	-70.9%	142.8%	50.0%	26.5%	15.0%	7.0%
Documentary Transfer Tax		-31.9%	46.3%	2.0%	2.5%	2.5%	2.0%	2.0%
Utility Users Tax		-6.4%	-6.8%	1.8%	1.5%	1.5%	1.8%	2.0%
Other Taxes and Fines		64.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Subtotal: Taxes		-12.3%	-4.3%	1.5%	5.4%	7.0%	4.0%	3.1%
Charges for Services		7.9%	0.0%	-1.9%	0.6%	2.2%	1.2%	1.2%
Permits and Licenses		3.7%	0.0%	-0.8%	5.4%	3.4%	3.3%	1.9%
Return on Investments		-22.5%	-19.7%	-3.5%	-4.2%	-3.3%	2.4%	2.8%
Rental Income		-0.1%	0.0%	-3.0%	2.6%	2.6%	2.6%	2.6%
From Other Agencies		-63.9%	0.0%	0.0%	-7.9%	0.0%	0.0%	0.0%
Charges to Other Funds		8.1%	0.0%	-5.2%	3.3%	2.5%	2.0%	0.7%
Other Revenue		-9.7%	0.0%	-1.2%	0.0%	0.0%	0.0%	0.0%
Total Non-Tax Revenue		2.3%	-0.3%	-2.6%	2.0%	2.3%	1.9%	1.5%
Operating Transfers-In		3.8%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
BSR Contribution (One-Time)								
Total Source of Funds		-6.2%	-2.5%	-0.1%	3.7%	4.7%	2.9%	2.3%

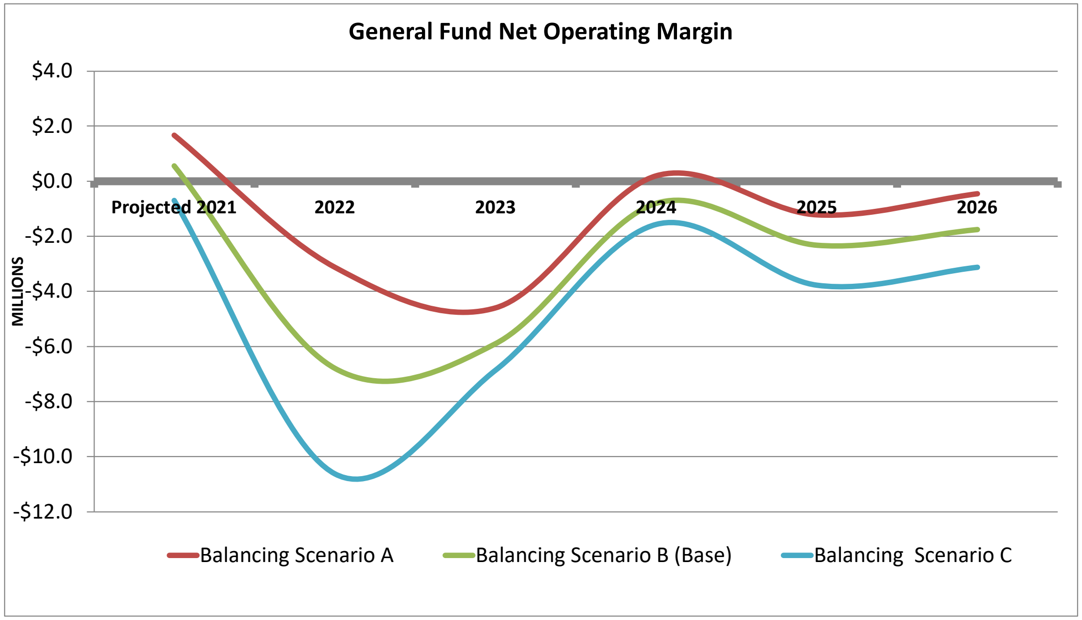
Net One-Time Surplus/(Gap)

	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	Cumulative Surplus/ (Gap)
Balancing Scenario A	($0.5)	$1.7	($3.1)	($7.7)	($7.5)	($8.7)	($9.2)	($36.3)
Balancing Scenario B (Base)	($0.5)	$0.6	($6.8)	($12.7)	($13.5)	($15.8)	($17.6)	($66.3)
Balancing Scenario C	($0.5)	($0.7)	($10.6)	($17.5)	($19.0)	($22.8)	($25.9)	($95.9)



Net Operating Margin

	Projected 2021	2022	2023	2024	2025	2026	Cumulative Surplus/ (Gap)
Balancing Scenario A	$1.7	($3.1)	($4.6)	$0.2	($1.2)	($0.5)	($9.2)
Balancing Scenario B (Base)	$0.6	($6.8)	($5.9)	($0.8)	($2.3)	($1.8)	($17.6)
Balancing Scenario C	($0.7)	($10.6)	($6.9)	($1.6)	($3.8)	($3.1)	($25.9)



FY 2022-2031 Long Range Financial Forecast – Base Case
Detailed Revenue and Expense Assumptions

Detailed information related to the City's revenue and expense assumptions used in the development of the FY 2022-2031 Long Range Financial Forecast (LRFF) for the General Fund are included below. The tabular data for this Base Case forecast, also referred to as Scenario B in the staff report, can be found in Attachment A.

REVENUE ASSUMPTIONS

On October 19, 2020, the City Council reviewed and discussed the preliminary Q1 FY 2021 financial status report. While this report provided a snapshot in time, uncertainty around the pandemic grows, with some revenues expected to continue to do significantly worse than originally projected, others are trending above expected levels. Tax revenues constitute approximately 60 percent of General Fund resources and in FY 2022, the forecast projects a $2.0 million, or 1.8 percent, tax revenue increase compared to the levels in the Adopted FY 2021 Budget. These tax increases are partially offset by reductions in other revenue categories. In total, revenues are anticipated to stay flat compared to the FY 2021 Adopted Budget, remaining at $197.0 million in FY 2022. The changes by revenue category, as well as the current expected FY 2021 status of many of the categories, are discussed in greater detail below.

TABLE 11: FY 2022 – 2031 General Fund Revenue Forecast

Revenue & Other Sources	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	CAGR 10 Years
Sales Taxes	$30,563	$20,500	$25,030	$28,034	$30,557	$32,543	$34,170	$35,366	$36,604	$37,555	$38,532	$39,534	$40,562	7.1%
Property Taxes	51,089	52,000	53,173	51,228	52,124	54,844	57,038	59,320	61,693	64,160	66,727	69,396	72,172	3.3%
Transient Occupancy Tax														
General Purpose	11,568	8,344	2,740	2,529	2,950	4,300	4,601	4,924	5,194	5,444	5,699	5,979	6,278	-2.8%
Infrastructure	6,985	6,556	2,090	5,899	8,849	11,628	12,442	13,312	14,045	14,719	15,411	16,166	16,974	10.0%
Documentary Transfer Tax	6,903	4,700	6,875	7,137	7,246	7,451	7,701	7,965	8,245	8,543	8,853	9,195	9,553	7.4%
Utility Users Tax	16,140	15,100	14,080	14,370	14,801	15,263	15,767	16,240	16,646	17,062	17,488	17,925	18,374	2.0%
Other Taxes and Fines	1,172	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	1,925	0.0%
Subtotal: Taxes	124,422	109,125	105,913	111,122	118,452	127,954	133,644	139,052	144,352	149,408	154,635	160,120	165,838	4.3%
Charges for Services	23,557	25,418	25,418	24,934	25,087	25,629	25,928	26,235	26,552	26,878	27,214	27,560	27,878	0.9%
Permits and Licenses	8,038	8,336	8,336	8,273	8,717	9,015	9,310	9,484	9,597	9,828	10,139	10,330	9,280	1.1%
Return on Investments	1,419	1,100	883	852	816	789	808	831	855	880	906	936	966	-1.3%
Rental Income	16,037	16,022	16,022	15,534	15,935	16,347	16,772	17,210	17,662	18,127	18,605	19,096	19,600	2.0%
From Other Agencies	1,529	551	551	551	508	508	508	508	508	508	508	508	508	-0.8%
Charges to Other Funds	11,099	11,992	11,992	11,364	11,743	12,042	12,285	12,368	12,375	12,573	12,788	12,998	13,325	1.1%
Other Revenue	2,848	2,571	2,571	2,539	2,540	2,541	2,541	2,542	2,543	2,544	2,545	2,546	2,546	-0.1%
Total Non-Tax Revenue	64,526	65,990	65,773	64,048	65,345	66,871	68,153	69,179	70,092	71,338	72,704	73,973	74,104	1.2%
Operating Transfers-In	20,568	21,359	21,359	21,362	21,365	21,368	21,371	21,374	21,377	21,380	21,383	21,386	21,389	0.0%
BSR Contribution (One-Time)														
Total Source of Funds	$209,515	$196,474	$193,045	$196,532	$205,162	$216,193	$223,168	$229,605	$235,821	$242,126	$248,722	$255,479	$261,330	

This table is available in a larger format in Attachment A.

Sales Tax

Sales tax receipts have seen significant declines as the City's revenue base is dependent on many high-end goods and dining options at regional destinations, such as Stanford Shopping Center. These significant declines were partially offset by business to business sales, the one sector that outpaced other areas with 3.3 percent year-over-year growth. Based on activity and receipts for the recent quarter close, it is estimated that sales tax revenue will exceed the FY 2021 Adopted Budget by $4.5 million, or 22.1 percent, and will generate a total of $25.0 million by year-end of FY 2021. In FY 2022, sales tax is expected increase to $28.0 million, or 12.0 percent, above the revised FY 2021 forecast. Segments contributing to this growth include restaurants and auto sales and leases. Department and furniture/appliance sales experienced declines. The FY 2021 – FY 2031 LRFF anticipates a 7.1 percent compounded annual growth rate (CAGR) through the term of the forecast, with significant growth in FY's 2022 and 2023 as the local economy adjusts to health guidelines and restrictions caused by the pandemic. The forecast then tapers down to 2.6 percent growth annually.

Property Tax

Property tax revenue is the General Fund's largest revenue source and represents approximately 25 percent total revenues. The average annual property tax growth over the last 10 years has been approximately 6.6 percent. Although not in decline, trends currently indicate a delay in timing and therefore are expected to remain flat through FY 2022 as that year will be a reflection of activity in 2020, where average and median home prices currently reflect a slight downward trend and the CPI will remain below the two percent maximum. In addition, fiscal years 2018, 2019, and 2020 included receipts of $1.4 million, $2.7 million, and $3.9 million respectively, for excess Educational Revenue Augmentation Fund (ERAF) distributions from the County of Santa Clara. ERAF is the fund used to collect and disburse property taxes that are shifted to/from cities, the County, and special districts prior to their reallocation to K-14 school agencies. When the state shifts more local property tax than required to support schools these funds are returned and known as excess ERAF. As a result of the volatility of ERAF, it is not considered a permanent local revenue source.

The FY 2021 Adopted Budget assumes $52.0 million in total property tax and is expected to grow to $53.2 million, a $1.2 million increase, by year-end which includes $3.2 million in Excess ERAF. FY 2022 is property tax is expected to remain flat and, in light of the uncertainties surrounding the continued receipt of Excess ERAF, has been reduced in the FY 2022 forecast by $1.0 million and conservatively added back in FY 2024 ($1 million annually) for the remainder for the forecast.

Transfer of ownership continues to be significant driver of growth and at a macro level, it can be seen that the number of sales has been on the decline even pre-pandemic, and the growth in value, or the difference between the assessed value before the sale and the assessed value after the sale has also continued to decline. Through July 2020, the median sales price in the City of Palo Alto remained relatively flat, increasing slightly from $2.8 million to $3.0 million (Zillow.com).

Transient Occupancy Tax (TOT)

TOT continues to be the most significantly impacted, though revenues have improved slightly above the activity seen in April and May 2020. Currently, receipts are tracking approximately 80 percent below pre-COVID levels. As a region where business and other non-leisure travel is a driving impact, it is expected that until the virus is under control and both domestic and international travel resumes, the City will continue to experience significantly reduced TOT revenue. Rapid progression in vaccines as well as the expected opening of new hotels in Palo Alto are positive developments that will drive recovery for this tax revenue.

Compared to the FY 2021 Adopted Budget, the FY 2021 estimate represents a decrease of 67.6 percent, or $10.1 million. Year-over-year, daily average room rates decreased by half, from $314 per day to $156 per day, while the occupancy rate has declined from 80 percent to 44 percent. According to CBRE, demand for hotel rooms nationally was down by 36.8 percent year-over-year from Q3 calendar year 2019 to 2020, and national hotel occupancy declined a corresponding 37.9 percent year-over-year. San Francisco saw a significant 84.1 loss in Revenue Per Available Room (RevPAR), the third greatest decline in the continental U.S., behind Boston and New York. San Jose saw a loss slightly greater than 70 percent from Q3 calendar year 2019 to 2020.

TOT realized double digit growth in FYs 2015 and 2016 due the 2 percent rate increase (from 12 percent to 14 percent tax rate), the recovering economy, and the addition of the three large hotels. The forecast assumes that TOT revenue levels decline further by the end of FY 2021 and, as a vaccine proves to prevent the spread of COVID-19, rebounds in FY's 2023 and 2024, with moderate growth between 4.7 to 7.0 growth for the remainder of the forecast.

Utility User's Tax (UUT)

The UUT is levied on electric, gas, and water consumption, as well as on telephone usage. In total, FY 2021 revenues were budgeted at $15.1 million and is currently on target to be realized by the end of the fiscal year.

Documentary Transfer Tax (DTT)

In FY 2015, DTT peaked at $10.1 million. This milestone was a consequence of several large commercial transactions on Page Mill Road and in the Stanford Research Park. Since that time, DTT has significantly moderated, with $6.9 million earned in FY 2020. Revenue from July through October in FY 2020 is running 10.0 percent above the same period in FY 2019 and anticipates that DDT revenues will exceed the FY 2021 Adopted Budget by 46.3 percent, or $2.2 million.

As in past years, this revenue source is challenging to forecast since it is highly dependent on sales volume and the mix of commercial and residential sales. The number of transactions through October 2020 (229) are running higher than those through October 2019 (186); however, the total value of these transactions has decreased by 6.0 percent. Though the Palo Alto housing market remains strong, as discussed in the Property Taxes section, residential median sales price in Palo Alto has flatlined and property turnover has increased; 1.5 to 3.9 percent annual growth is assumed over the length of the forecast.

Charges for Services and Permits and Licenses

Revenues in the 'Charges for Services' and the 'Permits and Licenses' categories are anticipated to be $24.9 million and $8.3 million, respectively, in Fiscal Year 2022. These amounts are approximately $0.5 million lower than the FY 2021 Adopted Budget amounts, mainly due to adjustments to revenue from new Fire Department fees discussed below. Revenues in these categories were impacted by changes in FY 2021 such as the planned opening of the newly remodeled Junior Museum and Zoo with a ticketed entry fee and membership program.

Two new proposed fees in the Fire Department, a first responder fee (assessed on commercial insurance companies) and an ambulance subscription fee, were assumed in the FY 2021 Adopted Budget, totaling $1.9 million. These fees would cover the cost for initial response for first due engine and secure co-pay free ambulance transport, respectively. Both fees proposed by the Fire Department are still in development and have not generated revenue in FY 2021. The ambulance transport fee was discussed with the Finance Committee in December 2020 (CMR 11710) and will be brought forward to City Council for consideration and established as a new Municipal Fee.

Overall, revenue estimates in these categories are primarily driven by the cost of staff to provide services to the community; therefore, revenues are impacted by the City's personal service costs. Typically, revenue estimates and corresponding fees are increased by rates consistent with salary and benefits and general CPI trends. Staff analysis year to date estimates that annual revenue collections in these categories will remain within current budgeted levels in FY 2021. Additionally, the return of canceled or modified services due to the pandemic are still uncertain. Revenue estimates in these categories have therefore been kept generally consistent over the forecast period. One exception to this is for Development Services activities and related revenue. Development Services fees are fully cost recoverable and the department has been modeled as cost-neutral through the forecast. Staff will analyze municipal fee revenue activity as part of the FY 2022 Budget development process and bring forward adjustments as appropriate.

Return on Investment

The return on investment category reflects the interest earnings on the City's investment portfolio. This category is a combination of past investments, new investments at current market rates, and available investable cash which fluctuates seasonally and annually. Staff had anticipated the decline in interest rate would occur sooner and at a faster rate than it has occurred, so the City experienced a higher than anticipated return on investments. In addition, prudent investments further resulted in higher investment yields and earnings.

The average portfolio rate of return for the first quarter of FY 2021 was 1.85 percent, a 2.0 percent average yield as of the fourth quarter of FY 2020. The revised FY 2021 interest earning forecast of $0.9 million is $0.2 million lower than the Adopted Budgeted of $1.1 million. In FY 2022, the forecast is $0.9 million which reflects the declining interest rate environment. Since the City's portfolio is laddered over a ten-year period, each year, around 10 percent to 16 percent of investments mature that is typically reinvested at the current market rates. As a result, the City's portfolio yield and earnings decline more gradually than the market rate declines.

Rental Income

Rental Income of $15.5 million primarily reflects rent paid to the General Fund from the City's Enterprise Funds and the Cubberley Community Center. There is a slight decrease in rental income from FY 2021 to FY 2022 of $0.5 million. This decrease represents the completion of the payments from the Refuse Fund to the General Fund associated with the Landfill in FY 2021, partially offset by a 2.0 percent CPI increase. Steady growth after that reflects a 2.5 to 3.0 percent increase for this area partially offset by minor adjustments throughout the forecast. The annual increase for rental revenue is based on a review of the changes in the California Consumer Price

Index (CCPI) in the San Francisco Bay Area from the August to August period with an slight increase in the CPI amount to account for anticipated steady economic recovery after the current health crisis is complete. It is expected that revenues will be reviewed and revised subsequent to this forecast based on updated information, typically the December to December change in the CCPI.

Charges to Other Funds

The main source of revenues in this category is General Fund administrative cost allocation plan charges to the Enterprise and Internal Service Funds. Internal support departments such as Administrative Services, Human Resources, and Council Appointed Offices provide services to Enterprise and Internal Service Funds. The costs for these services are recovered through the administrative cost allocation plan charges. The FY 2022 estimate for Charges to Other Funds of $11.4 million reflects a slight decrease of 5.2 percent from the FY 2021 Adopted Budget of $12.0 million; this is primarily attributable to fully adjusting the costs associated with the allocated charges in the Internal Support Departments to the adjustments made as part of the FY 2021 Budget. After FY 2022, growth is moderate, ranging from 0.1 percent up to 3.3 percent annual increases throughout the forecast period.

Operating Transfers-in

Operating Transfers-in materialize as expenses in other funds throughout the City and as a revenue in the General Fund. This budget category includes repayment of a previous loan from the General Fund to the Airport Fund, funding for police patrol in the downtown area, and the equity transfer from the Electric and Gas funds. In accordance with a methodology approved by the City Council in June 2009, the equity transfer is calculated by applying a rate of return on 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). Under previously approved methodologies, the transfer amount is calculated based on the Utility Department's projections from the Electric and Gas Five Year Financial Forecasts, as approved by the City Council in spring 2020. Overall, the Operating Transfers-in are estimated to remain the same as the FY 2021 Adopted Budget level of $21.74 million. This estimate does not take into account a class action lawsuit for refund of charges to gas and electrical customers that was filed against the City in October 2016. For further information, refer to the 'Litigation' discussion below on page 16 of this Attachment B.

EXPENSE ASSUMPTIONS

As part of developing the FY 2022 Forecast expenditure budget, the General Fund expense categories have been adjusted by removing FY 2021 Adopted Budget one-time expenses and updating major cost elements such as salary and benefits costs. The tables below display the expense forecast and when compared to the FY 2021 Adopted Budget, growth of 3.2 percent is expected in FY 2022, with growth ranging from 1.5 percent to 7.1 percent throughout the ten-year forecast.

TABLE 12: FY 2022 – 2031 General Fund Expense Forecast

Expenditures & Other Uses	Actual 2020	Adopted 2021	Projected 2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	CAGR 10 Years
Salary	$72,958	$67,421	$67,421	$70,649	$72,862	$74,708	$76,559	$78,175	$79,814	$81,445	$83,075	$84,936	$86,317	2.5%
Benefits	60,257	57,121	$ 57,121	62,420	65,545	68,078	70,444	71,265	71,347	72,611	73,874	75,253	76,623	3.0%
Subtotal: Salary & Benefits	133,216	124,541	124,541	133,069	138,407	142,786	147,003	149,441	151,161	154,055	156,949	160,189	162,940	2.7%
Contract Services	25,360	21,953	21,953	20,710	21,220	22,147	22,747	23,365	24,003	24,658	25,334	26,031	26,748	2.0%
Supplies & Material	2,710	2,975	2,975	3,027	3,102	3,194	3,289	3,387	3,488	3,592	3,699	3,809	3,922	2.8%
General Expense	9,755	9,079	9,079	7,526	7,597	7,684	7,774	8,424	9,164	10,080	11,023	9,156	9,200	0.1%
Rents & Leases	1,520	1,862	1,862	1,913	1,966	2,021	2,079	2,139	2,200	2,262	2,326	2,393	2,461	2.8%
Facilities & Equipment	462	427	427	435	446	459	473	487	501	516	531	547	563	2.8%
Allocated Charges	21,771	18,311	18,311	19,310	21,129	21,634	22,042	22,478	22,949	23,421	23,987	24,443	24,871	3.1%
Total Non Sal/Ben Before Transfers	61,579	54,607	54,607	52,921	55,459	57,139	58,403	60,280	62,304	64,529	66,900	66,378	67,764	2.2%
Operating Transfers-Out	8,049	4,334	4,334	4,428	4,458	4,489	4,520	4,556	4,588	4,625	4,662	4,695	4,733	0.9%
Transfer to Infrastructure - Base	17,187	6,911	6,911	7,006	10,673	13,640	16,607	19,575	20,009	20,455	20,912	21,381	21,862	12.2%
Transfer to Infrastructure - TOT	6,985	6,556	2,090	5,899	8,849	11,628	12,442	13,312	14,045	14,719	15,411	16,166	16,974	10.0%
Total Use of Funds	$227,015	$196,949	$192,483	$203,322	$217,846	$229,681	$238,974	$247,163	$252,106	$258,383	$264,833	$268,808	$274,273	3.4%

This table is available in a larger format in Attachment A.

Salary and Benefits

Table 6 above (also included in Attachment A) depicts the estimated General Fund salaries and benefits costs for the next decade. Over the forecast period, the salaries and benefits costs remain relatively consistent in comparison to the total expenditure budget. In FY 2022, salaries and benefits costs represent approximately 65 percent of the General Fund budget expenditures, similar to the FY 2021 Budget, and decrease to approximately 60 percent of total General Fund expenditures at the end of the 10-year forecast.

Salary and Benefits are projected to increase $8.3 million or 6.9 percent from the prior year, from $124.5 million to $133.1 million. Discussed in the following sections, this is primarily attributable to increases in salaries ($3.1 million or 4.5 percent), pension costs ($3.1 million or 9.6 percent), and workers' compensation ($1.1 million or 33.2 percent).

Salary

Consistent with the City's salary budget methodology for recent budgets, positions are budgeted at the actual rate of pay of employees including benefits as of Fall 2020. Then, by position, salary costs are updated in accordance with applicable Memorandum of Agreements (MOA's) between the City and its labor groups and the Management and Professional Personnel and Council Appointees Compensation Plan(s).

In the prior year, the City engaged with various labor groups and successfully negotiated concessions with some of its labor groups to generate cost savings. The FY 2021 Adopted Budget includes concessions with the unrepresented Management and Professionals Group at the equivalent of a 10 percent 'give-back' that consists of a wage freeze, furlough, and reduced flexible management benefits. In total, this generated savings of $3.5 million in savings citywide ($2.3 million in the General Fund). Agreements with safety groups include a deferral of wage increases for one year in the Fire Chief's Association (FCA), Police Management Association (PMA), and Palo Alto Peace Officers' Association (PAPOA), and deferral of wage and step increases for one year in the International Association of Fire Fighters (IAFF) Group. The savings achieved in the safety groups were used to fund retirement incentives and offset an attrition period that allows the Fire and Police Departments to delay the separation of filled positions identified to be held vacant in FY 2021 (position freezes).

As part of concessions, the City reached agreements with the management and safety groups that extend the terms of the existing Memorandum of Agreements (MOA's) to reduce or postpone negotiated increases and other forms of compensation one year. With these extensions, agreements expire June 30, 2021 and June 30, 2022 respectively. The City has negotiated labor agreements with the Service Employees International Union (SEIU) that extends through December 2021 and anticipates developing new labor agreements with the Utilities Management and Professional Association (UMPAPA) whose contract expired June 30, 2020.

The FY 2022 – 2031 forecast assumes that wage increases resume beginning in FY 2022, including step increases for employees in applicable positions, including SEIU, IAFF, and PAPOA and merit increases for Management and Professional employees. Additional general wage adjustments of 2.0 percent are included in each year of the Forecast for all employees in years when there is not a MOA in effect. This is consistent with prior Council direction to use the 2.0 percent increase as a forecasting model, not as a commitment to future negotiations. If agreements are negotiated with salary increases greater than presumed in the forecast, then expenses will increase accordingly.

Benefits

Pension: Pensions are budgeted based on CalPERS determined rates as of the June 30, 2019 valuation (CMR 11607) for the City's Miscellaneous and Safety plans. The annual valuation provides estimates for the first six years of the forecast and the CalPERS Pension Outlook Tool has been used to estimate the remaining years.

CalPERS determines the City's total contributions for a given Fiscal Year as the sum of two factors: Normal Cost (NC) and Unfunded Accrued Liability (UAL). Together the NC and the UAL expressed as a percentage of payroll is the 'blended rate' and is used to represent total costs in the discussion below.

The *Normal Cost (NC)* is expressed as a percentage of payroll and is paid as part of the payroll reporting process of active employees. Commonly referred to as the 'pay-go' cost, the NC is variable and increases or decreases directly with the salary levels of the City. It represents the necessary funding for the City to pay for employees presuming that CalPERS meets the current set of assumptions.

In a year that CalPERS does not meet assumptions, due to plan changes, assumption changes, method changes, or plan experience (including investment gains/losses), there is an increase or decrease to the *Unfunded Accrued Liability (UAL)*. Commonly referred to as the 'catch-up' cost, the UAL is expressed as a dollar amount and is calculated over an amortized period with defined annual payments, similar to a mortgage. The contributions for UAL are billed as a flat dollar amount as opposed to a percentage of payroll due to potential funding issues that could arise from a declining payroll or number of active members in the plan. However, CalPERS provides an estimated percentage of payroll for UAL to allow a consistent comparison of total costs.

The decision by the CalPERS Board of Administration to lower the discount rate from 7.5 percent to 7.0 percent over three years has resulted in significant impacts to the City's pension liability. The final year of this phase in occurred in FY 2021, reducing the rate from 7.25 to 7.00 percent. However, due to the amortization policy to ramp-up UAL gains and losses over a 5-year time period, the full impact of this change will not be realized until FY 2025.

In the miscellaneous plan, total costs are projected to increase from the current 38.4 percent in FY 2021 to 41.8 percent in FY 2022. The rate steadily increases to a peak of 43.7 percent in FY 2025 before tapering down over a two-year period to 36.2 percent in FY 2027. The decline in the outer years of the forecast is associated with various amortization factors including the pay-down of previously sustained losses due to assumption changes and benefit improvements offered to employees. CalPERS also anticipates that NC will decrease as employees in lower cost pension plans replace employees in higher cost plans over time.

In the safety plan, total costs are projected to increase from the current 65.3 percent in FY 2021 to 69.6 percent in FY 2022. Similar to the Miscellaneous plan, rates steadily increase to a level of 74.2 percent in FY 2025 before tapering in the outyears. However, the decline in the outyears of the safety plan is not as prominent due to the pay-down of a smaller benefit change.

The table below shows CalPERS' FY 2021 and FY 22 blended cost rates and CalPERS projected FY 2023 through FY 2031. These rates do not consider the employee pick-up of the employer share; that pick-up materializes as savings in the City's pension costs. Consistent with applicable MOAs, the forecast does presume that employees in the miscellaneous plan will pick up 1 percent of the employer pension cost and that safety plan members will pick up percentages between 3 to 4 percent, depending on the year and the unit.

TABLE 13: CalPERS' Projected FY 2021-2031 Blended Retirement Rates

(percentage of payroll)

	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031
Miscellaneous	38.4	41.8	43.0	43.3	43.7	40.6	36.2	35.6	35.2	34.9	34.5
Safety	65.3	69.6	72.3	73.5	74.2	73.8	73.2	71.2	70.4	69.5	68.7

Consistent with current practice, the forecast also includes supplemental contributions to the City's irrevocable Section 115 Pension Trust ("Pension Trust Fund"). In January 2017 the City council authorized the establishment of a Pension Trust Fund with the Public Agency Retirement Service (PARS) (CMR 7553). Through FY 2021, a total of $32.3 million in principal contributions will have been made to the PARS Trust. Contributions were initially made on an ad-hoc basis, using one-time savings or excess revenues. In October 2018, the City Council directed staff to include in budget assumptions the NC for pension benefits at an equivalent of 6.2 percent discount rate and a transfer of the additional funding beyond CalPERS actuarial determined contribution levels to the Pension Trust Fund (CMR 9740). This practice was reinforced in the development of a Pension Funding Policy, scheduled for City Council adoption in November 2020 (CMR 11722). In this forecast, an approximate $5.1 million ($3.0 million in the General Fund) in supplemental contributions is assumed in FY 2022, relatively constant to prior year contribution levels. Approximately $49.9 million ($32.6 million in the General Fund) in supplemental contributions are assumed over the ten-year horizon.

In addition to the CalPERS and supplemental Pension Trust Fund contributions, the FY 2022 – 2031 forecast assumes losses for the preliminary 4.7 percent return on investments in the period ending June 30, 2020. CalPERS completes their actuarial analysis two years in arrears by practice, so these losses were not included in the most recent actuarial valuation report and will not materialize until FY 2023. Using the CalPERS Pension Outlook Tool, and holding all other assumptions constant, the projected losses for a 4.7 percent investment return are approximately $44.4 million ($32.6 million in the General Fund). This amount will be amortized over a 20-year period with a five-year ramp up; gradually increasing from $0.5 million ($0.4 million in the General Fund) in FY 2023 to $2.5 million ($1.8 million in the General Fund) in FY 2027 - 2042.

In the General Fund, it is anticipated the City will spend a total of $35.1 million on total pension costs in FY 2022, including both CalPERS contributions and supplemental Pension Trust Fund contributions. This is approximately $3.1 million higher than the prior year costs of $32.0 million, or a 9.6 percent increase. It is anticipated that these costs will increase to a peak of $39.6 million in FY 2025. These expenses represent approximately 15 to 18 percent of the General Fund's total expenses.

Retiree Medical: Retiree Medical is based on the most recent actuarial study prepared by Bartel Associates, which is completed every two years. The most recent study was completed in FY 2020 and presented to the City Council as part of the Fiscal Year 2021 Adopted Budget (CMR 11330). The table below details the cost to the General Fund for every year through FY 2028 based on that actuarial study. The final year represents an extrapolation of the actuarial study but are consistent with the year over year growth seen throughout the time period. Consistent with City Council direction, as recommended by staff, the City continues to budget for the full payment of the Actuarial Determined Contribution (ADC) for retiree healthcare. Since CalPERS blends active employees with pre-Medicare retirees and charges the same medical premium, even though younger employees on average consume less healthcare and thereby subsidize older employees and retirees, there is an implied subsidy that effectively lowers the funding necessary to meet the ADC. The table below excludes the implied subsidy.

TABLE 14: FY 2022 – FY 2031 Retiree Medical General Fund Contributions (Millions)

	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031
General Fund	$8.8	$9.0	$9.2	$9.5	$9.8	$10.1	$10.5	$10.9	$11.2	$11.5

The City's CERBT Trust, which contains prefunding for the City's Other Post Employment Benefit (OPEB) liabilities, maintains a very healthy fund balance. The CERBT Trust currently has over $130 million in assets. As the City continues through the next few years, it will be important to examine impacts associated with Retiree Medical and, if financially prudent, to subsidize the City's ADC payments with withdrawals from the OPEB CERBT Trust. That savings could possibly be used for other competing priorities, such as prepaying an additional portion of the City's pension UAL.

Healthcare: Consistent with the most recent labor agreements between the City and its bargaining units in the General Fund, the City's contribution amounts towards medical costs for employees are based on a flat rate contribution from the City, with the employee contributing towards the remaining medical plan premium. Like salaries, healthcare costs are updated in accordance with applicable Memorandum of Agreements (MOA) between the City and its labor groups and the Management and Professional Personnel and Council Appointees Compensation Plan(s). Consistent with the prior year's forecast, this forecast assumes an inflation factor of four percent on healthcare and two percent on dental and vision costs to the City in each year of the Forecast for all employees in years when there is not a MOA in effect.

Workers' Compensation: The budget appropriation for workers' compensation includes an estimate for claims incurred and reserves for current filings at an 85 percent confidence level, based on actuary studies completed by Bickmore. In recent periods, claims costs have been trending up. In FY 2020, expenditures increased by $1.3 million or 26 percent from $5.1 million to $6.4 million from the prior year, exceeding budgeted levels and requiring additional allocations to departments to offset expenses and ensure a positive fund balance. Actuary estimates completed in August 2019 informed FY 2021 budget levels of $5.7 million ($3.8 million in the General Fund). As part of cost reduction strategies in FY 2021, department allocations for workers' compensation were reduced by $625,000, from $5.7 million to $5.1 million, with costs offset by fund balance. More recent actuary estimates completed in August 2020 project higher than expected levels for FY 2021 at $6.5 million ($4.3 million in the General Fund). The fund balance cannot support this expense level, and staff anticipates bringing forward any necessary corrective actions in a subsequent budget process. Estimates for FY 2022 are $6.8 million ($4.5 million in the General Fund), representing a $1.6 million increase ($1.1 million in the General Fund) or 33.2 percent increase over the Adopted FY 2021 Budget of $5.1 million ($3.4 million in the General Fund). Estimates for workers' compensation increase in the forecast at rates consistent with general CPI increases.

Contract Services

This forecast assumes contract services of $20.7 million in FY 2022, reflecting a 5.7 percent decrease from the FY 2021 Adopted budget of $22.0 million. This decrease is driven primarily by the removal of one-time costs adopted in FY 2021 including funding for legal dispute resolutions and funding to address COVID recovery efforts. These decreases are partially offset by a 2.0 percent CPI cost increase in FY 2022 based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August to August period. Steady growth after that reflects a 2.5 to 2.8 percent increase for this area partially offset by minor adjustments throughout the forecast. The annual increase in the CPI amount to account for anticipated steady economic recovery after the current health crisis is complete. It is expected that the estimated CPI increases will be substituted with department base budget requests as part of the FY 2022 budget process.

Supplies and Materials

The FY 2021 Adopted Budget for the General Fund included $3.0 million for Supplies and Materials, which is anticipated to increase slightly by a 2.0 percent CPI cost increase in FY 2022 based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August to August period in FY 2022. Steady growth after that reflects a 2.5 to 3.0 percent increase for this area partially offset by minor adjustments throughout the forecast. The annual increase in the CPI amount to account for anticipated steady economic recovery after the current health crisis is complete. It is expected that the estimated CPI increases will be substituted with department base budget requests as part of the FY 2022 budget process.

General Expense

This category includes costs for travel and meetings, telephone and non-city utilities, contingency accounts, bank card service charges, and subsidies and grants provided through the Human Services Resource Allocation Program (HSRAP). These figures do not include General Expenses for the Cubberley Lease, which is explained in further detail below. The FY 2021 Adopted Budget of $9.1 million included $1.8 million in a Budget Uncertainty Reserve that has been removed in FY 2022 and accounts for the reduction to $7.5 million in FY 2022. That reduction is partially offset by a 2.0 percent CPI cost increase in FY 2022 based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August to August period in FY 2022. The annual increase in the CPI amount to account for anticipated steady economic recovery after the current health crisis is complete. It is expected that the estimated CPI increases will be substituted with department base budget requests as part of the FY 2022 budget process.

General Expense - Cubberley Lease: In FY 2015, the City and Palo Alto Unified School District (PAUSD) agreed to an extension of the Cubberley lease by five years starting January 1, 2015 and expiring December 31, 2019. On October 7, 2019, Council directed Staff to negotiate with PAUSD to extend the lease agreement an additional five years, though December 31, 2024 (CMR 10730). A new Cubberley lease was approved by the City Council on June 23, 2020 (CMR 11460). The new lease is for a smaller portion of the Cubberley site and has a correspondingly lower base rent payment, as detailed in a report on June 15, 2020 (CMR 11386). As part of the original lease agreement, the City Council approved creation of a fund for Cubberley infrastructure improvements. The new lease continues an annual $1.9 million transfer to the Cubberley Property Infrastructure Fund. Therefore, the $1.9 million is classified as an Operating Transfer Out which is discussed in further detail below. With the Cubberley infrastructure funds set aside, the FY 2021 Budget funded $3.7 million for Cubberley Lease payments; this includes extended child daycare sites and associated utility costs. For planning purposes, it is assumed that the current agreement will continue during the entire Forecast period.

Rents and Leases

The Rents and Leases expense category for FY 2022 is estimated to remain relatively consistent to prior-year levels of $1.9 million. This category includes the lease agreement for Development Services staff at locations outside City Hall (285 Hamilton and 526 Bryant). A new lease agreement for the Development Services office location at 526 Bryant Street was approved by the City Council on December 15th (CMR 11426), limiting the space to the basement level. This will be included in the development of the FY 2022 budget, reducing Development Services rent by approximately $400,000, from $1.4 million to $1.0 million. As expenses for rent for Development Services are adjusted, a corresponding revenue adjustment will be made to ensure Development Services maintains cost recovery levels. Including the reductions to Development Services lease costs, the rent category will be reduced by approximately 21.0 percent from FY 2021 to FY 2022. Steady growth after that reflects a 2.7 to 2.9 percent increase for this area partially offset by minor adjustments throughout the forecast.

Facilities and Equipment

The Facilities and Equipment expense category is expected to increase from the FY 2021 Adopted level of $427,000 to $435,000 in FY 2022. This budget category includes subscription payments for equipment such as public safety radios as well as other non-capital equipment. Steady growth after that reflects a 2.5 to 3.0 percent increase for this area partially offset by minor adjustments throughout the forecast.

Allocated Charges

Allocated Charges represent expense allocations by the City's Enterprise and Internal Service Funds for services and products they provide to General Fund departments. The FY 2021 Adopted Budget for the General Fund included $18.3 million for these expenses, including utilities usage, general liability insurance, technology costs, vehicle equipment maintenance and replacement costs and other charges. The FY 2022 allocated charges in the Forecast update the revenues and expenses for these various allocations based on the information available at the time of the Forecast development. FY 2022 is anticipated to experience an increase of 5.5 percent to a total of $19.3 million. This change is primarily due to general CPI and rate increases applied to various charges.

Operating Transfers Out

Operating Transfers Out include transfers from the General Fund to Debt Service Funds, the Technology Fund, and various other funds but excludes transfers to the Capital Improvement Fund, which are detailed in the following Transfer to Infrastructure section. Transfers to debt service funds began reflecting debt issued to fund the renovation of the golf course in FY 2021 and these payments continue throughout the term of the forecast.

The FY 2021 Adopted Budget included Operating Transfers Out of $4.3 million. This was lowered by $185,000 from initial FY 2021 estimates based on the transition to License Plate Reader (LPR) parking enforcement in the Residential Preferential Parking (RPP) program eliminating the need for the one-time operating subsidy transfer from the General Fund to the Residential Parking Permit (RPP) fund to cover an operating deficit. In FY 2022, Operating Transfers Out are anticipated to increase to $4.4 million as a result of standard annual cost escalators of transfers between the General Fund and the Electric and Technology funds.

Transfer to Infrastructure

During the development of the FY 2021 budget, uncertainties from COVID-19 were anticipated to significantly decrease TOT revenues, which represents a significant portion of the General Fund transfer to Capital Improvement Fund. The anticipated impact was reflected in the FY 2021 adopted General Fund transfer to the Capital Improvement Fund, which was $11.6 million and comprised of $5.0 million base transfer including interest earnings and $6.6 million from TOT revenue generated through an additional voter-approved 3.5 percentage point TOT increase. Incremental TOT increases from the voter-approved rate increase and new hotels are dedicated to the Capital Improvement Fund to support the 2014 Council Infrastructure Plan, consistent with City Council direction. Transfers from TOT revenues in FY 2021 are currently projected to decrease further to $2.1 million before increasing in FY 2022 to $5.9 million and steadily increasing to previous levels over the next five years. This budget category also includes the separate $1.9 million transfer to the Cubberley Property Infrastructure Fund, described earlier in this document. The Cubberley transfer remains consistent throughout this Forecast despite the sunset date of the current lease in FY 2024 for Cubberley to capture the anticipated costs.

Committed Additions

The Committed Additions included in the 2022-2031 Long Range Financial Forecast account for anticipated operating and maintenance (O&M) costs in the years they are anticipated to materialize in the General Fund. Anticipated O&M costs begin once capital projects are completed in the 2021-2026 Capital Improvement Plan (CIP). Costs can vary from project to project, depending on what was previously budgeted for a facility and generally include, but are not limited to, costs for fixtures and equipment to outfit a new or expanded facility; custodial, landscaping, and maintenance services; utilities; and additional staff to support operations at the facility. As capital projects are completed and come online, the anticipated O&M expenses would be reflected in the Operating budget.

A majority of O&M costs anticipated for 2022-2026 are for the New Public Safety Building (FY 2024; $355k), Highway 101 Pedestrian/Bicycle Overpass (FY 2022; $100k), and the Library Automated Material Handling Project (FY 2023; $45k). The assumed O&M costs for the Highway 101 Pedestrian/Bicycle Overpass project is a preliminary estimate for the anticipated costs of the maintenance agreement between the City and Caltrans. O&M costs for projects related to parking have not been included in the General Fund forecast, because it is assumed that parking fees in separate parking funds will be collected to support the O&M costs for these projects. However, depending on funding needs, loans between funds to support investments and operating costs may be needed.

There are also a number of capital projects that are included in the five-year CIP that do not have an O&M estimate, either because the full scope of the projects has not yet been defined, or the projects require an initial study in order to establish the full scope of the project. These projects and their subsequent O&M costs would generally fall under the category of Assumptions Not Included in the Forecast which are detailed further below in this document.

TABLE 15: FY 2022 – FY 2031 Committed Additions (Millions)

	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031
General Fund	$100K	$148K	$507K	$522K	$537K	$554K	$570K	$587K	$605K	$623K

ASSUMPTIONS NOT INCLUDED IN FORECAST

It should be noted that this Forecast does not include several potential impacts to the FY 2022 projected budget and the out years of the Forecast. Below is a list of a few items not included. This is not intended to be a comprehensive list nor in any priority order.

Labor negotiations: The City has extended agreements with safety units by one year, through June 30, 2022. These safety units are the Palo Alto Peace Officers Association (PAPOA), the International Association of Fire Fighters (IAFF), Fire Chiefs Association (FCA), and Palo Alto Police Management Association (PAPMA). Additionally, the City extended the Management and Professional agreement by one year, through June 30, 2021. Agreements with the Service Employees International Union (SEIU) extends through 2021 and new labor agreements are anticipated with the Utilities Management and Professional Association (UMPAPA) whose contract expired June 30, 2020. The Base Case Forecast models only modest increases to salaries in years where there is not a contract. This region’s competition for a qualified workforce remains a significant pressure on the City’s anticipated salary costs.

Capital Infrastructure Plan: As referenced earlier, the June 2014 Council approved Infrastructure Plan of $125.8 million in projects was based on construction and design costs with data from 2012. As construction costs have increased and the City is required to pay prevailing wages, the Infrastructure Plan’s funding status has shifted. The FY 2021 Adopted Capital Budget anticipated that these projects would cost $260.5 million.

<u>Grade Separation:</u> The City is currently in the process of determining the number and type of grade separations to pursue. Therefore, the financial impacts remain difficult to define. Additionally, it may make sense to undertake a coordinated area plan for transit in the downtown area to synchronize with the grade separation process. Costs for these items are not included in this forecast. Measure B funds were expected to be a significant portion of the funding for grade separation but at the November 12, 2020 Valley Transportation Authority (VTA) Policy Advisory Committee meeting there was a presentation of the Measure B Base Case in which all funding through the ten-year forecast was allocated to BART Phase II instead of allocated to member cities by project category, as initially planned. This decision would result in an annual revenue impact of approximately $1.3 million for the next ten years.

<u>Parks Master Plan:</u> The Parks Master Plan was finalized in 2017; however, when approved it identified a need to develop a funding strategy and this is still in process. As such, this Forecast does not yet contemplate the necessary investments to fully execute this plan.

<u>Racial Equity Work:</u> The Race & Equity Framework and action plan was approved in June 2020 (CMR 11441) and corresponding funding is available in FY 2021. The Council Ad Hoc committee is continuing to bring forward recommendations to help further the City's race and equity priorities. As Council provides direction, projects may emerge that require additional funding. These will be brought forward through the budget process.

<u>Foothills Nature Preserve Opening to Non-Residents:</u> In November 2020, the City Council approved opening Foothills Nature Preserve to the general public (CMR 11706), lifting the resident-only access restriction. Opening Foothills Nature Preserve to the general public is likely to increase usage at the Nature Preserve, which will impact Community Service Department (CSD) resources. The magnitude of impacts depends on the level of increased use. Staff will monitor these impacts and have discussed with the City Council both the need for budgetary adjustments and an entry fee at the January 19, 2021 meeting.

<u>Other Capital Improvement Projects:</u> Ongoing discussion on major projects that may impact this fund such as the Roth building, Public Safety Building, or Rail Grade Separation, are not factored into the Forecast.

<u>City owned assets operated by non-profit organizations:</u> This Forecast does not include any additional capital or operating investments for the Avenidas Senior Center (beyond the current $5 million pledge), the Palo Alto History Museum, the Ventura Child Care Center, the Junior Museum and Zoo, nor the Sea Scout Building. As costs around potential capital or operating investments for these assets solidify, staff will return to City Council to address them as appropriate.

<u>Cubberley Community Center Concept Plan:</u> The City is in the process of designing a Cubberley Community Center Concept Plan; however, costs to implement that concept plan in excess of the

dedicated Cubberley infrastructure funding included in the existing agreement between the PAUSD and the City are not assumed in this Forecast.

Loans for special projects: From time to time the City's General Fund will assist other City operations with modest cash flow loans to bridge fiscal years. For example, the City provided over $3 million in loans to the Airport Fund as it works to secure significant grant funding from the Federal Aviation Administration (FAA) for capital improvement costs. As of the FY 2020 Adopted Budget, the Airport Fund has begun to pay back the loan to the General Fund. As mentioned in the Committed Additions section, the Base Case presumes that the parking funds will be able to sustain the ongoing operating and maintenance costs of new parking related capital infrastructure. However, these additions and other initiatives may need financial support from the General Fund to ensure they are fully implemented. Additional loans from the General Fund are not assumed in this Forecast.

Legislative Updates: Various actions at the state and federal level that could impact the City of Palo Alto have not been incorporated into this forecast due to the changing context and uncertainty of the quantitative impacts of potential legislative changes. This includes the Cadillac Healthcare Tax at the federal level, property tax changes at a state level, and state-level efforts focused on the provision of affordable housing. Property Tax changes may be impacted by a state level ballot measure, Proposition 19 approved in November 2020. As uncertainty regarding the potential impact of various legislative initiatives is clarified, appropriate adjustments will be identified and brought forward as part of the development of the FY 2021 Operating Budget.

Tax revenue alignment with updated Comprehensive Plan: The City Council recently completed updating its Comprehensive Plan, including the potential fiscal impact of various land use scenarios. The fiscal impact of this plan and various land use scenarios are not factored into this Forecast.

Litigation: As any organization, the City continues to face legal claims against it for various transactions and occurrences. The City currently has active litigation that may result in costs to the City for dispute resolution. The City Attorney is of the opinion that a loss is reasonably possible for some of these cases however legal proceedings remain ongoing. The City continues to be self-insured and holds some reserves for many of these matters, however, staff have also worked to proactively begin to reserve additional funds for risk associated with dispute resolution with approximately $1 million appropriated as part of FY 2021 Adopted Budget.

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

FY 2022 Budget Development Guidelines

1) Develop a structurally balanced budget that brings ongoing revenues and expenses into alignment. Develop a plan for any structural imbalance to ensure that the City maintains it fiscal sustainability over the short, medium, and long-term.

2) Allocate one-time resources for one-time needs rather than committing one-time resources to ongoing services. Examine appropriate uses of revenue surpluses that exceed forecasted levels including planning for recession needs.

3) Ensure appropriate resource allocation for City Council's existing priorities.

4) Focus on business process redesign to enhance quality, flexibility, and cost-effectiveness of service delivery (include examining opportunities to streamline, simplify, reorganize, and reallocate resources to avoid duplication of effort).

5) Explore alternative service delivery models (such as partnerships with non-profits or other public/private sector groups) to minimize overlap, maximize cost share, and effectively use resources.

6) Continue to thoroughly analyze non-personnel/equipment/other costs, such as contract services, for cost savings opportunities.

7) Explore the expansion of existing revenue sources or the addition of new revenue sources, including the alignment of existing charges for services and the opportunity to establish new fees, when appropriate.

8) Continue to analyze and prioritize resource augmentations, seeking to offset augmentations with reductions elsewhere for net-zero impacts to the budget whenever possible.