CITY OF PALO ALTO
CITY COUNCIL
Special Meeting
Monday, February 13, 2023
Council Chambers & Hybrid
3:30 PM

Agenda Item

AA2. Review and Accept the FY 2024 - FY 2033 Long Range Financial Forecast (LRFF) and FY 2024 Budget Development Guidelines (8:30 – 10:30 PM) *Public Comment, Presentation (Continued from Febuary 6, 2023 Meeting)*

CITY OF PALO ALTO

CITY COUNCIL STAFF REPORT

From: City Manager
Report Type: ACTION ITEMS
Lead Department: Administrative Services

Meeting Date: February 6, 2023

TITLE

Review and Accept the FY 2024 - FY 2033 Long Range Financial Forecast (LRFF) and FY 2024 Budget Development Guidelines

RECOMMENDATION

The Finance Committee and staff recommend that the City Council accept the Fiscal Year (FY) 2024 to 2033 General Fund Long Range Financial Forecast Revised Base Case and annual Budget Development Guidelines (Attachment B) and direct staff to use this forecast as the starting point for the initiation of the FY 2024 budget process.

EXECUTIVE SUMMARY

The FY 2024 - 2033 Long Range Financial Forecast (LRFF) was reviewed with the Finance Committee on December 6, 2022 (Attachment A) along with the annual Budget Development Guidelines (Attachment B) and were unanimously approved by the Committee. This report 1) summarizes the key discussion points with the Finance Committee, 2) provides a revised Base Case Forecast in alignment with cost estimates of City and labor group positions on economic proposals[1], and 3) provides preliminary information regarding Utility rates which may impact development of the FY 2024 Budget.

The Revised Base Case General Fund forecast reflects projected gaps in the first four years (FY 2024-FY 2027) with expenses out pacing revenues resulting in deficits ranging between $500,000 to $5.8 million annually. Staff expect that a combination of one-time funds and the eventual collection of new Business tax revenues from the passage of Measure K will assist in resolving these deficits.

Per City Council policy, items that are unanimously approved by the Finance Committee are placed as a consent agenda item for the City Council. However, staff and the Committee have placed this item on the City Council's action agenda for deliberation of the full Council in

[1] Subsequent to the Finance Committee review in December 2022, the City has reached tentative agreement with two labor groups, on this same February 6, 2023 agenda for approval, and adopted a new management and professional compensation plan.

acknowledgement of the importance for financial planning in the continued varied economic conditions.

BACKGROUND

The LRFF is a preliminary ten-year forecast based on the most current information available, actual revenues for FY 2022, and projected results through FY 2023 at the point in time of release. General Fund expenditures are based on current City Council approved service levels (Base Case) compared to projected revenues over the next ten years. This Forecast allows staff and City Council to look at both the short-term and long-term financial status of current service levels in the General Fund to inform daily policy decisions and evaluate long-term goals and ongoing challenges.

- *Base Case Long Range General Fund forecast (as of December 2022)* projects a surplus of $0.4 million in FY 2024, followed by a $3.4 million gap in FY 2025 and a $2.6 million gap in FY 2026, with small but increasing surpluses in FY 2027 through FY 2033. This forecast maintains current service levels approved in FY 2023 and should be used for planning purposes to assist in gauging effects of major policy interventions against a likely "status quo" version of the future.
- *Alternate forecast scenario that reflects a more severe recession*. Compared to the Base Case, this scenario increases the General Fund gap over the next ten years. FY 2024 changes from a surplus to a gap of $3.5 million, and revenues are not anticipated to be able to fund the annual expenditures until FY 2029.
- *Alternate forecast that reflects estimated funding from Measure K* (new business tax) and the impacts on the General Fund over the next ten years reflects a surplus in FY 2024 of $1.1 million, a gap in FY 2025 of $1.9 million, and surpluses in FY 2026 through FY 2033. These alternate forecasts were done separately to show the impacts of each scenario in isolation; however, aspects of both alternate forecasts may occur in conjunction in the future.

As the COVID-19 pandemic is waning, economic uncertainty has heightened the intensity of financial forecasting and the budget development process including the need for complex problem-solving within an engaged public process across a wide range of issues. There are also several issues across the City continuing to impact the ability to transition beyond impacts of the pandemic including staff turnover, recruitment and retention, supply chain issues, and inflation that continue to increase costs across all aspects of the City. Development of the FY 2024 budget and planning for the subsequent years will balance the increased service level needs of the community with the financial resources projected. Ongoing revenues are unable to keep pace with expenses in the short term.

Based on this forecast, it is anticipated that the prioritization of spending and the use of one-time surplus funding from FY 2022 to cover short-term gaps over the next several years will be necessary to ensure continued financial stability. More detailed guidelines or Budget Policies to inform the development of the FY 2024 budget are discussed in Attachment B.

ANALYSIS

This report

1) Summarizes the key discussion points with the Finance Committee,
2) Provides a revised Base Case Forecast in alignment with cost estimates of City and labor group positions on economic proposals, and
3) Provides preliminary information regarding Utility rates which may impact development of the FY 2024 Budget.

Finance Committee December 2022 Review and Discussion

As part of the Finance Committee's review of the LRFF, there were no requests for additional information or changes to the report for the Council's review; however, a few topics were highlighted as part of the discussion. Staff has compiled these items below.

Economic Development:

- Potential for ongoing remote work and reduced office occupancy to impact major tax revenues, and lead to an extended local economic shift rather than a short term "blip".
- Permanent parklet program should be evaluated as a revenue source, or at minimum, cost neutral.
- Evaluate the potential for revenue from a new Fiber Utility.

Major Projects/Council Priorities:

- Repair of the Cubberley Gym should be prioritized as it impacts many children citywide.
- A majority of work related to the Sustainability and Climate Action Plan (S/CAP) is currently funded in the Utility Funds; however, as work continues to expand, this will become a shared responsibility across other funds.

Labor Costs and Staffing Analysis:

- As the biggest source of costs to the City, ensure that salaries and benefits such as pensions and medical plans are managed carefully, as outlined in the pension and retiree medical policies recently reviewed and updated by the Finance Committee.
- Quantifying service reinvestments should be evaluated in a manner other than just comparing headcount pre and post pandemic.

Revised Base Case Fiscal Year (FY) 2024 to 2033 General Fund Long Range Financial Forecast

Subsequent to the Finance Committees review of the LRFF, a new agreement with Management Employees has been approved by the City Council at the December 19, 2022 meeting, and agreements with the International Association of Fire Fighters (IAFF) and Service Employees International Union (SEIU) are scheduled for City Council approval on February 6, 2023. This report includes a revised LRFF forecast that aligns cost estimates with this updated status of City and labor group positions on economic proposals.

Consistent with prior Council direction in previous long range financial forecasts, a general wage adjustment of 2.0% was included for all years of the forecast along with a level of reserve to reach a target market placement for employee compensation in new labor agreements as a forecasting assumption, not as a commitment to future negotiations.

Staff will continue to refine these estimates during the FY 2024 annual budget process as labor agreements are finalized and more information is gathered on revenue trends. This revised Base Case, revises the LRFF reflecting gaps in the first four years, FY 2024 through FY 2027.

Table 1: Summary of Net One-Time Surplus/(Gap) – Base Case vs. Revised

Net Surplus/(Gap)	FY23 (Est.)	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
Base Case	\$0-6.0M	\$0.4M	(\$3.4M)	(\$2.6M)	\$1.5M	\$2.9M
REVISED Base Case	\$0-4.7M	(\$0.5M)	(\$5.8M)	(\$5.1M)	(\$1.0M)	\$0.3M

Table 2: REVISED Base Case, FY 2024 -2033 Long Range Financial Forecast

	Actual 2022	Adopted 2023	Projected 2023	2024	2025	2026	2027	2028
Total Revenue	\$238,735	\$237,751	\$238 - 244M	\$251,177	\$261,671	\$272,065	\$282,203	\$290,671
BSR Contribution (One-Time)	-	\$9,670	\$9,670	-	-	-	-	-
Total Source of Funds	\$238,735	\$247,421	\$247 - 253M	\$251,177	\$261,671	\$272,065	\$282,203	\$290,671
Year over Year increase (revenue only)				*5.6%*	*4.2%*	*4.0%*	*3.7%*	*3.0%*
Total Expenditures	\$197,963	\$247,421	\$248,721	\$251,715	\$267,500	\$277,159	\$283,240	\$290,359
Total Use of Funds	\$197,963	\$247,421	\$248,721	\$251,715	\$267,500	\$277,159	\$283,240	\$290,359
Year over Year increase				*1.7%*	*6.3%*	*3.6%*	*2.2%*	*2.5%*
Net One-Time Surplus/(Gap)	\$40,772	(\$0)	\$0 - 4.7M	(\$537)	(\$5,829)	(\$5,094)	(\$1,037)	\$313
Cumulative Net Operating Margin (One-Time)								
Net Operating Margin				(\$537)	(\$5,292)	\$735	\$4,057	\$1,349

<u>Preliminary Utility Rate Forecasts</u>

Current economic uncertainty and commodity prices are expected to result in recommended increases to the utility rates for FY 2024. New information, not available when the LRFF was published in late November, is being provided for review and a preliminary preview of rates expected to be discussed as part of the FY 2024 budget process. These rates will impact customers residential and commercial, including the City itself as a consumer of these commodities. This information can be seen in Attachment C. At the time of this preliminary review of estimated rate forecasts, the state of California has seen unprecedented rainfall and flooding. Staff are reviewing the impacts of this storm on rate forecasts and will ensure this is factored into the recommended rate changes for FY 2024. These recommendations are scheduled to be reviewed in March – May 2023 by the Finance Committee and adopted the City Council in June 2023.

FISCAL/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 2024 budget.

Upcoming milestones related to the City's fiscal standing and the FY 2024 Budget Process include:

- **February 13** Council Meeting – FY 2023 Mid-Year Budget Review and Second Quarter Fiscal Analysis Report
- **March/April** Utilities Advisory Commission (UAC) and Finance Committee Meetings – Five Year Utility Financial Plans and FY 2024 Rate Recommendations
- **May 1** Council Meeting – FY 2024 Proposed Operating and Capital Budgets Published
- **May** Finance Committee Hearings – FY 2024 Proposed Budget Review, including Utility Rates, Municipal Fees, and Five-Year Capital Improvement Plan
- **June** Finance Committee Meeting – FY 2023 Third Quarter Fiscal Analysis Report
- **June 19** Council Meeting – Adoption of the FY 2024 Operating and Capital Budgets, the Utility Rates, and Municipal Fees

STAKEHOLDER ENGAGEMENT

The preliminary forecast for FY 2024 represents the beginning of the fiscal year 2024 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 2023, according to the standard budget adoption process.

ENVIRONMENTAL REVIEW

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

ATTACHMENTS

Attachment A: FY 2024-2033 Long Range Financial Report (LRFF), CMR 14629
Attachment B: FY 2024 Budget Development Guidelines
Attachment C: Preliminary Utility Rates Forecast

APPROVED BY:
Kiely Nose, Assistant City Manager

Report #: 2301-0753

City of Palo Alto

Finance Committee Staff Report

(ID # 14629)

Meeting Date: 12/6/2022 **Report Type: Action Items**

Title: Review and Forward the FY 2024 - 2033 Long Range Financial Forecast

From: City Manager

Lead Department: Administrative Services

Recommendation

Staff recommends that the Finance Committee review and recommend that the City Council accept the General Fund Long Range Financial Forecast (LRFF) for Fiscal Year 2024-2033 and the FY 2024 annual Budget Development Guiding Principles (Attachment A) and direct staff to use this forecast as the starting point for the initiation of the FY 2024 budget process.

Executive Summary

Annually, the City presents a ten-year General Fund Long Range Financial Forecast (LRFF) in December that marks the beginning of the annual budget process. This preliminary forecast is based on the most current information available, actual revenues for FY 2022, and projected results through FY 2023 at the point in time of release. General Fund expenditures are based on current City Council approved service levels compared to projected revenues over the next year.

> The **Base Case Long Range General Fund forecast** projects a surplus of $0.4 million in FY 2024, followed by a $3.4 million gap in FY 2025 and a $2.6 million gap in FY 2026, with small but increasing surpluses in FY 2027 through FY 2033. This forecast maintains current service levels approved in FY 2023 and should be used for planning purposes to assist in gauging effects of major policy interventions against a likely "status quo" version of the future.
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> Staff modeled an **alternate forecast scenario that reflects a more severe recession**. Compared to the Base Case, this scenario increases the General Fund gap over the next ten years. FY 2024 changes from a surplus to a gap of $3.5 million, and revenues are not anticipated to be able to fund the annual expenditures until FY 2029.
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> Staff modeled an **alternate forecast that reflects estimated funding from Measure K** and the impacts on the General Fund over the next ten years reflects a surplus in FY 2024 of $1.1 million, a gap in FY 2025 of $1.9 million, and surpluses in FY 2026 through FY 2033. These alternate forecasts were done separately to show the impacts of each

scenario in isolation; however, aspects of both alternate forecasts may occur in conjunction in the future.

As the COVID-19 pandemic is waning, new economic challenges are emerging such as monetary policy tightening actions by the US Federal Reserve to tame persistently high inflation and increasing geopolitical risks which may lead the United States into a recessionary period. This economic uncertainty has heightened the intensity of financial forecasting and budget development 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 fiscal sustainability of these needs.

Locally, based on current election data, staff anticipate that both Measure L and K will be successful in gaining voter approval. Measure L, affirming the ongoing Equity Transfer from the Gas Utility Fund is included in the Base Case scenario. Measure K, approval of a new Business Tax, is not assumed in this LRFF as part of the Base Case scenario; a resolution for intended use of funding has been earmarked for investments in public safety, transportation and train crossing safety, and affordable housing and unhoused support.

There are several issues across the City continuing to impact the ability to transition beyond impacts of the pandemic including staff turnover, recruitment and retention, and supply chain issues and inflation that continue to increase costs across all aspects of the City. Development of the FY 2024 budget and planning for the subsequent years outlined in the forecast will need to be done strategically over the next several months in order to balance the increased service level needs of the community with the financial resources currently projected. With these variables, ongoing revenues are unable to keep pace with expenses in the short term.

City staff will continue to review and refine these projections to establish the FY 2024 budget and use this forecast to begin internal planning for budget balancing solutions. Based on this forecast, it is anticipated that the prioritization of spending and the use of one-time surplus funding from FY 2022 to cover short-term gaps over the next several years will be necessary to ensure continued financial stability. More detailed guidelines or Budget Policies to inform the development of the FY 2024 budget are discussed at the end of this document (Attachment A).

Included in this report and subsequent documents are the following:

- The Economy: discussion of the current financial climate of the United States to the local economy of the City of Palo Alto (details can be found in Attachment B)
- Summary Long Range Financial Forecast including Revenue and Expense assumptions in FY 2024-2033 (details can be found in attachment C and D)
    - Financial status of the General Fund as of the FY 2023 Adopted Budget
    - Brief discussion of FY 2022 surplus funding
    - Updated FY 2023 revenue assumptions based on current projections
- FY 2024 Budget Development Policies to inform the Budget process (Attachment A)

- Alternate scenarios to the base case forecast to demonstrate financial impacts to the City from:
    - Impacts from a moderate recession
    - Impacts from the passage of Measure K

Background

Annually the Office of Management and Budget produces a ten-year General Fund Long Range Financial Forecast (LRFF). 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, but 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. The LRFF also reviews the status of the current economy and various economically sensitive revenues such as Sales Tax, Documentary Transfer Tax, Property Tax, and Transient Occupancy Tax to explain key trends in those areas. This Forecast allows staff and City Council to look at both the short-term and long-term financial status of current service levels in the General Fund to inform daily policy decisions and evaluate long-term goals and ongoing challenges.

The Economy

U.S. workers and consumers have shown great resiliency throughout the pandemic, energy cost spikes, geopolitical uncertainty, and high inflation. National, state, regional, and local economic indicators are in transition; the economy exited 2021 in overdrive, but that growth combined with global supply chain constraints has pushed inflation higher than expected. The federal reserve began raising the fed funds interest rate in March 2022 and is expected to continue in 2023 which is intended to tame inflation, but as of the writing of this report, progress is slower than desired. This has begun to and is predicted to cool the economy and result in a rise in unemployment. The federal reserve's ability to balance the objectives of fighting inflation while maintaining employment and GDP growth will be challenging.

The local economy continues to show strong performance in the latter half of the calendar year 2022 though signs of "headwinds" are growing that are likely to stem economic growth. Additional details on economic statistics such as Gross Domestic Product (GDP) and Consumer Price Index (CPI) can be found in **Attachment B** in greater length.

Discussion

Palo Alto serves a diverse community with a broad range of unique services that adds to the complexity of managing a balanced budget and healthy fiscal outlook. This annual General Fund Long Range Financial Forecast is coupled with annual rate forecasts for the City's various enterprise activities such as electric, gas, and water utility services provided to the community. As the COVID-19 pandemic is waning, new economic challenges are emerging which may lead the United States into a recessionary period. This economic uncertainty has heightened the intensity of financial forecasting and budget development process and continues the rigger previously demonstrated by the Council and staff through the challenges of the pandemic. These forecast figures present staff with the challenge of prioritizing the growing needs of the City with the fiscal sustainability of these needs.

The FY 2024-2033 'Base Case' revenue and expense assumptions include updates on the status of the general fund as of the FY 2023 Adopted Budget, the FY 2022 fiscal year end, and current FY 2023 projected assumptions. As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document. This forecast assumes a mild 18-month recession at the beginning of the ten-year period. Major tax revenues continue to rebound from prior year levels, reserves for economically sensitive revenues have been eliminated as programs modified or canceled during the pandemic have returned, and investments in Capital projects are restored to pre-pandemic levels. One-time resources that have boosted the City's financial outlook in prior years: Coronavirus Aid, Relief, and Economic Securities Act (CARES Act) and American Rescue Plan Act (ARPA) have been allocated in full with no funds included in FY 2024.

Base Case

Table 1 displays the projected General Fund revenues and expenditures over ten years and the cumulative net operating margin.

- The *operating margin* reflects the variance between the projected General Fund revenues and expenditures for each year of the forecast or the annual surplus or shortfall.
- The *net operating margin* is presented on a one-time basis, as the annual surplus or shortfall for a given year, and on an incremental basis.

The incremental forecast assumes that each shortfall is addressed completely with ongoing solutions in the year it appears and that each surplus is completely expended with ongoing expenditures. It is the City's goal to remain in balance on an ongoing basis, so the incremental figure is useful to illustrate the additional surplus and/or shortfall attributed to a particular fiscal year. To the extent 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 remain and be pushed to the following year.

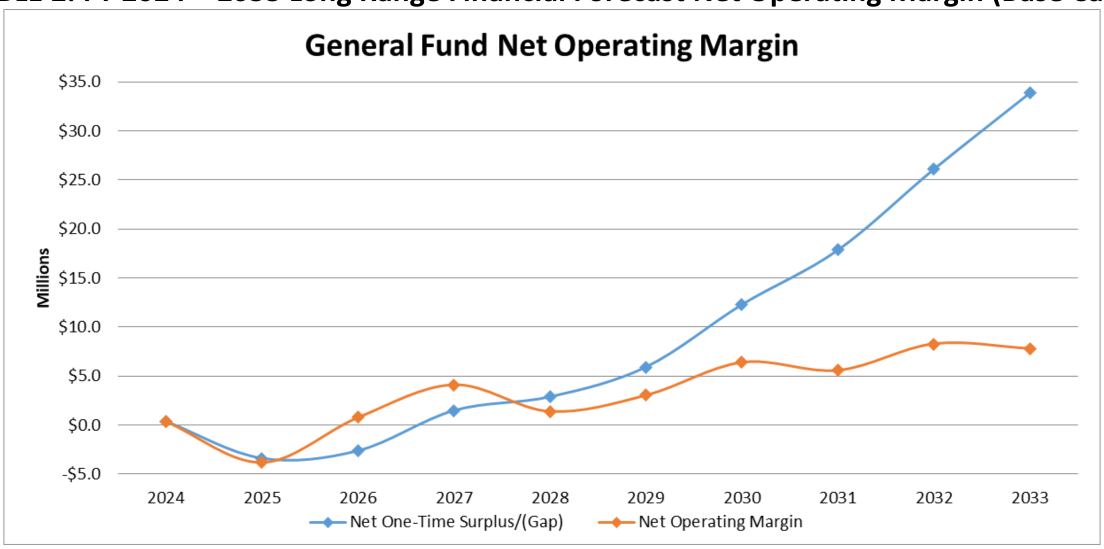
The Base Case financial forecast projects a surplus of $0.4 million in FY 2024, followed by a $3.4 million shortfall in FY 2025, a $2.6 million shortfall in FY 2026, and increasing surpluses thereafter. Based on these assumptions, the cumulative net operating margin, or ongoing surplus, during the forecast period is a surplus of $33.9 million.

TABLE 1: FY 2024 – 2033 Long Range Financial Forecast (Base Case)

BASE CASE

	Actual 2022	Adopted 2023	Projected 2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Total Revenue	$238,735	$237,751	$238 - 244M	$251,177	$261,671	$272,065	$282,203	$290,671	$302,477	$313,495	$325,552	$337,689	$351,101
BSR Contribution (One-Time)	-	$9,670	$9,670	-	-	-	-	-	-	-	-	-	-
Total Source of Funds	$238,735	$247,421	$247 - 253M	$251,177	$261,671	$272,065	$282,203	$290,671	$302,477	$313,495	$325,552	$337,689	$351,101
Year over Year increase (revenue only)				*5.6%*	*4.2%*	*4.0%*	*3.7%*	*3.0%*	*4.1%*	*3.6%*	*3.8%*	*3.7%*	*4.0%*
Total Expenditures	$197,963	$247,421	$247,421	$250,814	$265,083	$274,694	$280,726	$287,794	$296,558	$301,197	$307,685	$311,557	$317,193
Total Use of Funds	$197,963	$247,421	$247,421	$250,814	$265,083	$274,694	$280,726	$287,794	$296,558	$301,197	$307,685	$311,557	$317,193
Year over Year increase				*1.4%*	*5.7%*	*3.6%*	*2.2%*	*2.5%*	*3.0%*	*1.6%*	*2.2%*	*1.3%*	*1.8%*
Net One-Time Surplus/(Gap)	$40,772	($0)	$0 - 6M	$364	($3,412)	($2,629)	$1,478	$2,877	$5,919	$12,298	$17,867	$26,132	$33,908
Cumulative Net Operating Margin (One-Time)													$94,803
Net Operating Margin				$364	($3,776)	$783	$4,107	$1,399	$3,042	$6,379	$5,570	$8,265	$7,776
Cumulative Net Operating Margin													$33,908

TABLE 2: FY 2024 – 2033 Long Range Financial Forecast Net Operating Margin (Base Case)



Revenue Assumptions

The FY 2022 Annual Comprehensive Financial Report (ACFR), scheduled for review by the Finance Committee on November 29, 2022, reported higher annual earnings for general fund revenues as compared to the prior year; major tax revenues experienced faster recovery paces in the last two quarters of the fiscal year (CMR 14632[1]). Major tax revenues generated $137.5 million in FY 2022, an increase of $20.7 million or 17.7% over the FY 2021 levels of $116.8 million. Staff and the Council anticipated a portion of this increase in revenues and discussed $14 million during the May 2022 budget discussions for allocation in FY 2023. This recovery trend may continue as discussed in the First Quarter (Q1) FY 2023 Financial Report, scheduled for review by the Finance Committee on December 6, 2022; several categories appear to be tracking similarly in FY 2023 to FY 2022 (CMR 14630). The current timing and potential for recession makes it difficult to determine if these trends will continue in the near term. In FY 2023, Staff estimates a range of $238 to $244 million in total revenues, reflecting up to $6

[1] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20221129/20221129pfcsm-linked.pdf

million or 2.5% above adopted budget levels. The higher end of this projection assumes that revenues will continue a similar positive trend as recent quarters. However, actual results will vary depending on the timing and magnitude of recessionary impacts in the near term.

A summary of revenue assumptions are discussed here, extensive information regarding each revenue category can be found in **Attachment C**.

- Tax revenues constitute nearly 60% of General Fund resources. In FY 2024, the forecast projects an $11.4 million or 8.4% increase from FY 2023 adopted levels ($135.1 million to $146.5 million). This increase is primarily attributed to higher anticipated receipts for Sales Tax, Property Tax, and Transient Occupancy Tax (TOT) categories.
    - *Sales Taxes* is anticipated to increase $0.7 million or 2.2% from FY 2023 ($32.6 million to $33.3 million). Revenue in this category is experiencing growth; however, is not anticipated to reach pre-pandemic levels until FY 2026.
    - *Property Taxes* make up the largest source of the General Fund's revenue, approximately 25%. In FY 2024, this revenue is anticipated to increase $3.9 million or 6.5% from FY 2023 ($58.9 million to $63.7 million). During economic downturns, impacts to property tax occur a year later, however, due to robust residential and commercial property sales this source has continued to grow annually.
    - *Transient Occupancy Taxes* are impacted by business and other leisure/non-leisure travel and experienced significant reductions in the past few years due to a number of factors resulting from the pandemic. Though this revenue remains below pre-pandemic actuals, the opening of the two Marriott hotels in FY 2021 and the re-opening of multiple hotels in FY 2021 and FY 2022 were positive developments for this tax revenue. In FY 2024, this revenue is anticipated to increase $6.8 million or 37.3% from FY 2023 ($18.2 million to $25.0 million); however, this category is not anticipated to reach pre-pandemic levels until FY 2026.

- The forecast for non-tax revenues projects a $1.0 million or 1.2% increase in FY 2024 from FY 2023 adopted levels. This increase is primarily attributable to the alignment of revenue estimates for the Stanford agreement to provide Fire and Dispatch services, and the restoration of several programs and services that were modified due to public health orders, mainly in public safety and community services.

- One-time resources that have boosted the City's financial outlook in prior years have been eliminated:
    - The City received $13.7 million in American Rescue Plan Act (ARPA) funding that the Council, per the legislation, designated to address the significant revenue loss resulting from the pandemic;
    - $294,000 in Coronavirus Aid, Relief, and Economic Securities Act (CARES Act) funding to provide rental assistance and support safe parking and COVID-19

testing programs; and

- $3.5 million in federal funds in FY 2022 through the Staffing For Adequate Fire and Emergency Response (SAFER) Grant Program. This funding offset the hiring costs of 5.0 firefighters for a three-year period and is fully expended in FY 2025.

The changes by revenue category, including dates in which revenues are anticipated to reach pre-pandemic levels, are discussed in greater detail below.

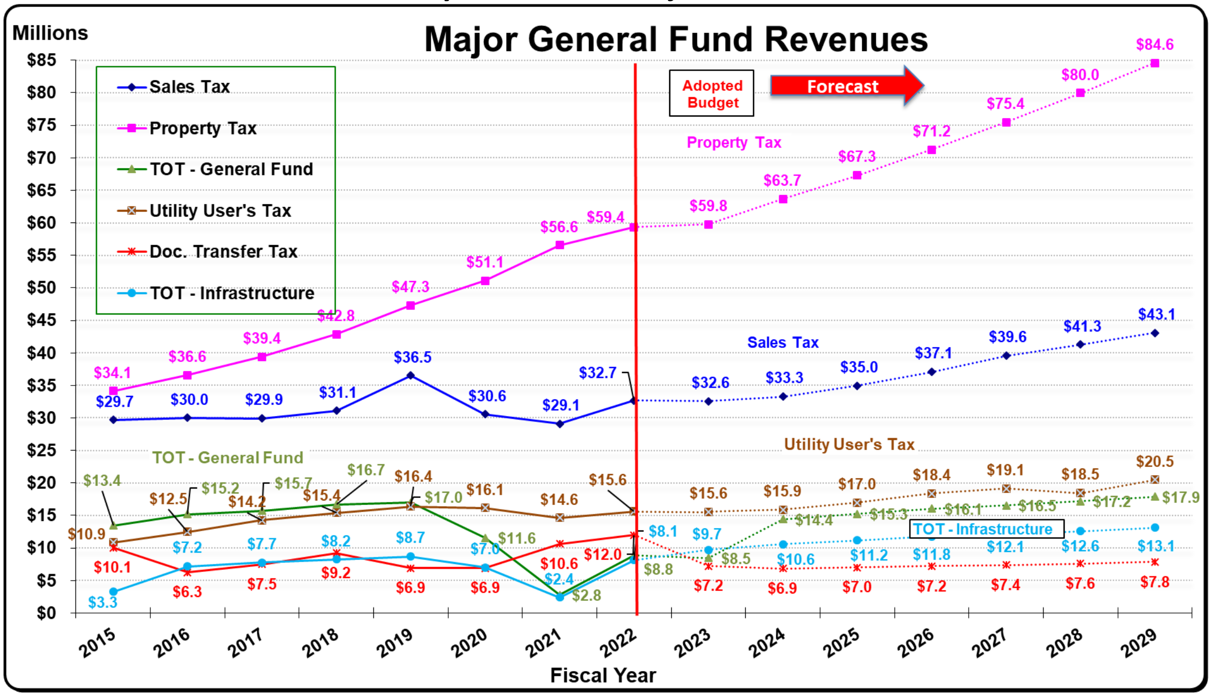
TABLE 3: General Fund Revenue Forecast

Revenue & Other Sources	Actual 2022	Adopted 2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	CAGR 10 Years	CAGR 5 Years
Sales Taxes	32,705	32,580	33,288	34,953	37,085	39,570	41,292	43,080	45,096	47,301	49,628	52,085	4.6%	2.2%
Property Taxes	59,353	59,770	63,669	67,305	71,224	75,448	79,950	84,570	89,238	94,334	99,937	106,164	5.2%	2.3%
Transient Occupancy Tax														
General Purpose	8,828	8,472	14,429	15,255	16,059	16,549	17,181	17,894	18,766	19,710	20,740	21,829	4.2%	1.8%
Infrastructure	8,118	9,727	10,567	11,173	11,762	12,121	12,583	13,106	13,744	14,435	15,190	15,987	4.2%	1.8%
Documentary Transfer Tax	11,990	7,217	6,867	7,029	7,200	7,381	7,574	7,849	8,152	8,452	8,755	9,066	2.8%	1.0%
Utility Users Tax	15,599	15,579	15,878	16,967	18,359	19,133	18,460	20,488	21,215	21,943	22,706	23,498	4.0%	1.5%
Other Taxes and Fines	893	1,784	1,784	1,784	1,784	1,784	1,784	1,784	1,784	1,784	1,784	1,784	0.0%	0.0%
Subtotal: Taxes	137,486	135,129	146,483	154,467	163,473	171,986	178,824	188,771	197,995	207,959	218,740	230,413	4.6%	2.0%
Charges for Services	28,671	30,271	33,355	33,648	33,847	33,952	34,040	34,225	34,379	34,563	34,622	34,744	0.4%	0.2%
Permits and Licenses	9,111	9,764	11,454	11,928	12,154	12,266	12,456	12,743	13,020	13,316	13,161	13,274	1.5%	0.8%
Return on Investments	1,325	1,066	1,492	1,528	1,574	1,622	1,671	1,734	1,805	1,881	1,960	2,043	3.2%	1.1%
Rental Income	13,681	15,572	16,447	17,303	18,034	18,635	19,151	19,682	20,228	20,792	21,372	21,968	2.9%	1.5%
From Other Agencies	9,232	7,526	1,281	998	266	266	266	266	266	266	266	266	-14.5%	-14.5%
Charges to Other Funds	13,980	13,690	14,460	14,810	14,989	15,091	15,398	15,668	15,963	16,261	16,330	16,411	1.3%	0.6%
Other Revenue	2,447	2,201	2,592	2,615	2,630	2,646	2,662	2,679	2,696	2,712	2,730	2,748	0.6%	0.3%
Total Non-Tax Revenue	78,447	80,090	81,080	82,830	83,495	84,477	85,643	86,996	88,357	89,791	90,441	91,454	1.2%	0.5%
Operating Transfers-In	22,802	22,532	23,614	24,374	25,097	25,740	26,204	26,709	27,143	27,802	28,508	29,233	2.2%	1.0%
BSR Contribution (One-Time)		9,670												
Total Source of Funds	$238,735	$247,421	$251,177	$261,671	$272,065	$282,203	$290,671	$302,477	$313,495	$325,552	$337,689	$351,101		

TABLE 4: General Fund Revenue Forecast Year to Year Percentage Change

Revenue & Other Sources	Actual 2022	Adopted 2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Sales Taxes		-0.4%	2.2%	5.0%	6.1%	6.7%	4.4%	4.3%	4.7%	4.9%	4.9%	5.0%
Property Taxes		0.7%	6.5%	5.7%	5.8%	5.9%	6.0%	5.8%	5.5%	5.7%	5.9%	6.2%
Transient Occupancy Tax												
General Purpose		-4.0%	70.3%	5.7%	5.3%	3.1%	3.8%	4.1%	4.9%	5.0%	5.2%	5.3%
Infrastructure		19.8%	8.6%	5.7%	5.3%	3.1%	3.8%	4.2%	4.9%	5.0%	5.2%	5.2%
Documentary Transfer Tax		-39.8%	-4.8%	2.4%	2.4%	2.5%	2.6%	3.6%	3.9%	3.7%	3.6%	3.6%
Utility Users Tax		-0.1%	1.9%	6.9%	8.2%	4.2%	-3.5%	11.0%	3.5%	3.4%	3.5%	3.5%
Other Taxes and Fines		99.7%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Subtotal: Taxes		-1.7%	8.4%	5.5%	5.8%	5.2%	4.0%	5.6%	4.9%	5.0%	5.2%	5.3%
Charges for Services		5.6%	10.2%	0.9%	0.6%	0.3%	0.3%	0.5%	0.4%	0.5%	0.2%	0.4%
Permits and Licenses		7.2%	17.3%	4.1%	1.9%	0.9%	1.6%	2.3%	2.2%	2.3%	-1.2%	0.9%
Return on Investments		-19.6%	39.9%	2.4%	3.0%	3.0%	3.0%	3.8%	4.1%	4.2%	4.2%	4.2%
Rental Income		13.8%	5.6%	5.2%	4.2%	3.3%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%
From Other Agencies		-18.5%	-83.0%	-22.1%	-73.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Charges to Other Funds		-2.1%	5.6%	2.4%	1.2%	0.7%	2.0%	1.8%	1.9%	1.9%	0.4%	0.5%
Other Revenue		-10.1%	17.8%	0.9%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.7%	0.7%
Total Non-Tax Revenue		2.1%	1.2%	2.2%	0.8%	1.2%	1.4%	1.6%	1.6%	1.6%	0.7%	1.1%
Operating Transfers-In		-1.2%	4.8%	3.2%	3.0%	2.6%	1.8%	1.9%	1.6%	2.4%	2.5%	2.5%
BSR Contribution (One-Time)			-100.0%									
Total Source of Funds		3.6%	1.5%	4.2%	4.0%	3.7%	3.0%	4.1%	3.6%	3.8%	3.7%	4.0%

TABLE 5: City of Palo Alto Major General Fund Revenues



Expense Assumptions

As part of developing the FY 2024-2033 Forecast expenditure budget, the General Fund expense categories have been adjusted by removing FY 2023 Adopted Budget one-time expenses and updating major cost elements such as salary and benefits costs. The table below displays the expense forecast and when compared to the FY 2023 Adopted Budget, growth of 1.4% is expected in FY 2024. The small overall annual growth is due to the elimination of large one-time reserves in FY 2023 that offset the increase in expenses in other categories such as Salary and Benefits and Transfers to Infrastructure.

A summary of expense assumptions are discussed here, extensive information regarding each expense category can be found in **Attachment D**.

- *Salary and Benefits* are projected to increase $11.3 million or 7.6% from the FY 2023 ($148.4 million to $159.7 million). This is primarily attributable to increases in salaries ($6.1 million or 7.7%) and pension costs ($4.1 million or 10.5%). A general wage adjustment of 2.0% is included for all employees starting in either January 2023 or July 2023 for all years of the forecast since no MOA's would be in effect at that time. A level of reserve to reach a target market placement for employee compensation in new labor agreements, as directed by the City Council is also assumed beginning in FY 2023.

- Long Term contributions to pension and other post-employment benefits and capital investments are being phased through the first three to five years of the forecast:

- *Pension 115 Trust contributions* reflect City Council approved discount rate from 6.2% to 5.3% over two years; FY 2023 is a transitional year in which six months or the equivalent of approximately 5.8% is budgeted and the full transition in FY 2024 ($12.2 million ($7.2 million in the General Fund) in supplemental contributions is assumed in FY 2024).
- *California Employers' Retiree Benefit Trust (CERBT) Fund for Retiree medical* liabilities contributions reflect a 5.75% discount rate (6.25% assumption), and shortened amortization (from 22 to 15 years). Through FY 2023, it is expected that $8.0 million in supplemental principal contributions will be made to the CERBT Trust. The FY 2024 Budget estimates $16.4 million ($10.5 million in the General Fund) for ADC, an approximate $0.5 million or 2.9% increase from FY 2023 levels of $15.9 million ($9.9 million in the General Fund).
- *Capital Infrastructure transfers* reflect the goal established as part of the 2022-2026 Capital Improvement Plan (CIP) to restore the base portion of this transfer to pre-pandemic levels by FY 2026. As the local economy continues to recover from the COVID-19 pandemic, estimated transfers from TOT revenues in FY 2024 are currently projected to increase to $10.5 million and the base transfer to increase to $10.8 million for a total $21.3 million transfer to the Capital Improvement Fund.

- Inflationary assumptions in this long range reflect the record inflation being seen at present, in FY 2024 and FY 2025, a 5% annual inflation is assumed, while in the outer years FY 2026 ongoing it is brought to the historical average of 3%.

- Previously committed investments are included in this forecast including but not limited to the continuation of the *two year restoration of key services* as adopted in the FY 2023 Budget. These services are assumed to be ongoing in this forecast in alignment with the expected voter approval of measure L and affirmation of current revenues to the General Fund. This LRFF includes the City's committed investment of $7.0 million in operating expenses for the partnership with LifeMoves and *Project Homekey* site services ($1.0 million annually which started in FY 2023 and is programmed through FY 2029).

TABLE 6: General Fund Expense Forecast and Year to Year Percentage Change

Expenditures & Other Uses	Actual 2022	Adopted 2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	CAGR 10 Years	CAGR 5 Years
Salary	71,145	79,732	85,869	90,166	92,806	95,320	97,394	99,341	101,269	103,198	105,127	107,056	3.0%	1.3%
Benefits	61,531	68,636	73,780	77,229	79,099	80,111	82,477	86,269	87,134	88,371	87,251	87,425	2.4%	1.1%
Subtotal: Salary & Benefits	132,676	148,368	159,649	167,395	171,905	175,431	179,871	185,610	188,403	191,569	192,378	194,481	2.7%	1.2%
Contract Services	20,844	24,194	23,921	25,375	25,863	26,555	27,106	27,931	28,461	29,330	29,834	30,688	2.4%	1.3%
Supplies & Material	2,508	3,205	3,270	3,426	3,519	3,612	3,705	3,798	3,891	3,984	4,077	4,170	2.7%	1.3%
General Expense	3,174	21,765	8,561	8,745	8,835	8,938	9,042	9,161	8,252	8,357	8,463	8,576	-8.9%	0.5%
Rents & Leases	453	1,333	1,368	1,405	1,443	1,482	1,522	1,564	1,606	1,649	1,694	1,741	2.7%	1.1%
Facilities & Equipment	538	480	450	471	484	497	510	523	536	549	562	575	1.8%	1.3%
Allocated Charges	19,647	22,714	24,744	25,741	26,454	27,121	27,860	28,623	29,403	30,227	31,072	31,939	3.5%	1.2%
Total Non Sal/Ben Before Transfers	47,164	73,691	62,314	65,163	66,598	68,205	69,746	71,600	72,149	74,097	75,701	77,689	0.5%	1.1%
Operating Transfers-Out	5,498	4,962	4,643	4,745	4,854	4,959	5,072	5,188	5,302	5,423	5,547	5,699	1.4%	0.9%
Transfer to Infrastructure - Base	4,506	10,673	13,640	16,607	19,575	20,009	20,523	21,053	21,599	22,161	22,740	23,336	8.1%	4.2%
Transfer to Infrastructure - TOT	8,118	9,727	10,567	11,173	11,762	12,121	12,583	13,106	13,744	14,435	15,190	15,987	5.1%	1.8%
Total Use of Funds	197,963	247,421	250,814	265,083	274,694	280,726	287,794	296,558	301,197	307,685	311,557	317,193	2.5%	1.4%

Expenditures & Other Uses	Actual 2022	Adopted 2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Salary		12.1%	7.7%	5.0%	2.9%	2.7%	2.2%	2.0%	1.9%	1.9%	1.9%	1.8%
Benefits		11.5%	7.5%	4.7%	2.4%	1.3%	3.0%	4.6%	1.0%	1.4%	-1.3%	0.2%
Subtotal: Salary & Benefits		11.8%	7.6%	4.9%	2.7%	2.1%	2.5%	3.2%	1.5%	1.7%	0.4%	1.1%
Contract Services		16.1%	-1.1%	6.1%	1.9%	2.7%	2.1%	3.0%	1.9%	3.1%	1.7%	2.9%
Supplies & Material		27.8%	2.0%	4.8%	2.7%	2.6%	2.6%	2.5%	2.4%	2.4%	2.3%	2.3%
General Expense		585.8%	-60.7%	2.2%	1.0%	1.2%	1.2%	1.3%	-9.9%	1.3%	1.3%	1.3%
Rents & Leases		194.1%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.8%
Facilities & Equipment		-10.7%	-6.2%	4.7%	2.8%	2.7%	2.6%	2.5%	2.5%	2.4%	2.4%	2.3%
Allocated Charges		15.6%	8.9%	4.0%	2.8%	2.5%	2.7%	2.7%	2.7%	2.8%	2.8%	2.8%
Total Non Sal/Ben Before Transfers		56.2%	-15.4%	4.6%	2.2%	2.4%	2.3%	2.7%	0.8%	2.7%	2.2%	2.6%
Operating Transfers-Out		-9.7%	-6.4%	2.2%	2.3%	2.2%	2.3%	2.3%	2.2%	2.3%	2.3%	2.7%
Transfer to Infrastructure - Base		136.8%	27.8%	21.8%	17.9%	2.2%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Transfer to Infrastructure - TOT		19.8%	8.6%	5.7%	5.3%	3.1%	3.8%	4.2%	4.9%	5.0%	5.2%	5.2%
Total Use of Funds		25.0%	1.4%	5.7%	3.6%	2.2%	2.5%	3.0%	1.6%	2.2%	1.3%	1.8%

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% of General Fund operating expenditures, with a target of 18.5%. Any reduction to the reserve below 15% requires City Council approval. At the discretion of the City Manager, any BSR balance above 18.5% may be transferred to the Infrastructure Reserve (IR) in the Capital Improvement Fund, and/or the City's Section 115 Pension Trust Fund, as outlined in the Pension Funding Policy. The BSR is used to fund unanticipated one-time costs as opposed to ongoing or recurring operating expenditures; ongoing revenue or expense trends are updated as part of the annual budget process to adjust ongoing needs. The City's intent is to fund ongoing programs and services with ongoing dollars. Maintaining the BSR at 18.5% also provides flexibility for the City to 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 information reported in the FY 2022 Annual Comprehensive Financial Report (ACFR) CMR 14632[2], the City’s current BSR balance is $59.8 million, approximately $14.2 million above the 18.5% target of $45.6 million for FY 2023. Micro and macro-economic conditions are adjusting daily, with rising inflation, changes in jobs, and recessionary trends creating significant uncertainty. As the State of California Legislative Analyst Office (LAO) wrote in their annual Fiscal Outlooks for California “Economic Conditions Weigh on Revenues, [the] booming

[2] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20221129/20221129pfcsm-linked.pdf

economy has led to high inflation…efforts to tame inflation are slowing the economy…inflation pressures remain, raising risk of recession…fiscal outlooks revenues balance competing risks.[3]" As shown in the table below, there are recommended adjustments in line with the City Manager's authority for transfer of excess BSR, adjusted for a recommendation to reserve funds to safeguard the stability the City has strived to achieve in the recent year by re-establishing an economic uncertainty reserve. Staff anticipates returning to Council in February 2023 with the FY 2023 Mid-Year Review and recommendations in alignment with the allocation below for the appropriation of BSR funds above the 18.5% level. Staff do recommend a transfer to the Infrastructure Reserve as inflationary costs are impacting capital project needs including anticipated significant price increases in the Automated Parking Guidance Project, as well as a need to provide safety improvements to critical assets such as the artificial turf playing fields. These actions will leave the BSR at $45.8 million or $0.2 million above the 18.5% Council recommended level.

TABLE 7: Budget Stabilization Reserve (BSR) Summary (in millions)

General Fund BSR Balance, June 30, 2022	**$72,835**
FY 2023 Approved Adjustments to the BSR Balance	
FY 2023 Adopted Budget	($9,072)
FY 2023 Services Reinvestment	($3,700)
Downtown Streets Team (CMR 14526)	($167)
Reappropriations (CMR 14728)	($100)
Subtotal: Approved Adjustments to the BSR Balance	***($13,039)***
Subtotal: BSR Balance, After Approved Adjustments	**$59,796**
Uses of the FY 2022 Surplus	
FY 2023 RECOMMENDED Adjustments to the BSR Balance (to be considered in FY 2023 Mid-Year Budget Review)	
Reserve for Economic Uncertainty	($5,000)
Transfer to Section 115 Pension Trust Fund	($5,000)
Transfer to Infrastructure Reserve (IR) in the Capital Improvement Fund	($4,000)
Subtotal: RECOMMENDED Adjustments to the BSR Balance	**($14,000)**
Current Projected FY 2022 BSR Level, (June 30, 2023)	**$45,796**

This trend may continue as discussed in the First Quarter (Q1) FY 2023 Financial Report, scheduled for review by the Finance Committee on December 6, 2022, in which several categories appear to be exceeding budgeted levels in FY 2023 similar to FY 2022 (CMR 14630).

[3] The 2023-24 Budget California's Fiscal Outlook, California Legislative Analyst's Office (LAO), November 16, 2022, https://lao.ca.gov/Publications/Report/4646

Although revenues have experienced growth in recent periods, the potential for recession makes it difficult to determine if these trends will continue in the near term. This LRFF assumes a mild 18-month recession at the beginning of the ten-year period and projects a range of $238 to $244 million in total revenues in FY 2023, reflecting up to $6 million or 2.5% above adopted budget levels. The higher end of this projection assumes that revenues will continue a similar positive trend as the summer period. Although staff may complete the 115 Pension Trust Fund and Infrastructure Reserve transfer, staff recommend waiting until more data is available on current trends to ensure staff and the Council are making an informed decision on how best to position the city to ensure stability during these uncertain times. Staff expect that one-time funding such as these will be critical to continue to mitigate impacts from a recession and bridge the near term gaps seen in the first few years of this LRFF.

Assumptions NOT Included in Forecast

It should be noted that this forecast does not include several potential impacts to the FY 2024-2033 LRFF that are outlined below. These items are known projects or areas of investment that are a priorities, but have not been fully developed in terms of costs and timelines. This is not intended to be a comprehensive list nor in any priority order.

Project Homekey: On September 27, 2021 the City Council directed staff to apply for Project Homekey funding in conjunction with LifeMoves to build an emergency shelter at the former Los Altos Treatment Plant (LATP) site (CMR 13595[4]). This project will rapidly deploy modular housing to provide interim housing opportunities for homeless individuals and families in the City of Palo Alto. The grant was awarded in Summer 2022 and the City is currently in negotiations with local partners on operational roles to leverage local expertise and ensure high quality services. This LRFF includes the City's committed investment of $7.0 million in operating expenses ($1.0 million annually which started in FY 2023 and is programmed through FY 2029); however, with the actual timing of the funding still to be determined, and commitments from other local partners negotiated, City costs for this project could fluctuate throughout the ten year period.

Sustainability and Climate Action Plan (S/CAP): In early 2020, the City launched an update of the Sustainability and Climate Action Plan (S/CAP) Framework to determine the goals and key actions needed to meet its sustainability goals, including the goal of reducing greenhouse gas (GHG) emissions to 80 percent below 1990 levels by 2030 (the "80x30" goal). As part of the FY 2022 Mid-Year Review (CMR 13801[5]) and the 2023 Adopted Operating Budget[6], Council approved several actions to increase resources to support S/CAP needs. In October 2022 (CMR

[4] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2021/09-september/20210927/210927accsm-amended-final.pdf

[5] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20220207/20220207pccsm-revised-final.pdf

[6] https://www.cityofpaloalto.org/files/assets/public/administrative-services/city-budgets/fy2023-city-budget/adopted-fy23/operating-budget_final-4.pdf

14720[7]), City Council accepted the updated S/CAP Goals and Key Actions and adopted a goal to make the City carbon neutral by 2030. Staff commenced California Environmental Quality Act (CEQA) evaluation of the S/CAP upon Council's acceptance of the proposed S/CAP Goals and Key Actions. The City is currently in the process of finalizing the Three-Year Work Plan, which will be brought to Council for review and discussion in December 2022. The final S/CAP Report will be brought to Council for acceptance in Spring 2023. As the S/CAP Work Plan and final report are still in development, cost projections are not yet contemplated in the forecast. Implementation is anticipated to require significant resources, including internal staffing and consultant expertise.

Service reductions not restored to pre-pandemic levels:
The City made significant service reductions in FY 2021 and FY 2022 Adopted Budgets to align expenses with losses of nearly $40 million in General Fund tax revenues due to economic impacts resulting from the COVID-19 pandemic. During this time, many services were reduced or eliminated across the organization and essential services were prioritized. Ultimately, the City's General Fund workforce was reduced by 83 full-time staffing positions (76.50 FTE) and 107 part-time positions (26.18 FTE). In FY 2022, the City began to see gradual signs of improvement and a positive economic outlook that supported initial reinvestments in the first quarter (Q1) FY 2022 financial report (CMR 13439[8]), FY 2022 Mid-Year Budget Review (CMR 13801[9]), and the Staffing for Adequate Fire and Emergency Response (SAFER) grant (CMR 13643[10]). Further reinvestments were made in the FY 2023 Adopted Budget[11] to restore services that were previously reduced and provide resources to support priority initiatives. In total, full-time staffing levels have increased by 61.85 FTE, from the pandemic low of 956.00 FTE to 1,017.85 FTE. This level of staffing remains below pre-pandemic levels of 1,034.85 FTE. As of this LRFF, some services remain below pre-pandemic levels or have new and evolving changes to meet community needs. These services will continue to be evaluated and proposals brought forward in future budget processes for City Council consideration.

Significant code and ordinance updates: Updates to several significant programs, codes and ordinances are expected to be necessary in the near future; some of these updates include: Seismic Inventory Ordinance and Program Development, Historic Building Survey and Ordinance Development, and Zoning Code Updates. Depending on future Council direction, program implementation is anticipated to require significant resources, including internal staff and outside consultant expertise.

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[7] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20221003/20221003accsm-amended-presentations.pdf
[8] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2021/10-october/20211025/20211025pccsm-linked-w-times.pdf
[9] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20220207/20220207pccsm-revised-final.pdf
[10] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2021/11-november/20211101pccs-amended.pdf
[11] https://www.cityofpaloalto.org/files/assets/public/administrative-services/city-budgets/fy2023-city-budget/adopted-fy23/operating-budget_final-4.pdf

Fee and Organizational Studies: The Planning and Development Services (PDS) Department is in the process of completing two studies, a fee study and an organizational study on the Fire Prevention group. The purpose of the fee study is to align fees and revenues based on the updated department structure to continue to meet Council approved cost recovery levels. Ahead of the completion of the Department-wide study, an organizational study of the Fire Prevention program will be completed to inform the fee study. Because the Fire Prevention Program is currently housed in both the Fire and Planning and Development Services departments, recommendations may be made to realign the program and resources. The Library Department is also in the process of completing an organization study to assess staffing, resource, and service levels with the goal of increasing open hours and providing additional services to the community. Lastly, a citywide fee study needs to be completed periodically by an outside consultant to ensure the City's fees are in line with its cost recovery policies. This study will be scheduled to be completed by FY 2024 and could update fees and associated revenue assumptions in future year LRFF reports.

Labor negotiations: As of the timing of this report, all labor agreements are scheduled to expire on December 31, 2022, with the exception of the Service Employees International Union Hourly Unit (SEIU-H) agreement, which is extended through June 30, 2023. A general wage adjustment of 2.0% is included for all years of the forecast since no agreements would be in effect at that time. This is consistent with prior Council direction in previous long range financial forecasts to use the 2.0% increase as a forecasting assumption, not as a commitment to future negotiations. Additionally, this forecast includes a level of reserve to reach a target market placement for employee compensation in new labor agreements, as directed by the City Council. Staff expects to adjust these costs throughout the budget development process in accordance with market studies and final contract terms.

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 2023 Adopted Capital Budget anticipated that these projects would cost $261.8 million. Staff is working to maintain these projects within the current budget; however, project costs can fluctuate based on market conditions at the time of construction award.

Grade Separation: The grade separation project consists of the four at-grade crossings along the Caltrain corridor in the City of Palo Alto located at Palo Alto Avenue, Churchill Drive, Meadow Avenue, and Charleston Road. The City is working on conceptual alternative plans for the selection of the preferred alternative at Churchill Avenue, Meadow Drive, and Charleston Avenue crossings. In November of 2021, after performing a detailed review of the alternative plans under consideration, Council selected the Partial Underpass Alternative as the preferred alternative and designated Closure with Mitigation as a backup alternative for the Churchill Avenue crossing. Council also directed staff to conduct additional studies and to refine underpass alternatives by seeking input from stakeholders (Pedestrian and Bicycle Advisory

Committee, Palo Alto Unified School District, and Stanford University). Such input could further assist in narrowing down grade separation alternatives. On May 23, 2022 (CMR 14341[12]), the City Council authorized an amendment to the consultant contract for performing these additional tasks

Once preferred alternatives are selected, the next phase will include preparing preliminary engineering and environmental documents for the three crossings. The Valley Transportation Authority (VTA) 2016 Measure B Caltrain Grade Separation funding is available to the City for additional studies and the next phases of the project which include preliminary engineering and environmental review, right-of-way, design, and construction. In addition to this, on August 10, 2022 (Supplemental Memorandum AA1[13]) the City Council adopted advisory spending guidelines stating its intention to expend a portion of the revenues from Measure K on the rail grade separation project.

The 2016 Measure B program tax revenue amounts to a total of $700 million in 2017 dollars for all at-grade crossings in Santa Clara County, and the City anticipates allocation of 50% of said funding. The VTA is currently programming these funds in two-year increments. Grade Separation 2016 Measure B funding requires matching local funds as a result, additional funding sources will need to be identified to perform this work in upcoming years (FY 2024 – FY 2033). The full funding needed to complete the grade crossings project is unknown at this time; however, it is expected, that funding necessary to complete this work will exceed funding currently identified for this project. Therefore, additional resources will need to be explored to plan and fund these grade separations, including City staff pursuing additional funding through grant opportunities as they become available.

Parks Master Plan: The Parks Master Plan[14] 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.

Racial Equity Work: The Race & Equity Framework and action plan was approved in June 2020 (CMR 11441[15]) and remaining funding of $0.5 million has been reappropriated to be available in FY 2023. Staff is in the process of procuring consultants to assist with the City's diversity, equity, and inclusion efforts in engaging staff, the City Council, and Boards/Commissions. After this initial work, further recommendations are anticipated to be forthcoming and will likely require additional resources either for more consultant assistance and/or an ongoing in-house Equity Officer position (discussed during the 2020 Ad Hoc Committee meetings). These

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12 https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20220523/20220523pccsm-revised.pdf

13 https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/at-places-memo/20220810apmccsm.pdf

14 https://www.cityofpaloalto.org/files/assets/public/public-works/palo-alto-parks-master-plan.pdf

15 http://cityofpaloalto.org/civicax/filebank/documents/77273

recommendations are anticipated to be brought forward in FY 2023 or as part of the FY 2024 budget process.

Palo Alto Animal Shelter operations and rebuild
In early 2019, the City entered into a public private partnership with Pets In Need (PIN) to support the operation of the City's animal shelter. Part of PIN's operating proposal included robust fundraising to rebuild the current shelter into a state-of-the-art animal shelter for the City, with costs shared between the City and PIN. Since the initial agreement, PIN has indicated that additional construction projects are required, which will increase capital project costs significantly. Preliminary estimates are $3.0 to $4.0 million over existing commitments, and no funding is identified for these costs. The City and PIN both have an interest in continuing the partnership and on February 14, 2022 City Council directed staff to proceed with negotiations to update the service agreement (CMR 13952[16]).

City owned assets operated by non-profit organizations: This Forecast does not include any additional capital or operating investments for the Avenidas Senior Center, the Ventura Child Care Center, 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. As part of the FY 2023 Adopted Capital Budget[17] the City Council established the Roth Building Rehabilitation Phase 1 capital project (PF-23001) directed a funding strategy for the Roth Building Rehabilitation Project, which consists of utilizing $5.4 million from a variety of funding sources including the Stanford University Medical Center (SUMC) Fund; library, parks, and community center impact fees; grants from Santa Clara County; and donations from the Palo Alto Museum. This funding strategy is included in the LRFF; however, if costs for rehabilitating the Roth building increase, additional sources of funding would need to be identified.

Cubberley Community Center Concept Plan: The City and PAUSD completed a co-design process for a Cubberley Community Center Concept Plan in 2019; however, costs to implement the concept plan are not assumed in this LRFF in excess of the dedicated Cubberley infrastructure funding included in the existing agreement between the PAUSD and the City (discussed in the Transfer to Infrastructure section of this report). The Concept Plan may require revision before implementation as operational changes have occurred since its completion including execution of a new lease between the City and PAUSD for the school district owned portion of Cubberley, which commenced on July 1, 2020, and reduced the amount of building space leased to the City (discussed in the General Expense - Cubberley Lease section of this report). On February 14, 2022 the Council directed Staff to pause preparation of the Cubberley Concept Plan CEQA and return with a work plan to include: i. exploring a land swap at Fletcher or financial framework for acquiring available land; and ii. scoping the design process for Cubberley Community Center

[16] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20220214/20220214pccsm-amended-linked-final.pdf
[17] https://www.cityofpaloalto.org/files/assets/public/administrative-services/city-budgets/fy2023-city-budget/adopted-fy23/capital-budget_final-4-online-version.pdf

that is City owned once the acreage is determined. Staff is communicating with PAUSD on the potential to acquire additional land at Cubberley, including acreage amount. This could be through a land swap, acquisition, or ground lease. Staff is also determining next steps for repair of Cubberley Gyms A and B, which have been closed since February 2022 due to damage caused by water line breaks.

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 worked to secure significant grant funding from the Federal Aviation Administration (FAA) for capital improvement costs. As of FY 2020, the Airport Fund began paying back the loan to the General Fund. Additions and other initiatives funded in other funds may need financial support from the General Fund to ensure they are fully implemented. In FY 2023 the Residential Preferential Parking (RPP) Fund received a one-time $0.4 million General Fund loan to remain solvent while continuing operations given the sustained drop in parking demand during the pandemic. 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. As the potential impacts of various legislative initiatives are clarified, appropriate adjustments will be identified and brought forward as part of future budget development cycles.

Tax revenue alignment with updated Comprehensive Plan: The 2030 Comprehensive Plan was adopted in FY 2018, 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.

Aging or Noncompliant Infrastructure: The City maintains indoor and outdoor facilities, many of which have been identified in the City's ADA transition plan and by the Infrastructure Blue Ribbon Commission as requiring capital project work to bring them up to full ADA compliance and/or sufficient conditions. Facilities of concern include Cubberley Community Center, Foothills Park Restrooms, Lucie Stern Community Theatre restrooms, and Rinconada Pool locker rooms. Staff continues to program work needed in this area as part of the Americans with Disabilities Act Compliance capital project (PF-93009); however, the entire scope of work needed in this area exceeds current resources.

Parks Trash Removal: The City currently does not have weekend trash removal services at most urban parks. Prior to the COVID-19 pandemic, Rinconada and Mitchell Parks had weekend trash removal, because those parks had picnic tables that could be reserved by residents. Staff have noted that garbage cans can become overfilled on the weekends and are looking into how to fund and operationalize adjustments to mitigate this issue. Possible solutions under consideration include an increase in collection frequency, enhanced signage, and educational materials on waste reduction options such as reusable picnicware. Staff will bring forward needs for reinvestment in this area in FY 2023 or as part of the FY 2024 budget process.

Permanent Parklet Program: On June 23, 2020 the City Council adopted an emergency ordinance to temporarily permit businesses to operate outdoors on both public and private property, referred to as the pilot parklet program (CMR 11439[18]). On April 19, 2021 the Council directed staff to develop a permanent parklet program (CMR 12041[19]). The current pilot program was extended most recently on October 24, 2022 (CMR 14692[20]) to extend the temporary parklet program to June 30, 2023 and allow the other on-street and parking lot dining and retail programs through December 31, 2023. Staff are developing a permanent program which will include staffing and maintenance resources funded by new municipal fees and associated revenues. This program is anticipated to be brought forward for Council consideration in December 2022 and resources adjusted in FY 2023 or as part of the FY 2024 budget process.

General Liability Umbrella Excess Premiums: The City's General Liability Program provides funding to cover various insurance policies for City-owned equipment and machinery. The City is self-insured for the first $1.0 million in losses per occurrence and participates in a Joint Powers Authority for coverage up to $55 million per occurrence. These expenses are allocated to citywide departments. General Liability Umbrella Excess Premiums are anticipated to increase in future years due to significant national events and natural disasters such as claim costs for Hurricane Ian. Staff will bring forward adjustments for these costs as part of future budget cycles as they become available.

Fire Training Center: As part of the FY 2023 Adopted Capital Budget[21] the City Council approved the Fire Training Facility Replacement capital project (FD-24000) to identify an appropriate site and construct a new fire training facility in Palo Alto. Funding was only appropriated for the feasibility study portion of the project, and additional resources will need to be appropriated in future budget cycles based on the results of the study. In addition, the Fire Department is also evaluating opportunities to partner with other local jurisdictions for training needs, instead of building a permanent facility in Palo Alto.

FY 2023 Budget Development Guidelines

When the Fiscal Sustainability Workplan (CMR 10267[22]) was approved by the City Council on April 22, 2019 drafting a budget development policy was listed as part of the "Newly proposed

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[18] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2020/id-11439.pdf

[19] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2021/id-12041.pdf

[20] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20221024/20221024pccsm-amended.pdf

[21] https://www.cityofpaloalto.org/files/assets/public/administrative-services/city-budgets/fy2023-city-budget/adopted-fy23/capital-budget_final-4-online-version.pdf

[22] https://www.cityofpaloalto.org/civicax/filebank/documents/70506

or potential activities proposed to be completed". The inclusion of Budget Development Guidelines in with this forecast represents staff's recommended method of addressing this referral. Pairing Budget Development Guidelines with the forecast at the beginning of the budget process 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. This also ensures that the City is able to proactively address anticipated changes in its fiscal condition through the budget process.

As discussed earlier in this document, this preliminary forecast represents the initial steps of the FY 2024 budget development process. Due to the clear overlap of projecting the City's fiscal condition and the need to shape service level expectations, staff recommends that the inclusion of Budget Development Guidelines be incorporated into the discussions at the beginning of an annual budget process. The FY 2024 Budget Development Guidelines, which are detailed in Attachment A, 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.

Conclusion

This forecast maintains current service levels approved in FY 2023 and should be used for planning purposes to assist in gauging effects of major policy interventions against a likely "status quo" version of the future. The level of uncertainty in this forecast is reduced from where it was a year ago in terms of impacts from the COVID-19 Pandemic; however, the City is continuing to manage through current economic uncertainty and evaluating potential impacts on the local economy. Positive trends in major tax revenue categories that occurred in FY 2022 caused a one-time surplus of $14.2 million that Staff anticipates returning to Council in February 2023 with the FY 2023 Mid-Year Review and recommendations in alignment with the allocation for the appropriation of BSR funds above the 18.5% level. This includes transfers to the Infrastructure Reserve (IR) in the Capital Improvement Fund ($4.0 million) and the City's Section 115 Pension Trust Fund ($5.0 million), as outlined in the Pension Funding Policy, and a recommendation to reserve funds to safeguard the stability the City has strived to achieve in the recent year by re-establishing an economic uncertainty reserve ($5.0 million). Although revenues have experienced growth in recent periods, the potential for recession makes it difficult to determine if these trends will continue in the near term.

The LRFF Base Case assumes a mild 18-month recession at the beginning of the ten-year period in which revenue growth is anticipated to slow through the end of FY 2024. As a result, the LRFF projects a surplus of $0.4 million in FY 2024, followed by a $3.4 million gap in FY 2025, and a $2.6 million gap in FY 2026, with small but increasing surpluses in FY 2027 through FY 2033. Additionally, this LRFF projects a range of $238 to $244 million in total revenues in FY 2023, reflecting up to $6 million or 2.5% above adopted budget levels. The higher end of this projection assumes that revenues will continue a similar positive trend as recent quarters. However, actual results will vary depending on the timing and magnitude of recessionary impacts in the near term. If these additional revenues continue to materialize in FY 2023, Staff anticipates returning to Council as part of the FY 2023 Mid-Year Budget Review to recommend using this funding to increase the economic uncertainty reserve to help mitigate impacts from a recession as well as smooth the near-term gaps seen in the first few years of this LRFF.

In addition to the Base Case Forecast, staff modeled an alternate forecast scenarios that are discussed below. The first alternative reflects a more severe recession compared to the Base Case and increases the General Fund gap over the next ten years. FY 2024 changes from a surplus to a gap of $3.5 million, and revenues are not anticipated to be able to fund the annual expenditures until FY 2029. Staff also modeled an alternate forecast that reflects estimated funding from Measure K and the impacts on the General Fund over the next ten years. The surplus in FY 2024 increases to $1.1 million, the gap in FY 2025 reduces to $1.9 million, and FY 2026 changes from a gap to a small surplus. These alternate forecasts were done separately to show the impacts of each scenario in isolation; however, aspects of both alternate forecasts may occur in conjunction in the future.

Alternative Scenarios for Consideration

Alternative Forecast Scenario A: Moderate Recession

This alternative forecast models the impact of a moderate recession that assumes slower growth of major tax revenues as compared to the base case. In this alternative, the range for excess revenues in FY 2023 is reduced from an upper estimate of $6 million to $3 million. Additionally, growth rates in FY 2024 and beyond are slowed, reducing net earnings by approximately $4 to $6 million in the forecast and extending the timeframe to recover to pre-pandemic levels by one to three years. The summary table for this alternative forecast and the Net Operating Margin graph for this alternative forecast are below. Additional discussion for this alternative follows these figures.

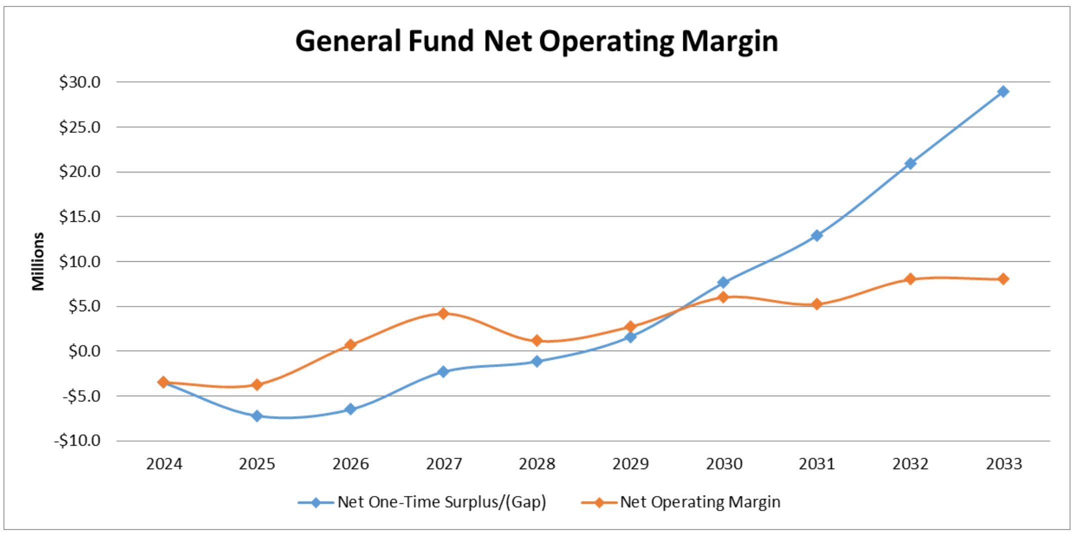
TABLE 8: FY 2024 – FY 2033 Long Range Financial Forecast
Alternative Forecast A

ALTERNATIVE SCENARIO: MODERATE RECESSION

	Actual 2022	Adopted 2023	Projected 2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Total Revenue	$238,735	$237,751	$238 - 241M	$247,033	$257,588	$267,881	$278,113	$286,327	$297,822	$308,476	$320,223	$332,101	$345,783
BSR Contribution (One-Time)	-	$9,670	$9,670	-	-	-	-	-	-	-	-	-	-
Total Source of Funds	$238,735	$247,421	$247 - 250M	$247,033	$257,588	$267,881	$278,113	$286,327	$297,822	$308,476	$320,223	$332,101	$345,783
Year over Year increase (revenue only)				*3.9%*	*4.3%*	*4.0%*	*3.8%*	*3.0%*	*4.0%*	*3.6%*	*3.8%*	*3.7%*	*4.1%*
Total Expenditures	$197,963	$247,421	$247,421	$250,507	$264,764	$274,361	$280,385	$287,445	$296,196	$300,826	$307,298	$311,154	$316,793
Total Use of Funds	$197,963	$247,421	$247,421	$250,507	$264,764	$274,361	$280,385	$287,445	$296,196	$300,826	$307,298	$311,154	$316,793
Year over Year increase				*1.2%*	*5.7%*	*3.6%*	*2.2%*	*2.5%*	*3.0%*	*1.6%*	*2.2%*	*1.3%*	*1.8%*
Net One-Time Surplus/(Gap)	$40,772	$0	$0 - 3M	($3,474)	($7,176)	($6,481)	($2,272)	($1,118)	$1,626	$7,650	$12,925	$20,947	$28,990
Cumulative Net Operating Margin (One-Time)													$51,617
Net Operating Margin				($3,474)	($3,703)	$696	$4,209	$1,154	$2,745	$6,023	$5,275	$8,022	$8,043
Cumulative Net Operating Margin													$28,990

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

TABLE 9: FY 2024 –2033 Long Range Financial Forecast Net Operating Margin
Alternative Forecast A



The Base Case projected that by FY 2027, the City would begin to have a positive surplus; this alternative forecast extends the operating gap to FY 2029. In this alternative, the General Fund would have a gap of approximately $3.5 million in the first year of the forecast. This gap increases to a peak of $7.2 million in FY 2025 and begins to taper in the two years following. FY 2029 is the first-year revenues would reach levels sufficient to support expenses.

Alternative Forecast B: Measure K Funding

This alternative forecast assumes the use of approximately 30 percent of revenues generated from Measure K to offset known eligible expenses that contribute to funding gaps in the base case. Measure K was presented on the November 8, 2022 ballot to establish a tax on businesses operating in Palo Alto. This measure levies a tax on businesses based on a monthly rate of 7.5 cents per square foot of occupancy, subject to exclusions, with initial payments due January 2024. For the first two years, the tax would be imposed at half the rate. The tax rate and cap would be increased by 2.5% annually to account for general inflation, beginning July 2026. The tax would terminate January 1, 2058, unless extended by voters. The proposed tax is estimated to raise approximately $9.6 million each year for 35 years. The City Council has adopted advisory spending guidelines stating its intention to expend revenues on long-term stable funding for public safety, affordable housing and homeless services, and grade separated train crossings that maintain safety and mobility for vehicles, bicyclists, and pedestrians, and to annually report on tax revenues and expenditures. The summary table for this alternative forecast and the Net Operating Margin graph for this alternative forecast are below. Additional discussion for this alternative follows these figures.

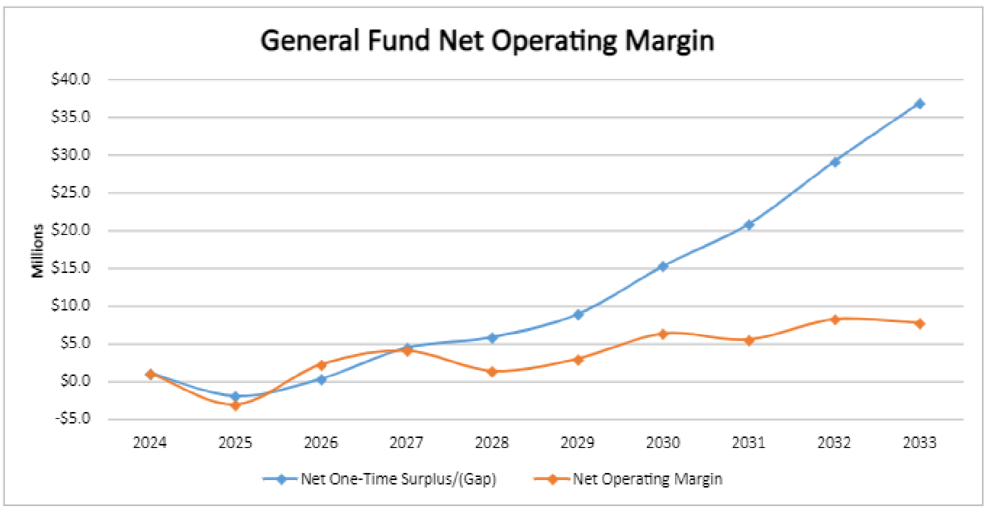
TABLE 10: FY 2024 – FY 2033 Long Range Financial Forecast
Alternative Forecast B

ALTERNATIVE SCENARIO: MEASURE K FUNDING

	Actual 2022	Adopted 2023	Projected 2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Total Revenue	$238,735	$237,751	$238 - 244M	$251,177	$261,671	$272,065	$282,203	$290,671	$302,477	$313,495	$325,552	$337,689	$351,101
BSR Contribution (One-Time)	-	$9,670	$9,670	-	-	-	-	-	-	-	-	-	-
Measure K (eligible funds)	-	-	-	$750	$1,500	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000
Total Source of Funds	$238,735	$247,421	$247 - 253M	$251,927	$263,171	$275,065	$285,203	$293,671	$305,477	$316,495	$328,552	$340,689	$354,101
Year over Year increase (revenue only)				*5.6%*	*4.2%*	*4.0%*	*3.7%*	*3.0%*	*4.1%*	*3.6%*	*3.8%*	*3.7%*	*4.0%*
Total Expenditures	$197,963	$247,421	$247,421	$250,814	$265,083	$274,694	$280,726	$287,794	$296,558	$301,197	$307,685	$311,557	$317,193
Total Use of Funds	$197,963	$247,421	$247,421	$250,814	$265,083	$274,694	$280,726	$287,794	$296,558	$301,197	$307,685	$311,557	$317,193
Year over Year increase				*1.4%*	*5.7%*	*3.6%*	*2.2%*	*2.5%*	*3.0%*	*1.6%*	*2.2%*	*1.3%*	*1.8%*
Net One-Time Surplus/(Gap)	$40,772	$0	$0 - 6M	$1,114	($1,912)	$371	$4,478	$5,877	$8,919	$15,298	$20,867	$29,132	$36,908
Cumulative Net Operating Margin (One-Time)													$121,053
Net Operating Margin			$0	$1,114	($3,026)	$2,283	$4,107	$1,399	$3,042	$6,379	$5,570	$8,265	$7,776
Cumulative Net Operating Margin													$36,908

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

TABLE 11: FY 2024 – 2033 Long Range Financial Forecast Net Operating Margin
Alternative Forecast B



In this alternative, the eligible funds for Measure K are phased-in over three years, in alignment with the anticipated implementation of the tax. As mentioned above, approximately 30 percent of the total anticipated receipts are used to offset eligible costs. These additional resources result in a higher surplus of $1.1 million in FY 2024 as compared to the base case. Additionally, the gaps in forecast years are significantly reduced or eliminated. In this scenario, the City has a one-time gap of $1.9 million in FY 2025 followed by continued surplus throughout the forecast.

STAKEHOLDER ENGAGEMENT

The preliminary forecast for FY 2024 represents the beginning of the fiscal year 2024 budget development process. Information provided in this report will be discussed with the City Council after Finance Committee and those conversations will provide direction 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 2023, according to the standard budget adoption process.

RESOURCE IMPACT

Financial implications from this report and input from the Finance Committee will be considered in the City Manager’s development of the Fiscal Year 2024 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 - FY 2024 Budget Policy Guidelines
- Attachment B - The Economy
- Attachment C - General Fund Base Case Revenue Assumptions
- Attachment D - General Fund Base Case Expense Assumptions

FY 2024 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 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 such as planning for recession needs, restoration needs, and strategic investments.

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 or realignment with current needs.

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; however, ensuring when resource augmentations are added, it is in alignment with one-time and ongoing forecasted sources.

9) Continue to prioritize proactively funding long term liabilities including but not limited to debt obligations, pension obligations, and capital infrastructure in accordance with City policies as approved by Council.

ATTACHMENT B

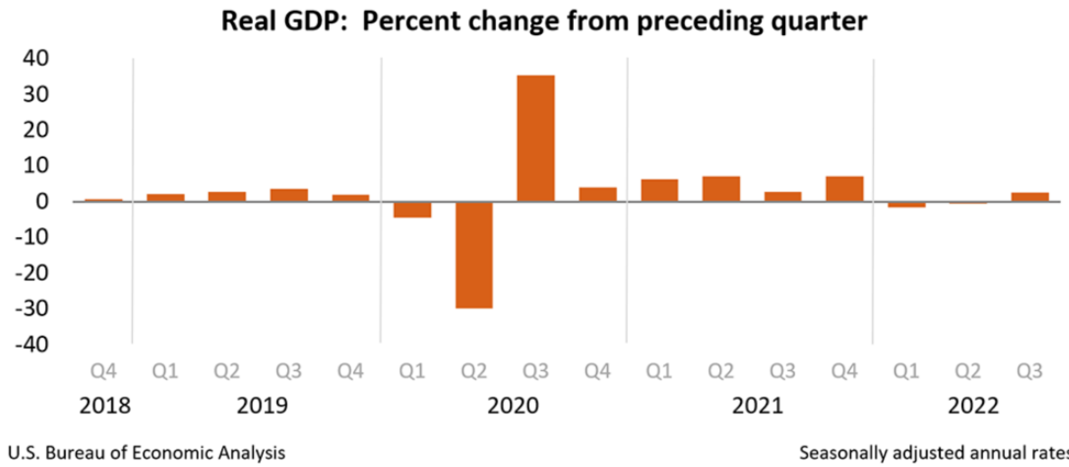
The Economy

The economy closed 2021 with GDP growing 6.9% by the end of this calendar year with inflation increasing, year-over-year by 7%, a level not seen since the early 1980s. As of October 2022, the consumer price index (CPI) was below 8%. The unemployment rate at the end of 2021 was 3.9% which was down from 6.4% at the beginning of this year. At the pandemic peak, unemployment rate was at 14.7% when significant portions of the economy were shut down. The GDP growth in 2022 is expected to be below 3% then drop to low 2% in 2023. The unemployment rate hovers around the mid 3% but is likely to go up as the economy cools down. The above outlook is predicated on the federal reserve achieving a "soft landing" whereby there's a slowdown in economic growth that avoids recession for the purpose of stopping the economy from overheating and continue to experience high inflation.

The local economy continues to show strong performance in the latter half of the calendar year 2022 though signs of "headwinds" are growing that are likely to stem economic growth. The UCLA Anderson Forecast for California paints a generally positive picture for the state as compared to national economic concerns, citing continued gains in gross domestic product. The outlook reports that increases in defense spending and the continued demand for tech will likely keep the economy growing, albeit at a slower pace. The outlook is that the world has become more unstable so the expectation is that federal defense spending over the next few years will increase. There have been broad-based hiring with leisure and hospitality, health care and social services, and technology. However, the "mixed-signals" in economic data and headline news such as technology sector layoffs are a concerning trend and a potential early indicator of an economic slowdown. Another concerning trend, which California and the local economy are sensitive to, is that the world economy seems to be worse than the U.S. With U.S. rising interest rates and global instability, investors have been putting their money in the U.S. causing the dollar to rise against other currencies. This causes U.S. exports to be more expensive around the world. The growing home inventory, higher mortgage rates, and low and diminishing affordability are expected to negatively impact the national and local housing market though demand for Palo Alto housing has always been and is expected to remain strong.

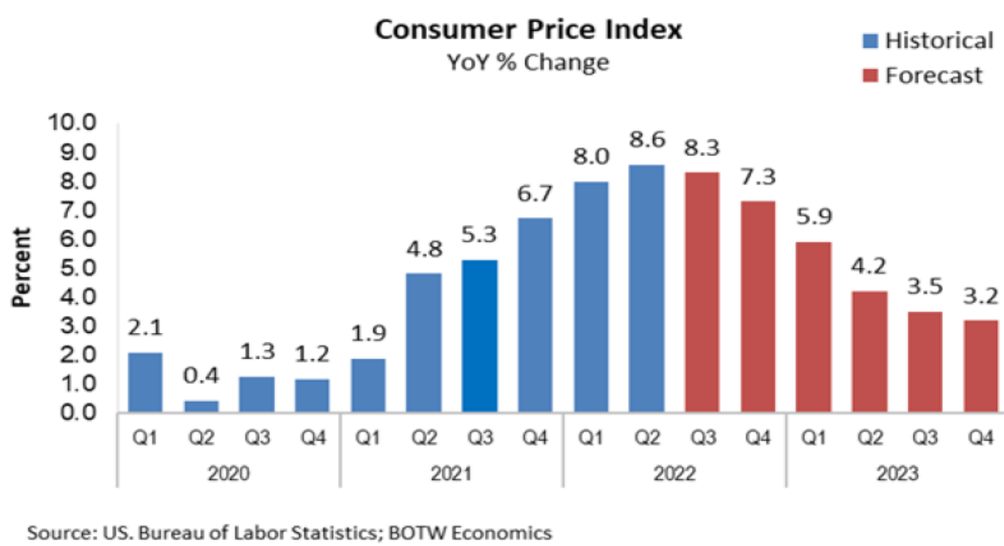
According to the US Bureau of Economic Analysis (BEA), the "advance" estimate of the U.S. economy's real gross domestic product (GDP) percentage change, from the preceding quarter, changed in the second and third (calendar) quarters of 2022 by a decline of .06% and an increase of 2.6%, respectively. Real GDP is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. According to the BEA, in the third quarter the increase in real GDP reflected increases in exports, consumer spending, nonresidential fixed investment, federal government spending, and state and local government spending, that were partly offset by decreases in residential fixed investment and private inventory investment. Imports, which are a subtraction in the calculation of GDP, decreased.

Table 1: National Gross Domestic Product (GDP)



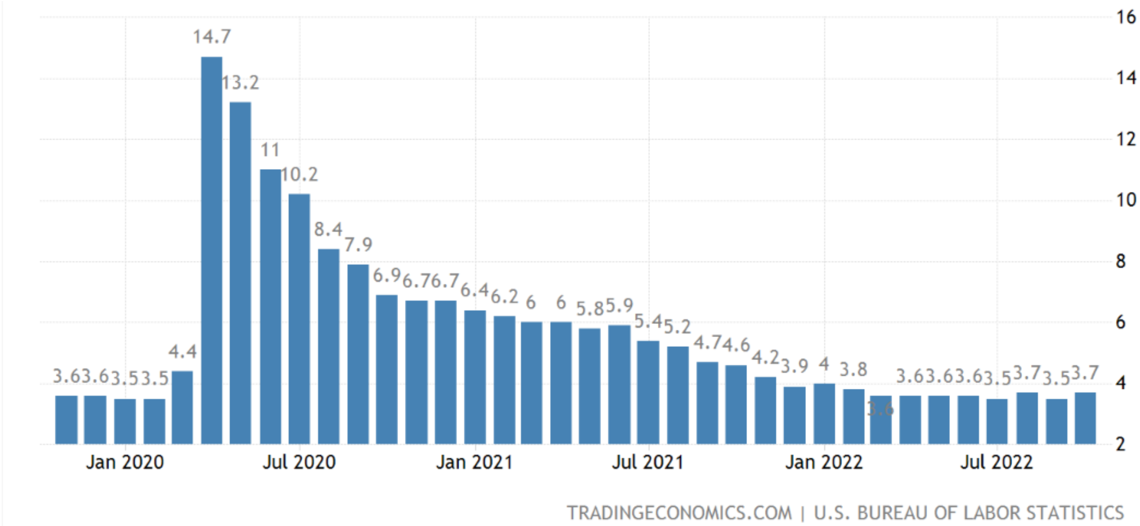
The national Consumer Price Index (CPI), as of the second calendar quarter peaked at 8.6% and is expected to steadily decline in the coming quarters. In the third quarter, actuals in July, September and October 2022 were 8.2%, 8.2% and 7.7%. This is slightly better than shown in the Table 2 third quarter forecast of 8.3% which bodes well for the forecasted declining trend.

Table 2: National Consumer Price Index



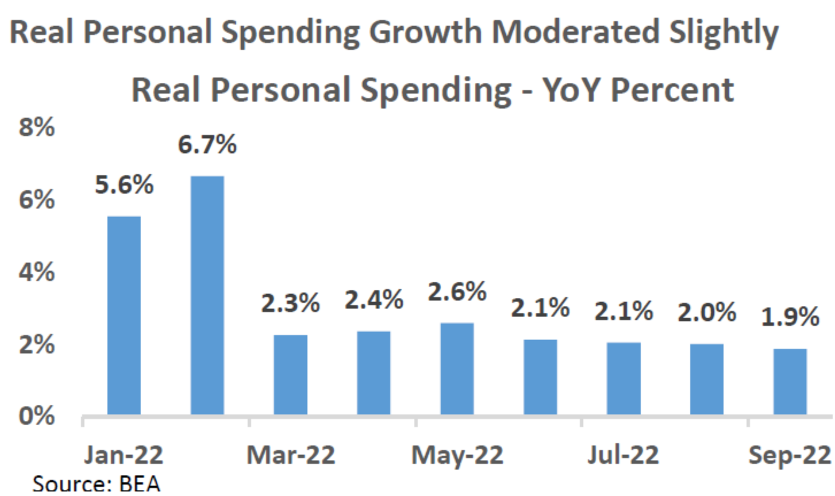
The nation's unemployment rate is 3.7% as of October 2022, compared to a record high of 14.7% at the height of the pandemic in April 2020. It is expected, by the U.S. Bureau of Labor Statistics, that the unemployment rate will rise due to the Federal Open Market Committee (FOMC or aka federal reserve) raising the federal funds (interest) rate in order to bring down the elevated inflation rate. Per the State of California's Employment Development Department, the state's unemployment rate as of September 2022 is 4.1% with the prior year being 7% and the County of Santa Clara is 2.3%. Nationally, the improved unemployment rates are driven by job gains in the leisure and hospitality; trade, transportation and utilities; professional and business services; education and health services; manufacturing, and construction. Historically, the Bay Area job growth has been led by the Peninsula for the past several years. The unemployment rate for the San Francisco Peninsula was also in the low 2%.

Table 3: U.S. Unemployment Rate



The high inflation rate has resulted in the continued erosion of purchasing power, however, this has not substantially deterred the U.S. consumer from spending. Real personal spending climbed 0.3% in September. This was driven by a 0.6% increase in services spending with goods spending declining by 0.1%, a tread reflected in the prior few months. As the pandemic restrictions have been removed, the trend reflects consumers are shifting their activity to services and away from goods. Though there's net monthly solid growth, as reflected in the below graph, the year over year shows a slight decline

Table 4: Real Personal Spending Growth



ATTACHMENT C

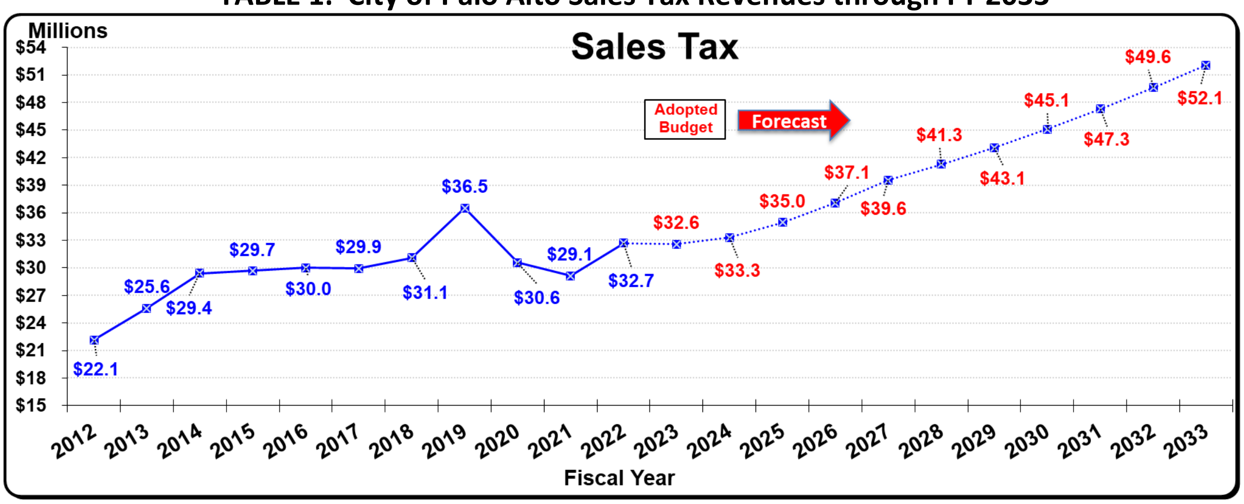
General Fund Base Case Revenue Assumptions

Sales Tax

Compared to FY 2019 pre-pandemic actuals of $36.5 million, sales tax revenue declined by $7.4 million, or 20.2%, during the pandemic in FY 2021. The recovery, which began in the last quarter of FY 2021, resulted in the FY 2022 receipts increasing by $3.6 million or 12.3%. Though this trend has continued in the first quarter of FY 2023, the rate of recovery is expected to decline. The general retail, food products (includes restaurants), business to business (includes car leasing), and transportation (includes auto sales) categories experienced significant increases. This economic trend also occurred in municipalities in the San Francisco Bay Area and in California. These significant upward trends were partially offset by construction activity, which has been declining.

The FY 2023 Adopted Budget for Sales Tax is $32.6 million, a $0.1 million or 0.4% decline over FY 2022 actuals of $32.7 million. In FY 2024, this revenue is anticipated to increase to $33.3 million, a $0.7 million or 2.2% increase over the FY 2023 Adopted Budget. Revenue in this category is experiencing growth; however, is not anticipated to reach pre-pandemic levels until FY 2026. The Base Case assumes 4.3 to 6.7% growth over the length of the forecast.

TABLE 1: City of Palo Alto Sales Tax Revenues through FY 2033



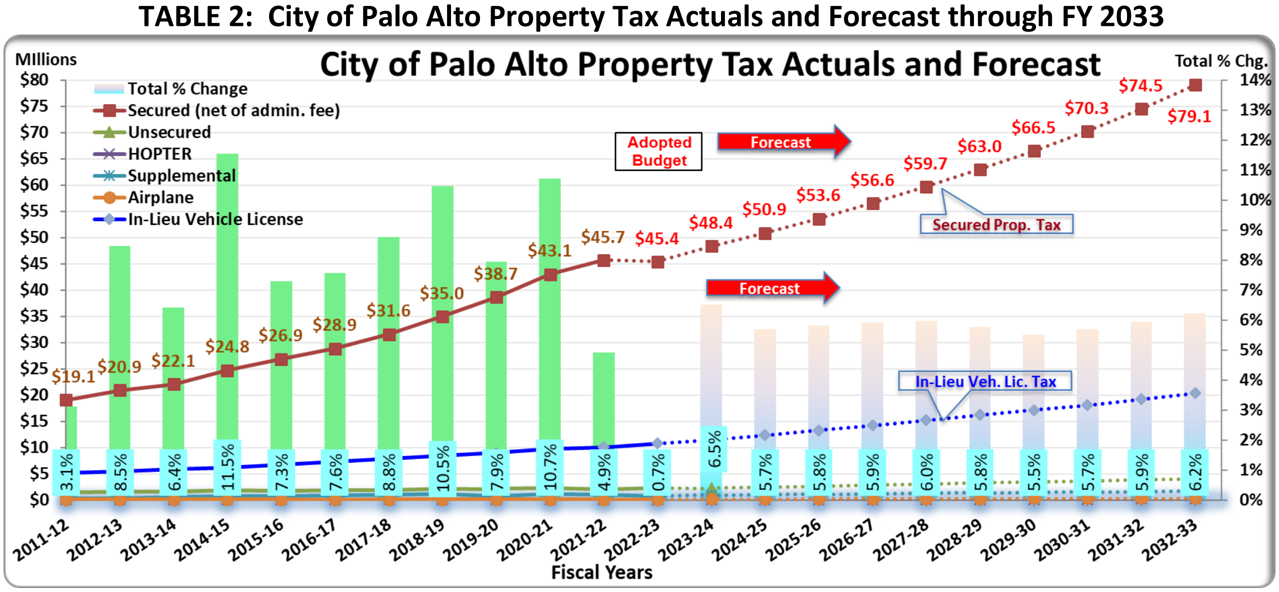
Property Tax

Property tax revenue is the General Fund's largest revenue source and represents approximately 25% of the total revenues. Historically, the 10-year compound annual growth rate (CAGR) was 8.4% with a low of 3.1% in FY 2012 and a high of 11.5% in FY 2015. During economic downturns, impacts to property tax occur a year later, however, due to robust residential and commercial property sales and significant Educational Revenue Augmentation Fund (ERAF) growth, the FY 2022 actual growth was 4.9%. In addition, fiscal years 2019, 2020, 2021, and 2022 included receipts of $2.7 million, $3.9 million, $5.5 million, and $6.6 million, respectively, for excess ERAF distributions from the County of Santa Clara. The FY 2022 budget included $4.9 million for excess ERAF, however, actual receipts were $6.6 million, or $1.7 million higher which is explained further below. 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.

In FY 2021, five counties including Santa Clara County, and the State were in a dispute over the calculation and disbursement of excess ERAF funds. In a claim by the State, calculations for excess ERAF incorrectly shifted too much property tax from schools to local agencies. The City set established a reserve for the potential litigation amounts that was later released to the Budget Stabilization Reserve (BSR) upon reaching a favorable resolution. In November 2021, the County of Santa Clara notified the cities that the California School Boards Association and its Education Legal Alliance filed a lawsuit against the Controller of the State of California arguing that the settlement reached with the counties is unlawful. The County estimates a range between 20 to 30% of Excess ERAF is at-risk. The FY 2023 Budget assumes 25% or $1.5 million for a potential loss starting in the current year and extending into forecast years. The FY 2022 amount at risk, $1.7 million, was sent to the City since the lawsuit wasn't settled in FY 2022; these funds were recognized as property tax receipts in FY 2022 and are reserved, pending the settlement of the lawsuit. Staff will continue to monitor the status of this dispute and report on any significant developments.

Transfer of ownership has been a significant driver of past growth; however, that growth is expected to moderate in FY 2023 due to the expected economic slowdown and the higher mortgage rate. For example, the median sales price of single family residential in the fourth (fiscal year) quarter of FY 2022 declined by 5.3% over the prior quarter.

TABLE 2: City of Palo Alto Property Tax Actuals and Forecast through FY 2033



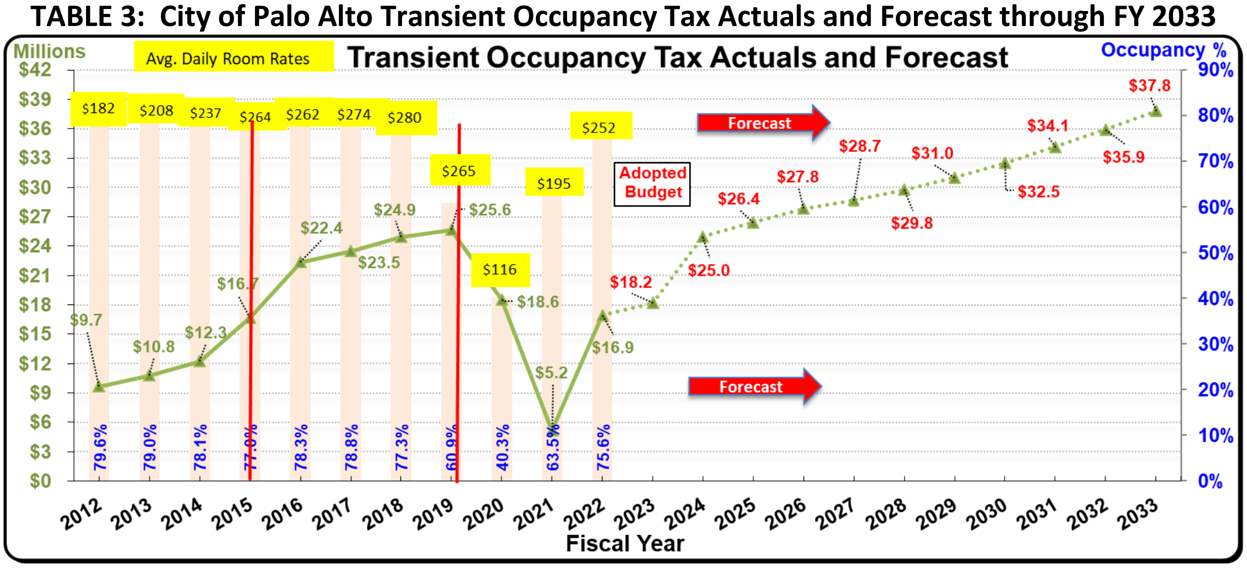
The FY 2023 Adopted Budget for Property Tax is $59.8 million, a $0.4 million or 0.7% increase over the FY 2022 actuals of $59.4 million. In FY 2024, this revenue is anticipated to increase to $63.7 million, a $3.9 million or 6.5% increase over FY 2023 Adopted Budget level.

<u>Transient Occupancy Tax (TOT)</u>

Revenue in this category is impacted by business and other leisure/non-leisure travel and has experienced significant reductions in FY 2020 and FY 2021 due to public health orders, travel restrictions, and diminishing business and personal travel plans resulting from the pandemic. TOT revenue declined by $20.5 million or 79.8%, when comparing the FY 2019 pre-pandemic actuals of $25.6 million to the pandemic FY 2021. As public health conditions improved and travel resumed, this revenue began to recover and significantly grew in FY 2022. Though this revenue remains below pre-pandemic actuals, strong growth was realized in the FY 2021 fourth quarter and in FY 2022. In FY 2022, actual receipts were $16.9 million, an increase of $11.8 million, or 227.2% higher. The opening of the two Marriott hotels in mid and late FY 2021 and the re-opening of multiple hotels in FY 2021 and FY 2022 were positive developments that help drive recovery for this tax revenue.

The FY 2023 Adopted Budget for TOT adopted is $18.2 million, a $1.3 million or 7.4% increase over FY 2022 actuals of $16.9 million. In FY 2024, this revenue is anticipated to increase to $25.0 million, a $6.8 million or 37.3% increase over the FY 2023 Adopted Budget. Year-to-date (as of August 2022), daily average room rates increased by 61.2% from $155.73 per day to $251.04 per day while occupancy rate increased by 24.4% from 60.2% to 75%. Revenue in this category is experiencing growth; however, is not anticipated to reach pre-pandemic levels until FY 2026.

TABLE 3: City of Palo Alto Transient Occupancy Tax Actuals and Forecast through FY 2033



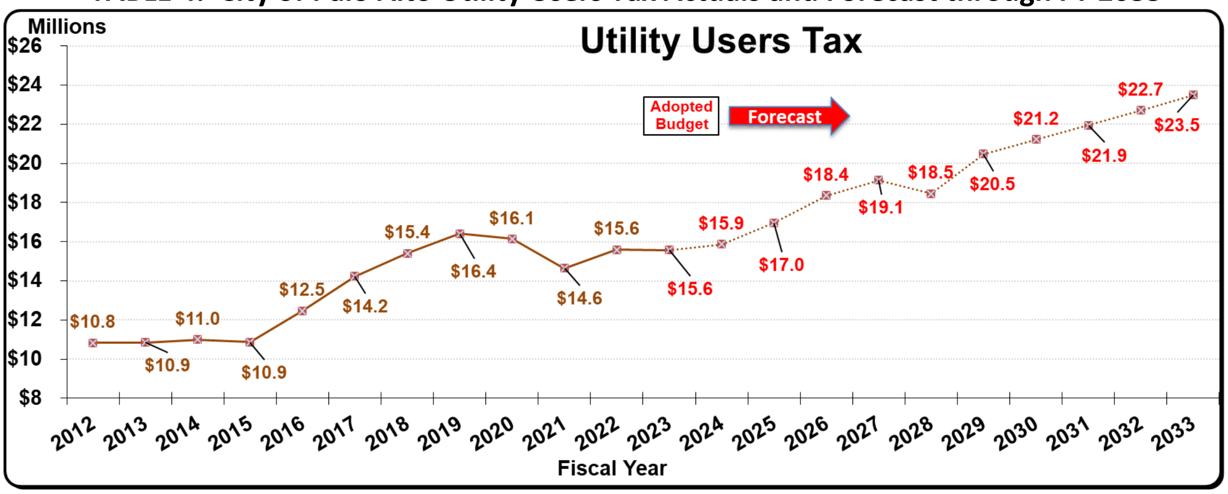
Note: January 2015, TOT Rate went from 12% to 14%

April 2019, TOT Rate went from 14% to 15.5%

Utility User's Tax (UUT)

The UUT is levied on electric, gas, and water consumption, as well as on telephone usage. Revenue in this category is impacted by consumption levels and has experienced reductions in prior periods due to water conservation programs and reduced workforces and business closures due to the pandemic. This revenue is expected to recover as the local economy recovers and workers partially return to the office. The FY 2023 Adopted Budget for UUT is $15.6 million, consistent with FY 2022 actuals. In FY 2024, this revenue is anticipated to increase to $15.9 million, a $0.3 million or 1.9% increase over the FY 2023 Adopted Budget. Revenue in this category is experiencing growth; however, is not anticipated to reach pre-pandemic levels until FY 2025.

TABLE 4: City of Palo Alto Utility Users Tax Actuals and Forecast through FY 2033

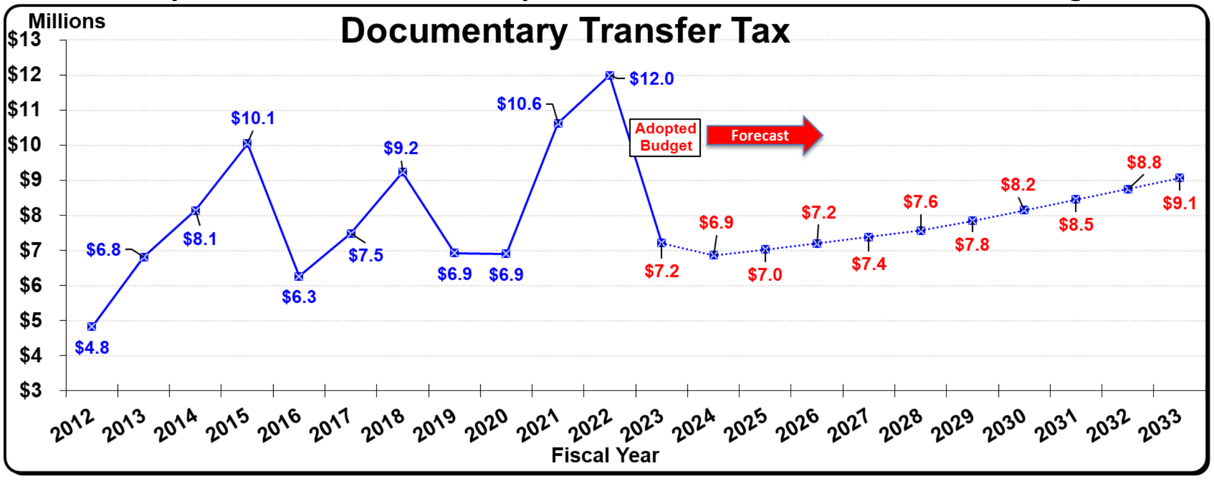


Documentary Transfer Tax (DTT)

Revenue in this category is highly volatile and dependent on sales volume and the mix of commercial and residential sales. DTT experienced record receipts in FY 2021 and FY 2022 at $10.6 million and $12 million, respectively. In both years, these milestones were a result of large commercial transactions, six in FY 2021 and nine in FY 2022, and robust residential sales. Revenue from July through October in FY 2022 is running 37.9% below the same period in FY 2021 which is expected, however, this is around 25% below the average normal year's receipt. The FY 2023 Adopted Budget for DTT is $7.2 million, $4.8 million or 39.8% lower than FY 2022 actuals of $12 million. In FY 2024, this revenue is anticipated to decrease to $6.9 million, a $0.3 million or 4.8% decrease from FY 2023 levels.

As in past years, this revenue source is challenging to forecast and can fluctuate month to month depending on real estate transactions. The number of transactions through September 2022 (136) are running lower than those through September 2021 (215) with the total value of these transactions decreasing by 37%. Though the Palo Alto housing market remains strong, as discussed in the Property Taxes section, single family residential median sales price in Palo Alto has slightly declined, which is an expected occurrence as the predicated economic downturn and higher mortgage rate will impact property sales activity in FY 2023.

TABLE 5: City of Palo Alto Documentary Transfer Tax Actuals and Forecast through FY 2033



Rental Income

Rental Income of $16.4 million in FY 2024 primarily reflects rent paid to the General Fund from the City's Enterprise Funds and the Cubberley Community Center. There is a slight increase in rental income of $0.8 million compared to the FY 2023 Adopted Budget. The increase can be attributed to a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period, and 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.

The City is no longer receiving rental income from the former Los Altos Treatment Plant (LATP) site. The site is no longer available for traditional rental as a laydown yard, although the contractors of the planned projects may need to use portions of the site for this use. The site is planned for two uses: 1) an interim housing project with Project Homekey to provide opportunities for homeless individuals and families, and 2) a joint water purification project with the Santa Clara Valley Water District. Please see the Expense Assumptions General Expenses section of this report for additional information regarding Project Homekey developments at the former LATP site. The water purification project is being funded in the Wastewater Treatment Fund, so it is not part of the General Fund LRFF; however, funding needs for the project will be discussed in the development of the FY 2024 budget for the Wastewater Treatment Fund.

Charges for Services and Permits and Licenses

Revenues in the 'Charges for Services' and the 'Permits and Licenses' categories are anticipated to be $33.4 million and $11.5 million, respectively, in FY 2024. Together, these amounts total $44.8 million and are approximately $4.8 million higher than the FY 2023 Adopted Budget of $40.0 million. Increases in this category are primarily due to revenue adjustments for the agreement with Stanford to provide Fire and Dispatch services, the elimination of the Economically Sensitive Department Revenue Reserve, and adjustments to development center revenues.

Revenues in these categories were impacted by changes in FY 2024, such as increasing golf revenue estimates in alignment with the last two fiscal years of operation. These budget categories also include revenues associated with two fee-based programs in the Fire Department: a first responder fee (assessed on commercial insurance companies), to cover the cost for initial response for first due engine; and an ambulance subscription fee (FireMed program), to secure co-pay free ambulance transport. These fees were implemented in 2022 with revenue expected to continue growing as advertising campaigns develop.

Additionally, revenues in these categories were impacted by a phase-out of the Economically Sensitive Department Revenue Reserve. This reserve was established to mitigate unexpected losses from services impacted by the COVID-19 pandemic, such as the suspension of parking enforcement, delays in opening the Junior Museum and Zoo, and limited operations at community centers, recreational facilities, and the Children's Theatre. In total, $2.5 million was set aside for this purpose in the prior year. This forecast assumes gradual overall improvements in the return of canceled or modified services by phasing out this reserve in its entirety in FY 2024.

The revenue estimates in these categories are based on current activity levels. These revenue sources are primarily driven by the cost of staff to provide services to the community. Therefore, as part of the FY 2024 Municipal Fee process, staff will evaluate and bring forward recommendations to align fees with target cost recovery levels, and general salary and benefits and CPI trends. 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 in this forecast. staff will analyze municipal fee revenue activity as part of the FY 2024 Budget development process and bring forward adjustments as appropriate.

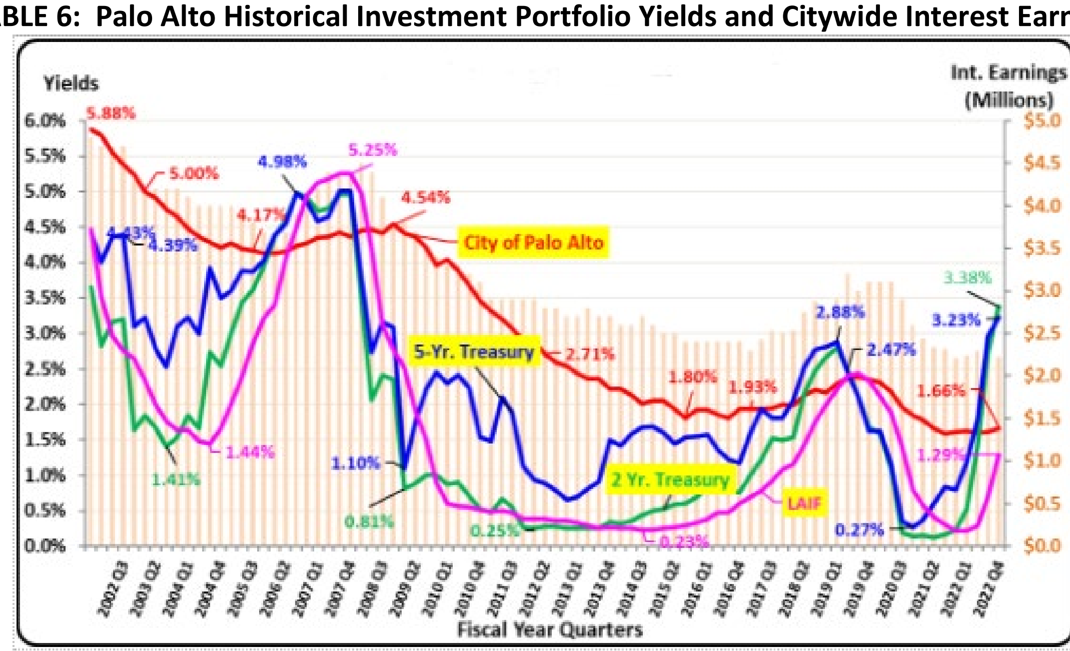
Charges for Service - Stanford Fire and Dispatch Services: The City and Stanford have two separate agreements for the provision of fire response and emergency dispatch services. The fire response services agreement became effective in July 2018 and outlines service level terms and a new cost allocation methodology as the baseline for agreement costs. The term extends through June 2023, with renewals through 2028 unless otherwise terminated. The agreement included a new staffing deployment model for suppression and medical services, which was approved by the City Council in October 2017 and deployed in January 2018. This forecast aligns with the new staffing model and, in accordance with the agreement, adjustments to revenue from Stanford have been aligned with the year-over-year changes to the operating expenses in the Fire Department for FY 2023. Similarly, changes to the revenue received for dispatching services have been aligned with the FY 2023 adjustments to the operating expenses in the Technical Services Division of the Police Department where the costs to provide these services are budgeted. For fire and police revenue, additional adjustments may be applicable if new labor agreements are negotiated. Revenues for these services are based on anticipated changes in salary and benefits costs within the Fire Department and Police Department Dispatch Unit.

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 2024 estimate for Charges to Other Funds of $14.5 million reflects a slight increase of 5.6% from the FY 2023 Adopted amount of $13.7 million; this is primarily attributed to fully adjusting the costs associated with the allocated charges in the Internal Support Departments to the adjustments made as part of the FY 2023 Budget as well as a technical adjustment to better align the cost plan methodology with the system calculations.

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. As of the timing of this LRFF, the Federal Open Market Committee (FOMC) has raised the federal funds rate six times totaling 3.75% and may increase this rate further to bring down the inflation rate between 2 to 3%. As a result, an increase in interest earnings is forecasted; earnings on new portfolio investments have increased from 0.5 to 2% to 4.5 to 6%.

The average portfolio rate of return for the first quarter of FY 2023 was 1.66%, and a 1.62% average yield as of the fourth quarter of FY 2022. The adopted budget General Fund FY 2023 interest earning is $1.1 million. Though this is below the FY 2022 actual of $1.3 million, the expectation is the actuals in FY 2023 will be higher. In FY 2024, the forecast reflects a relatively high interest rate environment with increased interest earnings through the ten-year period.

TABLE 6: Palo Alto Historical Investment Portfolio Yields and Citywide Interest Earnings



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. Overall, the Operating Transfers-in are estimated to be $23.6 million, a $1.1 million increase from the FY 2023 level of $22.5 million due to a $0.5 million increase from the Electric Fund and a $0.6 million increase from the Gas Fund.

In accordance with the methodology approved by the City Council in June 2009, the electric to general fund equity transfer has been calculated by applying a rate of return on the capital asset base of the Electric Fund. This rate of return is based on PG&E's rate of return on equity as approved by the California Public Utilities Commission (CPUC). This LRFF also assumed the passage of Measure L on the November 2022 ballot to seek voter approval of the City's gas to general fund equity transfer going forward. As outlined in the ballot measure language, Staff calculated the gas to general fund equity transfer as 18% of annual gross gas retail revenue.

This LRFF also considers the trial court's decision in Green v. City of Palo Alto (Santa Clara Superior Court Case No. 16CV300760), a class action lawsuit which challenged the City's gas and electric rates under Proposition 26, one of many such cases following a 2015 decision involving the City of Redding. In Green, the trial court judge found the City's electric rates valid, but held that the City's gas rates were taxes requiring voter approval under California's Proposition 26, because they were set at a level sufficient to fund an annual transfer to the City's general fund. On June 24, 2021, the trial court entered judgment partially against the City and ordered the City to pay $12.6 million to a common fund to refund gas ratepayers and for payment of incurred litigation costs.

The City and the plaintiffs appealed the trial court's judgment. Payment of refunds due to gas ratepayers under the trial court judgment are stayed pending a decision by the Court of Appeal (expected in 2023) on the parties' respective appeals. While the ultimate outcome of the claim is uncertain, the City set aside funding in the General Fund for the potential financial impacts. Specifically, the City recorded a claim payable of $17.5 million, which includes the trial court judgment covering claims for 2015-2019, plus an amount covering refunds for 3 additional years of plaintiff's claims that were tolled (paused) during active litigation. While the process for calculating the equity transfer from the Electric and Gas Funds has not changed, the City has placed the funds in a Litigation Reserve. This action continues the City's proactive actions to address known liabilities with the best information available at the time and sets these funds aside pending final resolution of this dispute.

ATTACHMENT D

General Fund Base Case Expense Assumptions

__Salary and Benefits__

The table above depicts the estimated General Fund salaries and benefits costs. Consistent with prior years, the FY 2024 salaries and benefits costs represent approximately 60% of the General Fund budget expenditures.

Salary and Benefits are projected to increase $11.3 million or 7.6% from the prior year, from $148.4 million to $159.7 million. Discussed in the following sections, this is primarily attributable to increases in salaries ($6.1 million or 7.7%) and pension costs ($4.1 million or 10.5%).

Salary

Consistent with the City's salary budget methodology for recent budgets, positions are budgeted at the actual rate of pay of employees including benefit selections as of Fall 2022. 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). It is important to note that as of this forecast, all bargaining groups are near the end of their agreement terms and the City is actively engaged in negotiations with the various labor groups. The forecast assumes step increases for employees in applicable positions, including SEIU, IAFF, and PAPOA, and merit increases for Management and Professional employees including UMPAPA. A general wage adjustment of 2.0% is included for all employees starting in either January 2023 or July 2023 for all years of the forecast since no MOA's would be in effect at that time. This is consistent with prior Council direction in previous long range financial forecasts to use the 2.0% increase as a forecasting assumption, not as a commitment to future negotiations. Additionally, this forecast includes a level of reserve to reach a target market placement for employee compensation in new labor agreements, as directed by the City Council. Staff expects to adjust these costs throughout the budget development process in accordance with final contract terms.

Benefits

Pension: Pensions are budgeted based on CalPERS determined rates as of the June 30, 2021 valuation (CMR 14628[1]) for the City's Miscellaneous and Safety plans. 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

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[1] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20220920/20220920pfcs.pdf

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.

In the miscellaneous plan, total costs are projected to increase from the current 42.9 percent in FY 2023 to the 44.8% in FY 2024. In the safety plan, total costs are projected to increase from the current 71.1% in FY 2023 to 74.0% in FY 2024. 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 FY 2023 forecast presumes that the miscellaneous plan will pick up 1 to 2% of the employer pension cost and that safety plan members will pick up 3 to 4%.

The FY 2024 budget was impacted by significant favorable investment returns of 21.3% (6.8% assumption) earned in the most recent June 30, 2021 valuation and changes to economic and demographic assumptions resulting from the CalPERS Asset Liability Management (ALM) process and Experience Study completed in November 2021. As part of the ALM, the CalPERS board approved a reduction to the discount rate (from 7.0 to 6.8%), revised actuarial assumptions (price inflation from 2.5 to 2.3%), and a new asset allocation targeting 1/3 investment in private assets, 5% leverage, and reduced public equity exposure.

Since the issuance of the current valuation, CalPERS announced a preliminary investment loss of 6.1% for the period ending June 30, 2022. These results will be included in the CalPERS valuation report issued in Fall 2023 to inform the development of the FY 2025 budget. The resulting liability of the investment loss will be amortized over 20 years with a 5-year ramp-up period. To inform this LRFF, staff used the CalPERS Pension Outlook Tool to calculate the estimated impacts, resulting in additional costs of $3.4 million ($2.6 million in the General Fund) in FY 2025, and increasing to $16.8 million ($12.9 million in the General Fund) at the peak of the 5-year ramp in FY 2029.

TABLE 1: CalPERS' Projected FY 2023-2033 Blended Retirement Rates

(percentage of payroll)

	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032	FY 2033
Miscellaneous	42.9	44.8	43.6	38.9	32.9	30.9	30.7	30.3	30.1	26.7	25.4
Safety	71.1	74.0	72.3	69.5	66.8	63.6	63.2	61.9	61.4	57.9	55.8

The City has taken several proactive steps to address rising pension costs and long-term liabilities, including cost-sharing in labor agreements, establishing an irrevocable Section 115 Pension Trust ("Pension Trust") (CMR 7553[2]), and adopting a Pension Funding Policy (CMR 11722[3]). As part of policy goals, the City seeks to reach a 90% funded status by FY 2036. This policy is subject to modification at City Council discretion and requires that staff report the status of the funding goal every three years. Consistent with the Pension Policy, staff continues to include the NC of pension at a more conservative discount rate than CalPERS in budget assumptions and transmits amounts above required payments ("supplemental contributions") to the Pension Trust. Beginning in FY 2023, the City Council approved to reduce the discount rate for supplemental contributions from the previously approved rate of 6.2% to 5.3% over two years; FY 2023 is a transitional year in which six months or the equivalent of approximately 5.8% is budgeted. Additional one-time contributions continue to be made each year if excess revenues or unspent savings are available, subject to City Council approval.

In accordance with Pension Policy reporting requirements, staff is engaged in a series of meetings with the Finance Committee in Fall 2022 to review the status of the City's pension and retiree healthcare plans, and Pension Policy. Staff expects as part of this review to memorialize any practices adjusted since the adoption of this policy, review progress towards policy goals, and recommend potential modifications to the Pension Policy or budgetary practices used to inform the financial planning of these benefits. This series of reports includes: 1) Review of the most current actuarial analysis as distributed by CalPERS (CMR 14628[4]), 2) Review of the current status of both the Pension and Other Post-Employment Benefits (OPEB)/retiree healthcare liabilities including the proactive contributions and discussion with plan providers (CMR 14829[5]), and 3) Review of actuarial analysis based on alternative assumptions as defined in the Pension Funding Policy and recommended revisions to the Pension Funding Policy for City Council consideration and adoption (tentatively scheduled December 6, 2022).

In this forecast, approximately $12.2 million ($7.2 million in the General Fund) in supplemental contributions is assumed in FY 2024. This reflects a $4.0 million ($2.7 million in the General Fund) increase over the prior year, primarily due to the transition to a lower discount rate. Through FY 2023, a total of $49.4 million (31.8 million in the General Fund) in principal contributions are expected to be made to the Pension Trust.

In the General Fund, it is anticipated the City will spend a total of $43.1 million on total pension costs in FY 2024, including both CalPERS contributions and supplemental Pension Trust Fund contributions. This is approximately $4.1 million higher than the prior year costs of $39.0 million, or a 10.5% increase. These expenses represent approximately 17% of the General Fund's total expenses.

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[2] http://cityofpaloalto.org/civicax/filebank/documents/55487

[3] http://cityofpaloalto.org/civicax/filebank/documents/79256

[4] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20220920/20220920pfcs.pdf

[5] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20221018/20221018pfcs.pdf

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).

Retiree Healthcare/Other Post-Employment Benefits (OPEB): Retiree Medical is based on the June 30, 2021 actuarial study prepared by Bartel Associates, which is completed every two years. The most recent study was completed in June 2022 to inform the development of the FY 2023 and FY 2024 operating budgets (CMR 14112 as amended by CMR 14502[6]). Consistent with City Council direction, this forecast continues the practice to budget for the full payment of the Actuarial Determined Contribution (ADC) for retiree healthcare, using a more conservative discount rate to transmit amounts above the recommended payment as an additional discretionary payment ("prefunding") to the California Employers' Retiree Benefit Trust (CERBT) Fund.

The results of the recent valuation benefited from significant favorable investment returns of 27.5% (6.25% assumption) and lower than anticipated healthcare premiums. The City Council further adjusted funding to continue alignment with the proactive pension funding assumptions as well as known variable such as June 30, 2022 market returns. Budgetary assumptions in LRFF include a zero percent return in 2021-22 (one-time), a 5.75% discount rate (6.25% assumption), and shortened amortization (from 22 to 15 years). Through FY 2023, it is expected that $8.0 million in supplemental principal contributions will be made to the CERBT Trust.

CalPERS blends active employees with pre-Medicare retirees and charges the same medical premium, even though younger employees on average consume less healthcare. The higher premium to younger employees thereby subsidizes older employees and retirees who, on average, have higher claims and premiums. The FY 2024 Budget estimates $16.4 million ($10.5 million in the General Fund) for ADC, an approximate $0.5 million or 2.9% increase from FY 2023 levels of $15.9 million ($9.9 million in the General Fund). The implied subsidy is $3.1 million in FY 2024 and effectively lowers the funding necessary to meet the ADC.

TABLE 2: Retiree Medical General Fund Contributions

FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032	FY 2033
$10.2	$10.5	$10.9	$11.2	$11.5	$11.9	$12.3	$12.7	$13.1	$13.5

Workers' Compensation: The budget appropriation for workers' compensation includes an estimate for claims incurred and reserves for current filings at an 85% confidence level, based on actuarial studies completed by Bickmore. In FY 2022, claims expenditures decreased slightly by $39,000 or 0.6% from $6.07 million to $6.04 million from the prior year. Actuarial estimates

[6] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20220607/20220607pfcsm-final.pdf

completed in August 2021 informed FY 2023 budget levels of $6.5 million (approximately 65% in the General Fund). More recent actuary estimates completed in August 2022 project higher than expected levels for FY 2023 at $6.9 million. Staff will continue to monitor expenditures in the fund and bring forward adjustments as necessary. Estimates for FY 2024 are $7.3 million, representing a $0.8 million or 12.9% increase over the Adopted FY 2023 Budget. Estimates for workers' compensation increase in the forecast at rates consistent with general CPI increases.

Contract Services

This forecast assumes contract services of $23.9 million in FY 2024, a 1.1% decrease from the FY 2023 Adopted budget of $24.2 million. This decrease is driven primarily by the removal of one-time costs adopted in FY 2023 including funding to address continued COVID-19 recovery efforts across the City. These decreases are partially offset by service contract increases as well as a 5.0% CPI cost increase in FY 2024 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. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust contract funding needs as part of the FY 2024 budget process.

Contract Services - Committed Additions

The Committed Additions included in this forecast account for anticipated operating and maintenance (O&M) costs in the General Fund for capital projects anticipated to come online within the ten-year forecast period. A preliminary total estimate of $0.3 million for costs associated with the following projects anticipated to come online in FY 2024: Boulware Park Improvements (PE-17500), Dog Park Installation (PG-18001), Library Automated Materials Handling (LB-21000), Park Restroom Installation (PG-19000), Public Safety Building (PE-15001), and Rinconada Park Improvements (PE-08001). The Public Safety Building is anticipated to be complete in Fall 2023, so the full O&M cost for the facility is anticipated to be realized in FY 2025. Additional cost increases are included throughout the ten-year forecast 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. Timing and analysis of the funding needs for these projects will be evaluated as part of the FY 2024 Budget process. Also, estimated operating impacts from the Fire Station 4 (PE-18004) project are included starting in FY 2026.

TABLE 3: FY 2024 – FY 2033 Committed Additions (Millions)

FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032	FY 2033
$0.3	$0.6	$0.6	$0.6	$0.7	$0.7	$0.7	$0.7	$0.8	$0.8

Supplies and Materials
The FY 2023 Adopted Budget for the General Fund included \$3.2 million for Supplies and Materials, which is anticipated to increase by a 5.0% CPI cost increase in FY 2024 to \$3.3 million 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. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for supplies and materials as part of the FY 2024 budget process.

General Expense
This category includes costs for travel and meetings, telephone and non-city utilities, contingency accounts and reserves, bank card service charges, and subsidies and grants provided through the Human Services Resource Allocation Program (HSRAP). The FY 2023 Adopted Budget of \$21.8 million is expected to decrease to \$8.6 million in FY 2024, primarily due to phasing out the Utility Ligation reserve and elimination of the one-time Budget Uncertainty Reserve. Please see the Revenue Assumptions Operating Transfers-In section of this report for further information about the Utility Transfer Litigation reserve. The reduction is partially offset by a CPI cost increase 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. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for general expense items as part of the FY 2024 budget process.

General Expense – Project Homekey: On September 27, 2021 the City Council directed staff to apply for Project Homekey funding in conjunction with LifeMoves to build an emergency shelter at the former Los Altos Treatment Plant (LATP) site (CMR 13595[7]). This project will rapidly deploy modular housing to provide interim housing opportunities for homeless individuals and families in the City of Palo Alto. Project Homekey is a program, funded by the State of California Department of Housing and Community Development, intended to provide grant funding and facilitate a partnership with the State to quickly acquire, rehabilitate, or master lease a variety of housing types. Once developed, these projects provide interim or permanent housing options for persons experiencing homelessness and who are also at risk of health concerns. The site would be operated for at least fifteen years as interim housing per the program's durational requirement. This project would utilize a combination of funding sources including the Project Homekey Program for capital expenses and donations, grant funds, and City support for ongoing operations expenses. This LRFF includes the City's committed investment of \$7.0 million in operating expenses (\$1.0 million annually FY 2023 through FY 2029), with actual timing of the funding still to be determined. Some operating funding support is expected from Project Homekey as well as the County of Santa Clara. Any remaining gaps in funding will need to be closed by fundraising, operating cost containment strategies, and/or grant funds.

General Expense - Cubberley Lease: In FY 2015, the City and Palo Alto Unified School District (PAUSD) agreed to a five–year extension of the Cubberley lease from January 2015 to December

[7] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2021/09-september/20210927/210927accsm-amended-final.pdf

2019. In October 2019, the City Council directed staff to negotiate with PAUSD to extend the lease agreement an additional five years, through December 2024 (CMR 10730[8]). A new Cubberley lease was approved by the City Council in June 2020 (CMR 11460[9]) for a smaller portion of the Cubberley site with a correspondingly lower base rent payment (CMR 11386[10]). As part of the original lease agreement, the City Council approved creation of the Cubberley Infrastructure Improvements Fund. The new lease continues the $1.9 million transfer to the Cubberley Property Infrastructure Fund, which is classified as an Operating Transfer-Out and discussed in further detail in that section of this report below. With the Cubberley Infrastructure funds set aside, the annual base rent for the Cubberley premises is $2.7 million. Other pending factors at the Cubberley site that are part of ongoing discussions, but not included in the LRFF estimates are returning the S Building to PAUSD and the Community Services Department is still interested in negotiating with PAUSD to expand the Cubberley premises by renting additional space from the M Building. Separately, the City leases extended child daycare sites from PAUSD on a one-year lease from July 2022 to June 2023. The combined annual rent for the child daycare sites plus utilities amounts to $0.8 million.

Rents and Leases
The Rents and Leases expense category for FY 2024 is estimated to increase from the FY 2023 Adopted Budget level by approximately 2.7% to $1.4 million, This is based on current lease terms that include previously negotiated lease increases or CPI cost increases 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. This current estimate will be updated when the December-to-December CPI information is available. This category includes the lease agreement for Development Services staff at locations outside City Hall (285 Hamilton and 526 Bryant) as well as lease with Stanford for El Camino Park. A new lease agreement was executed in December 2020 for the Development Services office location at 526 Bryant Street, limiting the space to the basement level (CMR 11426[11]). The lease was amended in September 2022 to extend the term initially for 12 months with the right to automatically extend for four successive 12-month periods, potentially through January 31, 2028 (CMR 14713). In June 2021, the City entered into a seventh amendment for the Development Services office lease at 285 Hamilton Avenue to extend the term from February 2022 to January 2025 (CMR 12334[12]). As expenses for rent for Development Services are adjusted, a corresponding revenue adjustment will be made to ensure Development Services maintains cost recovery levels.

Facilities and Equipment
The Facilities and Equipment expense category is expected to decrease from the FY 2023 Adopted level of $480,000 to $450,000 due to the elimination of funding for one-time equipment

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[8] https://www.cityofpaloalto.org/civicax/filebank/documents/73558
[9] http://cityofpaloalto.org/civicax/filebank/documents/77365
[10] http://cityofpaloalto.org/civicax/filebank/documents/77073
[11] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2020-2/id-11426.pdf?t=59979.32
[12] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/2021/id-12334.pdf

purchases in FY 2023 such as electric leaf blowers and medical gurneys. Along with funding for various equipment across departments, this budget category includes subscription payments for equipment like public safety radios. The reduction is partially offset by a CPI cost increase 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. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for equipment needs as part of the FY 2024 budget process.

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 2023 Adopted Budget for the General Fund included $22.7 million for these expenses, including utilities usage, general liability insurance, technology costs, vehicle equipment maintenance and replacement costs, and other charges for services provided by other City departments and funds. The FY 2024 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 2024 is anticipated to experience an increase of 8.9% to a total of $24.7 million. This increase is primarily due to anticipated higher costs associated with technology services and utilities for City facilities such as water, electricity, and gas.

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. The FY 2023 Adopted Budget included Operating Transfers Out of $5.0 million. In FY 2024, Operating Transfers Out are anticipated to decrease to $4.6 million due to the elimination of funding for a one-time loan of $0.4 million to the residential parking permit fund in FY 2023. At this time no loans to the parking permit funds are anticipated as part of the LRFF; however, staff will be evaluating these funds as part of the FY 2024 budget development and will bring forward recommendations for additional loans if needed to keep the parking permit funds solvent.

Transfer to Infrastructure

Recovery from the COVID-19 pandemic were reflected in improved revenue levels in the FY 2023 budget compared to the FY 2022 budget. The total General Fund transfer to the Capital Improvement Fund budgeted in FY 2023 is $17.5 million compared to the $11.9 million transferred in FY 2022. This is comprised of a $7.8 million base transfer including interest earnings, and $9.7 million from TOT revenue generated through voter-approved rate increases and new hotels that is dedicated to the Capital Improvement Fund to support the 2014 Council Infrastructure Plan, consistent with City Council direction. As the local economy continues to recover from the COVID-19 pandemic, estimated transfers from TOT revenues in FY 2024 are currently projected to increase to $10.5 million and the base transfer to increase to $10.8 million for a total $21.3 million transfer to the Capital Improvement Fund. This forecast continues the goal established as part of the 2022-2026 Capital Improvement Plan (CIP) to restore the base portion of this transfer to pre-pandemic levels by FY 2026. This budget category also includes the separate $1.9 million transfer to the Cubberley Property Infrastructure Fund. This transfer to the Cubberley Property Infrastructure Fund supports general operating and maintenance needs a the Cubberley Community Center facility as well as capital improvement projects to maintain and upkeep the facility.

FY 2024 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 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 such as planning for recession needs, restoration needs, and strategic investments.

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 or realignment with current needs.

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; however, ensuring when resource augmentations are added, it is in alignment with one-time and ongoing forecasted sources.

9) Continue to prioritize proactively funding long term liabilities including but not limited to debt obligations, pension obligations, and capital infrastructure in accordance with City policies as approved by Council.

Attachment C

Preliminary FY 2024 Utility Rate Forecast

UTILITIES DEPARTMENT

Each year the Utilities Department develops a Financial Plan for the electric, gas, water, and wastewater utilities. Analogous to the Long-Range Financial Plan for the General Fund, these plans guide utility budget development and rate setting. Normally preliminary rate projections are discussed by the Utilities Advisory Commission (UAC) and Finance Committee, followed by formal Financial Plan recommendations from staff prior to the budget process. This year no preliminary projections were made due to the sudden retirement of a key staff member. Formal Financial Plan recommendations will be made in March and April.

Preliminary ranges for July 1, 2023 rate changes are shown below. Costs in all utilities have been increasing, primarily due to the replacement of aging infrastructure and rapid construction cost inflation, which are challenges utilities and public agencies across the country are confronting. At the time of this preliminary development, the state of California has seen unprecedented rainfall and flooding. Staff are reviewing the impacts of this storm on rate forecasts and will ensure this is factored into the recommended rate changes for FY 2024. These recommendations are scheduled to be reviewed in April 2023 by the Finance Committee.

Electric Utility

Tentative July 1, 2023 Rate Change:

- Change from current total FY 2023 rates (incld. hydro rate adjuster): -1% to +1% increase
- Base rate: 12% to 14% increase

At present, staff anticipates little or no change in total Electric rates in FY 2024; this is due to the decrease/elimination of in the hydroelectric rate adjuster, offset by a 12% to 14% increase in the base electric rate.

Electric supply purchase costs have risen substantially over the past three years from a combination of higher market energy prices, greater transmission costs, and lower energy generation from the electric utility's hydro resources. Revenues have also declined from lower loads during the COVID-19 pandemic. By the end of FY 2022 these factors had reduced operating reserve balances below minimum. A hydroelectric rate adjuster was activated in April 2022 due to decreased hydroelectric output and increased in December 2022 due to high electric market prices. This adjuster is expected to decrease in July 2023, but base rates are expected to increase due to long-term increases in electric supply costs and capital investment related to aging infrastructure and grid modernization. The net effect would be little or no change in customer bills in FY 2024.

Staff is incorporating a lower long-term forecast for hydroelectric output to stabilize rates during future droughts, minimizing the types of increases seen in 2022. Staff expects 3% to 8% base rate increases for FY 2025 to FY 2028, offset by continuing decreases in the hydroelectric rate adjuster, meaning little or no change to customer bills over the forecast period. In the longer term, load increases are expected to roughly balance increases in utility costs associated with electrification, leading to only modest increases in rates.

Gas Utility

Tentative July 1, 2023 Rate Change:

- Change from current total FY 2023 rates (incld. current commodity prices): -14% to 12%

decrease
- Distribution Rate: 7% to 9% increase

Currently, Gas rates are expected to decrease for the average customer in FY 2024. Natural gas prices are at unprecedented levels in California and other Western states; the gas utility reserves were severely depleted by an extreme spike in natural gas market prices in FY 2023, which exceeded what could be passed through to customers. Gas market prices are expected to remain elevated through the forecast period, though below FY 2023 levels. The decrease in gas commodity costs from FY 2023 to projected FY 2024 is expected to produce a net decrease in customer bills next year. The decrease in commodity costs will be partially offset by an estimated 7% to 9% increase related to rising gas utility operational and capital costs, and the need to begin to replenish reserves. Capital investment rates and how quickly to refill reserves are major variables being reviewed to finalize rate plans.

Rate increases in the 5% to 9% range are expected over the next three years, while in the longer term increases of no less than 5% are expected as the City electrifies. The City is considering strategies to protect those who are unable to take advantage of electrification from excessive gas bills as the transition proceeds.

Water Utility

Tentative July 1, 2023 Rate Change:
- 7% - 14% increase

At this time, Water rates are anticipated to increase 7-14% in FY 2024 as water supply costs remain the greatest source of uncertainty, and staff will adjust the City's water supply pass- through rate adjuster in July 2023 based on the final water supply rate from the City's water supplier. Palo Alto residents and businesses have responded to calls for water conservation during the ongoing drought. Recovery is projected to be slow and as in prior droughts, some conservation is projected to be permanent. Water supply costs continue to increase due to continuing investment in rehabilitating and seismically strengthening the Hetch Hetchy system. These factors are leading to the need for rate increases over the next several years. Staff will use the water utility's healthy reserve levels to spread increases over multiple years. Rate increases are expected to be around 3-4% annually long-term after FY 2024.

Wastewater Utility

Tentative July 1, 2023 Rate Change:
- 5% - 9% increase

Based on current information, Wastewater rates are anticipated to increase 5-9% in FY 2024 to pay for infrastructure replacement, including replacing and maintaining sewer lines, and replacing aging equipment at the City's Regional Water Quality Control Plant. Staff is evaluating a few rate projection scenarios, including accelerating the sewer mains replacement rate from 1 mile per year to 2.5 miles per year beginning in FY 2026 to allow the wastewater utility to replace aging mains before the end of their life expectancy. This scenario expects 8-9% rate increases over the next four years, and 3-5% in the outer years. The other scenario delays the accelerated sewer main replacement plan to begin in FY 2028 or later to mitigate the impact of rate increases on customers.

Attachment C

Preliminary FY 2024 Utility Rate Forecast

PUBLIC WORKS DEPARTMENT

Each year the Public Works Department evaluates and analyzes the enterprise funds that provide utility services as part of the budget development and rate setting process. Applicable projections and formal recommendations are presented to UAC and Finance Committee in alignment with the process the Utilities Department follows. Preliminary rate changes for July 1, 2023 are shown below.

Stormwater Management Fee

Tentative July 1, 2023 Rate Change:

- 4.9% increase

At this time, the Storm Water Management Fee is expected to increase 4.9% in FY 2024 to keep fund revenues consistent with general cost increases and to provide sufficient funds for planned storm water management capital and operating expenditures. Implementing a 4.9% increase based on the applicable Consumer Price Index is lower than the 6% maximum adjustment specified in the voter approved ballot measure.

Refuse Services

Tentative July 1, 2023 Rate Change:

- 3% increase

Refuse rates are anticipated to increase 3% in FY 2024 to provide sufficient funds for increasing operating expenses and to maintain the long-term health of our Rate Stabilization Reserve. The Refuse Fund has not adjusted commercial rates since FY 2017 and residential rates since FY 2018. The anticipated 3% increase across all sectors in FY 2024 will help to mitigate future potential rate adjustment spikes when the municipal solid waste collection and processing service agreements term out in FY 2026. Staff anticipates higher operating costs when a new agreement is to be implemented in FY 2027.

From: slevy@ccsce.com
To: Council, City
Cc: Nose, Kiely; Guagliardo, Steven
Subject: LRFF item before council
Date: Tuesday, January 31, 2023 4:35:35 PM
Attachments: AnnualReport2022-2023.pdf

CAUTION: This email originated from outside of the organization. Be cautious of opening attachments and clicking on links.

Dear Mayor Kou and council members,

I discuss 3 topics:

1) The connection between the City's Economic Development Strategy and the budget, particularly long-term revenue trends.This is my focus in this email.

2) The short and long-term economic outlook and

3) The LRFF

and I include the latest Assessor report on assessed value increases. I call your attention to pages 9,11,13,18,20 and 40.

Short and Long Term Economic Outlook

I will write a follow up email later this week after seeing what the Fed does on Wednesday and the U.S. jobs report on Friday.

The short-term outlook should be clearer by May but probably not before then. The impact of recent layoffs on job totals will show up in

February, March. April and May EDD reports. Year over year inflation trends will decline as the 2022 comparable months were very high BUT the

real focus should be on the near term monthly gains--will they remain low as in the past 6 months.

We will have a new UCLA forecast in March.

The LRFF

As usual the staff did a comprehensive and transparent job with the forecast illustrating the assumptions but also the long list

of what is not included.

I think we will know more about both short and long term trends in May and there is no need to guess about these trends now.

The Connection Between the Economic Development Strategy and Our Budget, particularly Revenue Trends

I have met with and emailed with staff and our Streetscene consultant.

Here are some of the points I raised.

1) Both for the ED strategy and for revenue forecasts, it is important to understand the drivers of key revenues including sales tax, TOT and property tax.

Staff reports clearly show the trends and top line numbers illustrating their importance to overall revenues.

But that is different from understanding the principal drivers of these revenues and how they can impact ED strategy choices.

My memory is that during the last Comp Plan, Hillary had a fiscal consultant report showing the main drivers (businesses, residents, Stanford and related visitors) of sales and TOT.

2) We have a lot of (at least DTN where I live, work and walk every day) vacant spaces mostly retail and office.

I believe that the choices made regarding these spaces will have long-term impacts on the budget so they are connected.

I hope council with advice from staff and the consultant and in collaboration with property owners can develop policies that will fill these spaces, particularly those that have been vacant a long time.

Even if the spaces are not filled with sales tax producers, they will be filled with potential customers for existing businesses.

I think there will be continuing no longer needed office space with WFH even if the economy continues to grow. What are the feasible repurposing strategies for these spaces.

The stated goal of the ED effort in the Nov council presentation is

"Develop a market-informed economic development strategy that will ensure Palo Alto's post-COVID competitiveness by identifying impactful public sector interventions, policies and investments for which there is both need and consensus for action."

As an economist I focus on the phrases "market-informed", "competitiveness" and "need".

While council can provide incentives and disincentives, ultimately property owners and businesses will decide what are their feasible and best options.

3) The ED strategy diagnostic and policy recommendation work will inform council and residents on ED choices that will impact revenue growth.

Some of these are

a) what are feasible options for increasing the customers bases and attractiveness (related issues) for DTN and Cal Ave?

b) How does open/closed for these streets impact question a?

c) How does parking availability and how close influence these choices?

I asked the staff and consultants when they thought the perspectives of restaurants/cafes/bar businesses were aligned with or differ with those of retail, service businesses and property owners on these questions.

I look forward to the next set of information provided by staff and Streetscene on ED issues and to future council and, hopefully, Finance Committee integration of our ED strategy choices into long-term revenue forecasts and related city options.

I have lived and worked in Palo Alto for 50+ years.

Stephen Levy

COUNCIL MEETING
2/6/2023
☑ Received Before Meeting
8

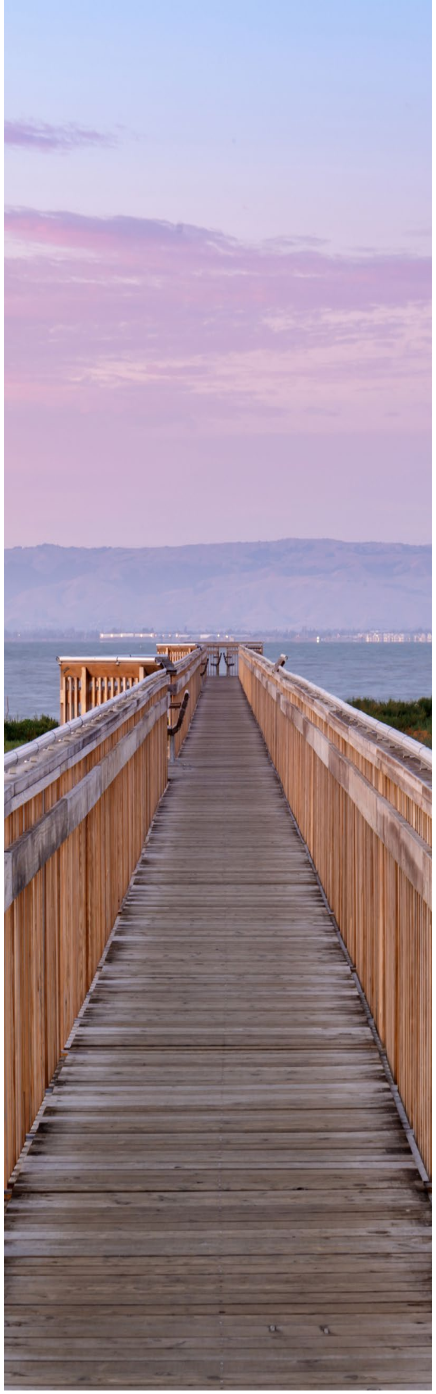
CITY OF
PALO ALTO

FY 2024 – FY 2033 LONG RANGE FINANCIAL FORECAST

City Council Item #8

February 6, 2023

www.cityofpaloalto.org



OVERVIEW

- Stagnant economic growth assumed for major tax revenues

- 2022 voter approved measures K & L (new business tax and natural gas transfer respectively
  - Measure L: IS assumed in the Base Case
  - Measure K: IS NOT assumed in Base Case, alt scenario provided

- Expense projections based on current approved service levels
  - FY 2023 Adopted 2-year service reinvestment funded ongoing
  - Costs for recent labor contracts included in revised forecast

- December 6th Finance Committee Highlights
  - Economic Development
  - Major Projects/Council Priorities
  - Labor Costing and Staffing Analysis

FISCAL YEAR 2024 - 2028 REVISED FORECAST

CITY OF PALO ALTO

- Mild 18-month stagnant growth beginning in FY 2023
- Voter Approval of Measure L (natural gas transfer)
  - Includes revenue and continuation of 2-year service restorations in FY 2023 Adopted
- Revised forecast reflects current estimates including recent labor contracts

	Actual 2022	Adopted 2023	Projected 2023	2024	2025	2026	2027	2028
Total Revenue	**$238,735**	**$237,751**	**$238 - 244M**	**$251,177**	**$261,671**	**$272,065**	**$282,203**	**$290,671**
BSR Contribution (One-Time)	-	**$9,670**	**$9,670**	-	-	-	-	-
Total Source of Funds	**$238,735**	**$247,421**	**$247 - 253M**	**$251,177**	**$261,671**	**$272,065**	**$282,203**	**$290,671**
Year over Year increase (revenue only)				*5.6%*	*4.2%*	*4.0%*	*3.7%*	*3.0%*
Total Expenditures	**$197,963**	**$247,421**	**$248,721**	**$251,715**	**$267,500**	**$277,159**	**$283,240**	**$290,359**
Total Use of Funds	**$197,963**	**$247,421**	**$248,721**	**$251,715**	**$267,500**	**$277,159**	**$283,240**	**$290,359**
Year over Year increase				*1.7%*	*6.3%*	*3.6%*	*2.2%*	*2.5%*
Net One-Time Surplus/(Gap)	**$40,772**	**($0)**	**$0 - 4.7M**	**($537)**	**($5,829)**	**($5,094)**	**($1,037)**	**$312**
Cumulative Net Operating Margin (One-Time)					**$0**	**$0**	**$0**	**$625**
Net Operating Margin				**($537)**	**($5,292)**	**$736**	**$4,057**	**$1,349**

FISCAL YEAR 2023 BUDGET STABILIZATION RESERVE STATUS

Year-End BSR Summary (in millions)	
General Fund BSR Balance, June 30, 2022	**$72,835**
FY 2023 Approved Adjustments	
FY 2023 Adopted Budget & FY 2023 Service Reinvestments (yr2)	($12,872)
Council Approved Items (Downtown Streets Team, Reappropriations)	($267)
Subtotal: BSR Balance, After Approved Adjustments	**$59,696**
FY 2023 Additional Adjustments (FY 2023 Mid-Year)	($14,000)
$5M to Economic Uncertainty Reserve (plan for forecasted deficits)	
$5M to Pension Trust Fund (per Council Policy)	
$4M to Infrastructure Reserve (IR) (per Council Policy)	
Projected FY 2022 BSR Level, (June 30, 2023)	**$45,796**

FY 2022 General Fund ended with a surplus, as expected in FY 2023 Adopted Budget
- $59.8 M, a surplus of $14.2M compared to the Council 18.5 percent target ($45.6M)

ASSUMPTIONS NOT INCLUDED IN FORECAST

- Service reinvestment to pre-pandemic levels
- Capital Infrastructure: Parks Master Plan, Animal Shelter Rebuild, Railroad Grade Separation, Fire Training Center
- Voter approved Measure K (new business tax) revenue or investments in three priority areas
- Labor contract terms beginning in FY 2026
- Cubberley Community Center Concept Plan and Gym Repair
- Operating changes: non-profit agreements, fee studies, code/ordinance changes, legislative updates, ADA compliance
- Resources for Council Priority Items: Sustainability and Climate Action Plan (S/CAP), Project Homekey, Advancing Racial Equity, Permanent Parklet Program

PRELIMINARY FY 2024 UTILITY RATE FORECAST

- Utilities Advisory Commission (UAC) to review rates, followed by Finance Committee (March – May), and City Council (June)
- FY 2024 rates will be effective July 1, 2023
- Staff actively evaluating recent storm impacts on rate projections (incld. Hydro Rate Adjuster)

UTILITY	FY 2024	FY 2025-FY 2028
Electric	-1% to 1%	3% to 8% annually
Gas	-14% to 12%	5% to 9% annually
Refuse	3%	0% to 3%
Stormwater	4.9%	Based on annual CPI
Water	7% to 14%	3% to 4% annually
Wastewater	5% to 9%	8% to 9% annually

BUDGET DEVELOPMENT GUIDELINES

- Guide development and recommended adjustments for annual budget processes
- Provide flexibility to address changing economic situations
- Ensure consistent methodologies to maintain balanced fiscal strategies year over year
- Align with Council Values as recommended by Policy & Services Committee

FY 2024 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 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 such as planning for recession needs, restoration needs, and strategic investments.
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 or realignment with current needs.
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; however, ensuring when resource augmentations are added, it is in alignment with one-time and ongoing forecasted sources.
9) Continue to prioritize proactively funding long term liabilities including but not limited to debt obligations, pension obligations, and capital infrastructure in accordance with City policies as approved by Council.

CONCLUSION

- Revenue trends indicate continued recovery from the pandemic
  - Signs of headwinds present opportunity for a recession
  - Strong financial discipline aids in managing the uncertain outlook
  - Alternative scenarios help plan for variability in assumptions
  - Measure L enables continued services from FY 2023
  - To manage the near- and long-term fiscal sustainability and new investments Measure K and one-time surpluses are needed
  - FY 2023 Mid-Year Budget:
  - Focus on balancing the economic risks with service needs; maintain stability in services over the next few years
  - Invest in priority areas as identified by Council and/or meet service needs

NEXT STEPS

CITY OF PALO ALTO

January City Council

- FY 2024-33 Long Range Financial Forecast (LRFF)
- FY 2022 Annual Comprehensive Financial Report (ACFR)

March - April
UAC & Finance Committee

- Utility Financial Plans and FY 2024 Rate Recommendation (Gas, Electric, Water, Wastewater, Refuse, Storm Drain, Fiber)

June

- FY 2023 3rd Quarter Fiscal Analysis Report
- Adopt FY 2024 Operating & Capital Budgets, utility rates, and municipal fees

January · February · March · April · May · June

February City Council

- FY 2023 Mid-Year Budget Review and 2nd Quarter Fiscal Analysis Report

May

- FY 2024 Proposed Operating and Capital Budgets Published
- FY 2024 Proposed Budget Review, including Utility Rates, Municipal Fees, and Five-Year Capital Improvement Plan

Staff Work: *Development and production of FY 2024 Proposed Budgets*

RECOMMENDED ACTION

Staff recommends that the City Council:

1. Direct staff to use this revised Base Case forecast as the starting point for the FY 2024 budget process.

2. Approve the Revised Fiscal Year 2024 – 2033 Long Range Financial Forecast and the FY 2024 Budget Development Guidelines (Attachment B).

CITY OF

PALO ALTO

COUNCIL MEETING
2/13/2023
☑ Received Before Meeting
AA2 & 8

CITY OF PALO ALTO

CITY COUNCIL REVIEW

FY 2024 – 2033 LONG RANGE FINANCIAL FORECAST & FY 2023 MID-YEAR BUDGET REVIEW

City Council, Items # AA2 and # 8

FEBRUARY 13, 2023

www.cityofpaloalto.org/budget

FY 2024–2033 LRFF & FY 2023 MID-YEAR COMPARISON

CITY OF PALO ALTO

	FY 2022 Actual	2023 Adopted	2023 Projected	2024	2025	2026	2027	2028
LRFF Net One-Time Surplus/(Gap)	$40.8M	($9.7M)	($10.0M)	($0.5M)	($5.8M)	($5.1M)	($1.0M)	$0.3M
2023 Mid Year Net One-Time Surplus/(Gap)	**$40.8M**	**($9.7M)**	**($21.7M)**	**($3.3M)**	**($8.3M)**	**($6.1M)**	**($2.0M)**	**($0.7M)**

Use of Budget Stabilization Reserve	-	$9.7M	$21.7M
Estimated BSR Balance	$72.8M	$63.8M	$51.8M
BSR Percentage of Budget	29.4%	25.8%	21.9%

Changes in assumptions from 2024-2033 LRFF to FY 2023 Mid-Year:

- Measure K (business tax); $9.6M revenue phased-in by FY26 for three priority areas
- FY 2023 Midyear General Fund Actions; $11.7M net costs ($2.6M ongoing)
- Annual BSR draw to cover one-time gaps

FY 2023 Mid-Year still does NOT include:

- Unfunded “Known Unknown” items; full list on packet pages 450 to 456
- Use of $14M Uncertainty to mitigate annual BSR draw
- Additional service augmentations proposed by departments for FY 2024 and beyond

FISCAL YEAR 2023 BUDGET STABILIZATION RESERVE STATUS

Year-End BSR Summary (in millions)	
General Fund BSR Balance, June 30, 2022	**$72,835**
FY 2023 Approved Adjustments	
FY 2023 Adopted Budget	($9,072)
Council Approved Items (Downtown Streets Team, Reappropriations)	($267)
Subtotal: BSR Balance, After Approved Adjustments	**$63,496**
FY 2023 Mid-Year Adjustments	**($11,686)**
+$8.6M Reserve/Program Savings	
+$6M Increased Major Tax Revenue Estimates	
$14M to Economic Uncertainty Reserve (plan for forecasted deficits)	
$5M to Pension Trust Fund (per Council Policy)	
$4M to Infrastructure Reserve (IR) (per Council Policy)	
$2.2M to Other Technical Adjustments	
$1.1M to Service Reinvestments	
Projected FY 2023 BSR Balance, June 30, 2023	**$51,810**

FY 2022 General Fund ended with surplus, as outlined in the FY 2023 Adopted Budget

- Council 18.5% target is $45.6M
- FY 2023 currently projecting a $6.2M surplus with a BSR of $51.8M (20.9%)

BUDGET BALANCING RISKS AND BENEFITS

Risks:

- Unresolved gap in FY26 and FY27 ($7M)
- New labor agreements end in FY25 (2% growth assumed)
- Recession like prior cycles
  (stagnant economic growth assumed)

Benefits:

- Measured revenue estimates
- New revenue from Measure K (business tax, FY 2025 first year)
- Healthy fund balances; e.g. Retiree Benefit Trusts and BSR
- $14M reserve ensures stability through est. FY24 & FY25 deficits

HIGH LEVEL TAKE AWAYS FROM LRFF

- Revenue trends indicate continued recovery from the pandemic
  - Signs of headwinds present opportunity for a recession
  - Measure L supports continued services from FY23
  - Measure K (not included in forecast) and one-time surplus funds support fiscal stability
- Looking Forward:
  - Continued strong financial discipline aids in managing the uncertain outlook
  - Balance financial risks with service needs; maintain stability over the next few years for the community and organization
  - Invest in priority areas as identified by Council and/or meet service needs

FY 2023 MIDYEAR REINVESTMENTS

Neighborhood, Community and Library Services (Net Cost $0.4M and 3.68 FTE)

- Community Services
  - 1.00 Division Manager of Parks, Open Space & Golf
  - Junior Museum and Zoo (JMZ) organizational study
  - Weekend trash pick-up, Team Sheeper (compensation for pool closure), overnight warming shelter, adult ceramics classes, and community grant to teachers
- Library
  - Staffing reorganization (net 2.73 FTE) to support additional programs and services; reflects recommendations in organizational assessment
  - Library collections

FY 2023 MIDYEAR REINVESTMENTS (CONT'D.)

Public Safety (Net Cost $0.4M and 1.00 FTE)

- Fire
  - Firefighter Academy and Personal Protective Equipment for 16.00 new hires; $1.5M of overtime costs offset with vacancy savings
- Police
  - 1.00 Court Liaison Officer in Records Division

FY 2023 MIDYEAR REINVESTMENTS (CONT'D.)

Planning and Transportation Services (Net Cost $0.2M and 2.00 FTE)

- Office of Transportation
  - Management Analyst reclassification to Senior Management Analyst
- Planning and Development Services
  - 2.00 Senior Planners in Long-Range Planning
  - Administrative Associate II reclassification to Administrative Associate III
  - Funding for senior level building inspection and plan review staffing

FY 2023 MIDYEAR REINVESTMENTS (CONT'D.)

Internal Services/Strategic Support (ALL Funds: Net Cost $0.4M and 1.00 FTE)

- Attorney's Office
  - Outside counsel for Roth Building rehabilitation
- Clerk's Office
  - Staff training for technical and leadership planning
- Information Technology
  - 1.00 Senior Technologist for Citywide technology project management
  - Citywide cybersecurity initiatives

FY 2023 MIDYEAR GENERAL FUND TECHNICAL ADJUSTMENTS

Technical Adjustments	Net Revenue/(Cost)
Major Sales Tax Revenue	$6,000
Consolidate Reserves and Program Savings 2023 Service Reinvestments, Utility Transfer Litigation, Transition Costs, Administrative Support, COVID-19, Rent Forgiveness, Advancing Racial Equity	$8,600
Operating Adjustments Legal Services, Public Safety Revenue, Golf Course Revenue, Flood Response, Equity Transfer, Electric and Gas Commodity Purchase	($2,200)
City Council Approved Actions FY22 Excess BSR to Pension Trust ($5M) and Capital Improvement Fund ($4M)	($9,000)
Budget Uncertainty Reserve Increase from $5M to $14M to offset losses in FY 2024 and FY 2025	($14,000)
Total Technical Adjustments (Net Cost, no FTE)	**$(10,600)**

NEXT STEPS

CITY OF PALO ALTO

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- FY 2024 Proposed Operating and Capital Budgets Published
- FY 2024 Proposed Budget Review, including Utility Rates, Municipal Fees, and Five-Year Capital Improvement Plan

Staff Work: *Development and production of FY 2024 Proposed Budgets*

RECOMMENDED ACTION

Staff recommends that the City Council:

FY 2024 – 2023 Long Range Financial Forecast (Item # AA2)

1. Direct staff to use this revised Base Case forecast as the starting point for the FY 2024 budget process.

2. Approve the Revised Fiscal Year 2024 – 2033 Long Range Financial Forecast and the FY 2024 Budget Development Guidelines (Attachment B).

FY 2023 Midyear Budget (Item # 8)

1. Amendments to the Fiscal Year 2023 Budget Appropriation for various funds and various capital projects, as identified in Attachment A and Attachment A, Exhibit 1 and 2 (requires a supermajority, 2/3 approval); and

2. Amend the FY 2023 Table of Organization in Attachment B consistent with the budget amendments in Attachment A, adding 5.25 full time and 2.43 part time FTE positions.

CITY OF
PALO
ALTO