CITY OF PALO ALTO

FINANCE COMMITTEE
Tuesday, December 7, 2021
Special Meeting
Virtual Meeting
6:00 PM
AMENDED AGENDA
Amended agenda items will appear below in red

*****BY VIRTUAL TELECONFERENCE ONLY*****

Click to Join **Zoom Meeting ID: 992-2730-7235 Phone: 1(669)900-6833**

Pursuant to AB 361, to prevent the spread of Covid-19, this meeting will be held by virtual teleconference only, with no physical location. The meeting will be broadcast on Midpen Media Center at https://midpenmedia.org. Members of the public who wish to participate by computer or phone can find the instructions at the end of this agenda. Members of the public may speak to agendized items; up to three minutes per speaker, to be determined by the presiding officer. All requests to speak will be taken until 5 minutes after the staff's presentation. Public comment may be addressed to the full Finance Committee via email at City.Council@cityofpaloalto.org and available for inspection on the City's website. Please clearly indicate which agenda item you are referencing in your email subject line.

CALL TO ORDER

ORAL COMMUNICATIONS
Members of the public may speak to any item NOT on the agenda.

ACTION ITEMS

Presentation 1. Review and Recommend That Council Accept the FY 2023 - FY 2032 Long Range Financial Forecast (LRFF) and FY 2023 Budget Development Guidelines

Presentation 2. Discuss Updates and Recommend Further Refinement of Potential Revenue Generating Local Ballot Measures (Late Packet Report)

3. First Quarter Financial Report FY 2022

FUTURE MEETINGS AND AGENDAS

ADJOURNMENT

AMENDED AGENDA ITEMS

Items that have been added/modified from the original publication of the agenda are listed below. Any corresponding materials are appended to the end of the initial packet. If full items have been added to the Agenda, they will be denoted with a number staring with AA, meaning Amended Agenda item.

2. Discuss Updates and Recommend Further Refinement of Potential Revenue Generating Local Ballot Measures (Late Packet Report)

PUBLIC COMMENT INSTRUCTIONS

Members of the Public may provide public comments to virtual meetings via email, teleconference, or by phone.

1. **Written public comments** may be submitted by email to city.council@cityofpaloalto.org.

2. **Spoken public comments using a computer or smart phone** will be accepted through the teleconference meeting. To address the Council, click on the link below to access a Zoom-based meeting. Please read the following instructions carefully.
   - You may download the Zoom client or connect to the meeting in- browser. If using your browser, make sure you are using a current, up-to-date browser: Chrome 30+, Firefox 27+, Microsoft Edge 12+, Safari 7+. Certain functionality may be disabled in older browsers including Internet Explorer. Or download the Zoom application onto your phone from the Apple App Store or Google Play Store and enter the Meeting ID below
   - You may be asked to enter an email address and name. We request that you identify yourself by name as this will be visible online and will be used to notify you that it is your turn to speak.
   - When you wish to speak on an Agenda Item, click on "raise hand." The Clerk will activate and unmute speakers in turn. Speakers will be notified shortly before they are called to speak.
   - When called, please limit your remarks to the time limit allotted.
   - A timer will be shown on the computer to help keep track of your comments.

3. **Spoken public comments using a phone** use the telephone number listed below. When you wish to speak on an agenda item hit *9 on your phone so we know that you wish to speak. You will be asked to provide your first and last name before addressing the Council. You will be advised how long you have to speak. When called please limit your remarks to the agenda item and time limit allotted.

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AMERICANS WITH DISABILITY ACT (ADA)

Persons with disabilities who require auxiliary aids or services in using City facilities, services or programs or who would like information on the City's compliance with the Americans with Disabilities Act (ADA) of 1990, may contact (650) 329-2550 (Voice) 48 hours or more in advance.

City of Palo Alto (ID # 13502)

Finance Committee Staff Report

Meeting Date: 12/7/2021

Title: Review and Recommend That Council Accept the FY 2023 - FY 2032 Long Range Financial Forecast (LRFF) and FY 2023 Budget Development Guidelines

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 2023-2032 and the FY 2023 annual Budget Development Guiding Principles (Attachment A) and direct staff to use this forecast as the starting point for the initiation of the FY 2023 budget process.

EXECUTIVE SUMMARY

Historically, the City has presented 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 2021, and expected results through FY 2022. 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 $2.4 million in FY 2023, followed by a $1.0 million gap in FY 2024, with small but increasing surpluses in FY 2025 through FY 2032. This forecast maintains current service levels approved in FY 2022 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, but the City is first and foremost continuing to manage through the unpredictable nature of the pandemic and impacts on the local economy.

In addition to the Base Case Forecast, staff modeled two alternate forecast scenarios that could more closely align with the City's service needs and financial outcome from the pandemic. The two scenarios are A) an immediate Restoration of Service to Pre-COVID-19 Service Levels, and B) a Competitive Market Compensation Adjustment. These scenarios are modeled separately for purposes of this report, but impacts from both of these scenarios could happen during the forecast period. Compared to the Base Case, both of these scenarios increase the General Fund gap over the next ten years. In Scenario A, FY 2023 changes from a surplus to a gap of $11.0

million, and revenues are not anticipated to be able to fund the annual expenditures until FY 2030. In Scenario B, the surplus in FY 2023 decreases to $0.9 million, the General Fund has a larger gap in FY 2024 of $2.6 million, and the gap continues into FY 2025 ($1.0 million) before returning to a surplus in FY 2026.

The difficult and significant actions that Council took to reduce services and balance the budget during the pandemic were never meant to be permanent; however, restoration of impacted services would require deliberate action. As mentioned in the preliminary FY 2022 Q1 financial status report (CMR 13439), there are several issues across the City impacting the ability to transition out of the pandemic including staff turnover, recruitment and retention, and supply chain issues that could continue into FY 2023. Development of the FY 2023 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.

City staff will continue to review and refine these projections to establish the FY 2023 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 consideration of measured restoration of services are necessary to ensure continued financial stability. More detailed guidelines or Budget Policies to inform the development of the FY 2023 budget are discussed at the end of this document (Attachment A).

Looking forward, the City continues to face several pressures from the uncertain recovery from the financial impacts of the COVID-19 pandemic, to funding and completing the 2014 Council approved Infrastructure Plan projects, and the growing costs of pension benefits and labor costs due to the current labor market and cost of living in the Bay Area. The continued policy direction from the City Council regarding proactively addressing the pension obligations, including the direction to assume a lower discount rate in calculating pension costs, is contained in the forecast model. The City continues to face critical choices in order to balance short term revenue projections based on the current economic situation and lingering impacts of COVID-19, with future financial challenges including any unforeseen program needs, any additional proactive funding contributions to pension liabilities, and evaluating service restorations to pre-pandemic levels. The review of this forecast and the planning that follows will be critical since the City is facing many requests and has identified several key programs that the community would like to fund and complete.

Included in this report and subsequent documents are the following:
- Discussion of the current financial climate of the United States to the local economy of the City of Palo Alto
- Current financial forecast including Revenue and Expense assumptions in FY 2023-2032
    - Current financial status of the General Fund as of the FY 2022 Adopted Budget, and a brief discussion of revised FY 2022 revenue estimates by category (a more

detailed discussion is in the preliminary 1st Quarter Financial Status Report CMR #13439)

- FY 2023 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:
  - Full restoration of services to pre-pandemic levels; reductions in FY 2021 and FY 2022 as a result of the COVID-19 Pandemic, and
  - Modeled potential market-based compensation adjustments

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. Important to note in this LRFF is the ongoing budget adjustments that were approved in the FY 2022 Adopted Budget and in the FY 2022 Q1 Preliminary Financial Status Report (CMR 13439). 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.

Palo Alto serves a diverse community with a broad range of unique services that adds to the significant complexity of managing a balanced budget and healthy financial outlook. The demands and conflicts coupled with an economy that is recovering with some uncertainty after the COVID-19 pandemic have heightened the intensity of the financial forecasting and budget development processes. 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.

The Economy

National, state, regional and local economic indicators are mixed, while the national economy performance is strong it has cooled as summer ends. The local economy on the other hand had strong performance in the second and third (calendar) quarters of 2021 with the expectation this will continue into calendar year 2022 and beyond, albeit at a slower growth rate, as progress on vaccinations allow economic activity to resume and/or expand particularly in previously shut-down sectors like restaurants, hotels, entertainment, and travel. Increased spending of household pandemic-era savings due to pent-up demand for services created by the pandemic restrictions could result in stronger economic growth as the pandemic restrictions further wane. However, increased spending on services may slow spending on durable goods which has increased and added to the strain to the supply chain. Business investments continue to be robust, particularly in information processing equipment and software. Overall housing construction remains strong, but it is expected to gradually decline since building is outpacing population growth and demand. This is expected to a lesser degree in high demand and densely populated areas like the San Francisco Bay Area. With the recent passage of the bipartisan infrastructure bill in Congress, the concern about the impact of the Federal stimulus packages ending, that contributed to the positive economic indicators over the past year, has lessened though there remains uncertainty about the infrastructure spending timing in the short-term.

As of the printing of this report, the rising vaccination rate, declining hospitalizations, and slowing of the spread of the virus in California and particularly in the Bay Area bodes well for Palo Alto's economic recovery. On a national level, areas of the country that are slower to address the pandemic might cause a slower national economic recovery in calendar year 2022. Another impediment to growth, both nationally and locally, is the labor market contraction. The pre-pandemic employment declined by about 10 million nationally, and businesses of all types are impacted by labor shortages. Employment remains down by millions over the pre-pandemic level even with the population growing over the past year. Some of this is explained by lack of childcare preventing a parent from re-entering the labor force, health concern especially those at higher risk and/or cannot be vaccinated due to a high risk of complications, and the long known and expected baby boomers' retirement trend that the pandemic is thought to have accelerated. This has created the conditions for companies to offer higher wages and/or benefits to both skilled and lower-skilled workers to attract and retain them. However, issues like the labor shortages, supply chain challenges, and rising gas and oil prices are stoking inflationary pressures which could, if unchecked, dampen economic growth. The Federal Open Market Committee (FOMC), whose actions during the pandemic kept the financial markets liquid and operating, is carefully monitoring the economy and has already taken steps to address the rising inflation, although the ability to keep this in an acceptable range is uncertain.

According to the US Bureau of Economic Analysis (BEA), the "advance" estimate of the U.S. economy's national gross domestic product (GDP) percentage change from the preceding quarter grew in the second and third (calendar) quarters by 6.7 percent and 2 percent, respectively. According to the BEA, "the increase in real GDP in the third quarter reflected increases in private inventory investment, personal consumption expenditures (PCE), state and local government spending, and nonresidential fixed investment that were partly offset by decreases in residential fixed investment, federal government spending, and exports. Imports, which are a subtraction in the calculation of GDP, increased (see below Table 1). The increase in third quarter GDP performance reflected the continued economic impact of the COVID-19 pandemic. A resurgence of COVID-19 cases resulted in new restrictions and delays in the reopening of establishments in some parts of the country. Government assistance payments in the form of forgivable loans to businesses, grants to state and local governments, and social benefits to households all decreased. The national consumer price index (CPI), as of the third calendar quarter has grown 5.3 percent and exceeds smaller increases in first and second quarters of 1.9 percent and 4.8 percent. More households could see their finances as worse if inflation erodes their nominal wage gains and shrinks their real purchasing power. The recent inflation spike has driven pandemic pessimism, but it's not clear if this will lead into reduced retail spending. The following graphs depict the GDP and consumer price index (CPI) over the past few years and CPI forecast in calendar year 2022.

Table 1: National Gross Domestic Product (GDP)

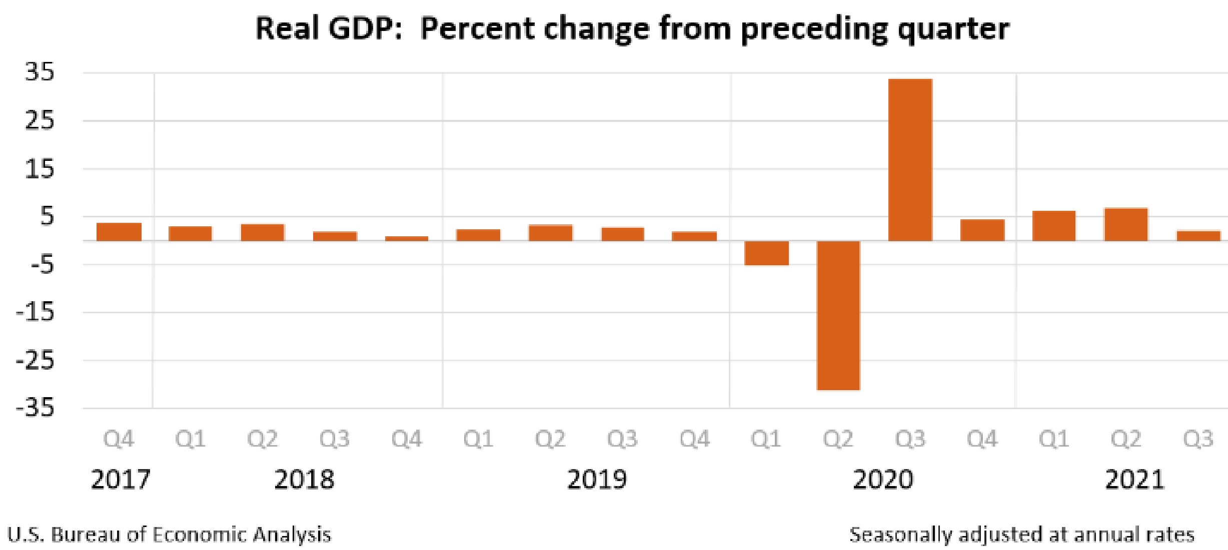
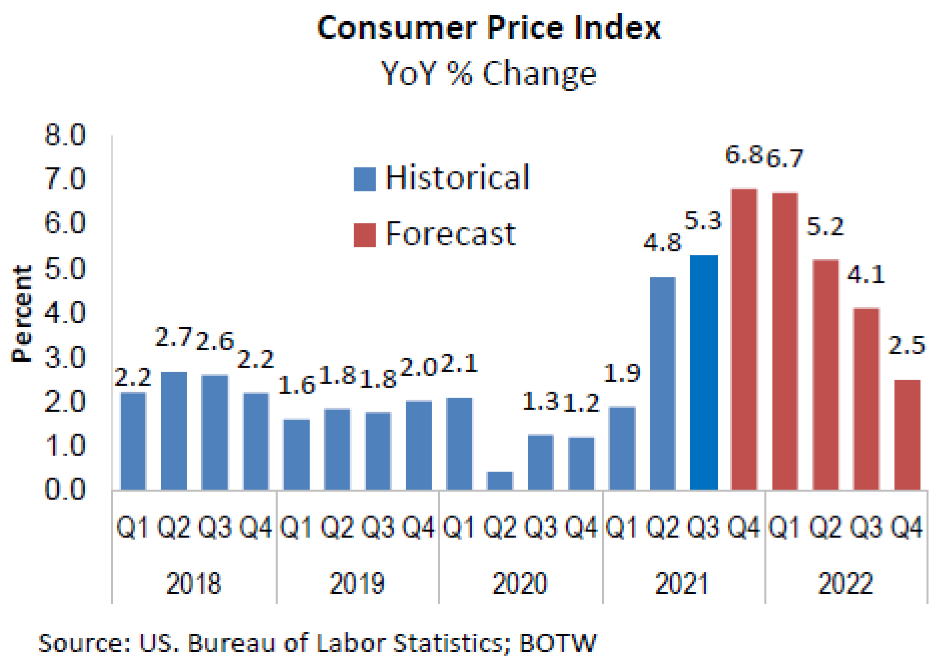
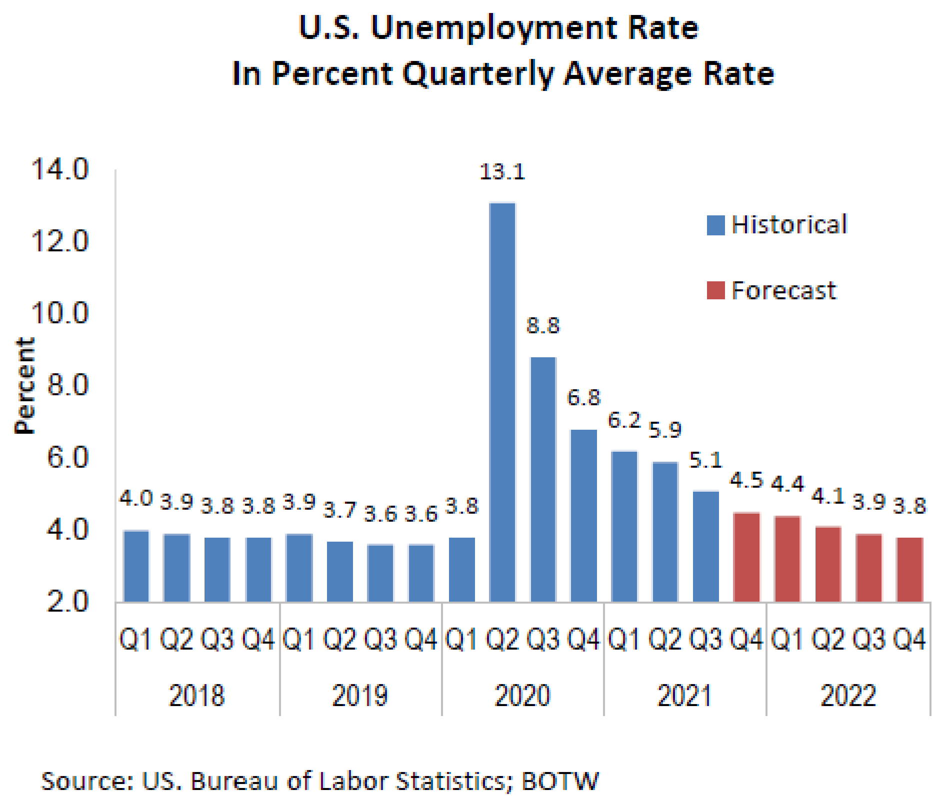


Table 2: National Consumer Price Index



The nation's unemployment rate fell to 5.1 percent in the third quarter, compared to a record high of 13.1 percent at the height of the pandemic in the second (calendar) quarter of 2020. It is expected, by the U.S. Bureau of Labor Statistics, that the unemployment rate will decline below the pre-pandemic low of 3.5 percent. Per the State of California's Employment Development Department, the state's unemployment rate as of September 2021 is 6.4 percent and the County of Santa Clara is 3.9 percent. 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. As shown in Table 2, these trends are expected to continue in calendar year 2022. 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 improved to 4.7 percent in September 2021 compared to 9.0 percent in September 2020.

Table 3: U.S. Unemployment Rate



DISCUSSION

Included in this section are the Base Case and revenue and expense assumptions. As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document. For example, General Fund revenues may exceed or fall below expectations based on changes in economic or non-economic conditions. Various cost elements can also vary from year to year. Adding to this complexity is the uncertain recovery from the financial impacts of the COVID-19 pandemic. This forecast assumes a gradual improvement of economic conditions and the continued easing of public health restrictions. In this forecast major tax revenues continue to rebound from prior year levels, reserves for economically sensitive revenues are phased out as modified or canceled programs return, and investments in Capital projects are restored to pre-pandemic levels. It also recognizes legislative responses to the pandemic that have boosted the City's financial outlook in the near term, such as the Coronavirus Aid, Relief, and Economic Securities Act (CARES Act), and American Rescue Plan Act (ARPA). As one-time sources, these funds are eliminated in FY 2024.

Base Case

The following table 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. Because it is the City's goal to remain in balance on an ongoing basis, the incremental figure is useful to illustrate the additional surplus and/or shortfall attributed to a particular fiscal year. To the extent that a shortfall is not resolved, or a surplus is not expended on an ongoing basis, it is important to understand that the remaining budget gap or surplus will carry over to the following year.

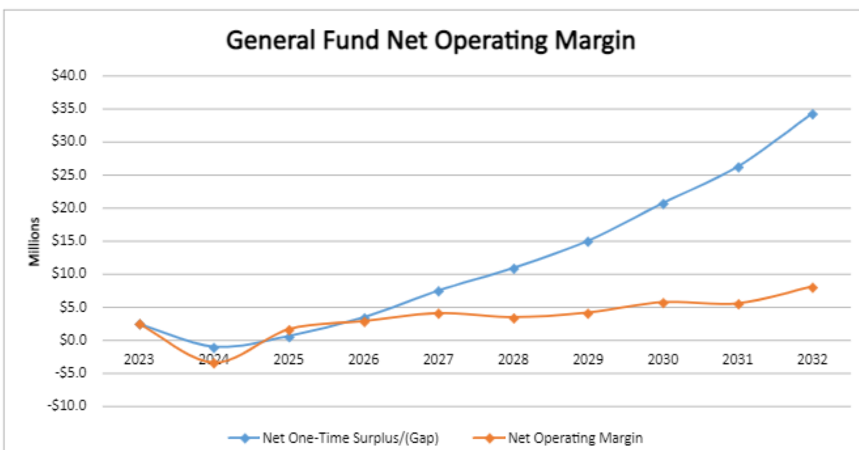
The current Base Case financial forecast projects a surplus of $2.4 million in FY 2023, followed by a $1.0 million shortfall in FY 2024, with small but increasing surpluses in FY 2025 through FY 2032. As outlined above, if the City spends the projected FY 2023 surplus of $2.4 million on an ongoing basis, the available projected gap for FY 2024 will be approximately $3.4 million. Based on these assumptions, the cumulative net operating margin, or ongoing surplus, during the forecast period is $34.3 million.

TABLE 4: FY 2023 – 2032 Long Range Financial Forecast (Base Case)

	Actual 2021	Adopted 2022	Projected 2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Total Revenue	$200,925	$206,452	$218,167	$230,393	$239,692	$252,271	$259,853	$268,149	$277,233	$286,670	$297,136	$308,506	$320,187
			5.7%	*5.6%*	*4.0%*	*5.2%*	*3.0%*	*3.2%*	*3.4%*	*3.4%*	*3.7%*	*3.8%*	*3.8%*
Total Expenditures	$185,634	$209,210	$207,468	$227,995	$240,741	$251,691	$256,437	$260,691	$266,344	$271,661	$276,414	$282,271	$285,855
			-0.8%	*9.9%*	*5.6%*	*4.5%*	*1.9%*	*1.7%*	*2.2%*	*2.0%*	*1.7%*	*2.1%*	*1.3%*
Net One-Time Surplus/(Gap)	**$15,291**	**($2,758)**	**$10,699**	**$2,398**	**($1,049)**	**$581**	**$3,416**	**$7,458**	**$10,889**	**$15,009**	**$20,722**	**$26,235**	**$34,332**
Cumulative Net Operating Margin (One-Time)													$119,990
Net Operating Margin			$0	$2,398	($3,446)	$1,629	$2,836	$4,041	$3,431	$4,120	$5,713	$5,513	$8,097
Cumulative Net Operating Margin													$34,332

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

TABLE 5: FY 2023 – 2032 Long Range Financial Forecast Net Operating Margin (Base Case)



Revenue Assumptions

On October 25, 2021, the City Council reviewed and discussed the preliminary Q1 FY 2022 financial status report (CMR 13439). This report provided a snapshot in time, with some revenues projected to exceed the FY 2022 Adopted Budget estimates that reflected a slow to moderate recovery pace as directed by the City Council (CMR 11954).

Tax revenues constitute nearly 60 percent of General Fund resources and the FY 2022 forecast projects a 10.5 percent, or $11.6 million, increase over adopted levels that is driven by higher than anticipated receipts in Sales Tax, Property Tax, and Transient Occupancy Tax (TOT) categories. In FY 2023, the forecast projects a $9.1 million, or 7.5 percent, tax revenue increase compared to the FY 2022 projected levels. The forecast assumes that major tax revenues continue to rebound from prior-year levels; however, overall tax revenues in FY 2022 remain below pre-pandemic levels by $12.3 million, or 9.1 percent, and are not expected to reach pre-pandemic levels until FY 2024 in this LRFF.

The FY 2022 forecast for non-tax revenues projects a slight 0.2 percent, or $112,000 increase over adopted levels. In FY 2023, the forecast projects a $3.6 million, or 5.0 percent, increase compared to FY 2022 projected levels. This increase is primarily attributable to new fee-based programs in the Fire Department and the restoration of several programs and services that were modified due to public health orders, mainly in public safety and community services.

As part of the Federal stimulus support, the City is expected to receive $13.7 million in American Rescue Plan Act (ARPA) funding that the Council, per the legislation, has designated to address the immediate financial impacts resulting from the COVID-19 pandemic, specifically the significant revenue loss. Budgetarily, and included in this forecast, is the assumed use of $8.2 million (60 percent) appropriated in FY 2022 and $5.5 million (40 percent) appropriated in FY 2023 to assist in smoothing the revenue loss as a result of the pandemic. As a one-time funding source, ARPA funding is eliminated in FY 2024 and beyond which contributes to the fluctuations in the surplus/operating gap in the first few years of the 10-year forecast. The changes by revenue category, as well as the current expected FY 2022 status of many of the revenue categories, are discussed in greater detail below.

TABLE 6: General Fund Revenue Forecast

Revenue & Other Sources	Actual 2021	Adopted 2022	Projected 2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	CAGR 10 Years	CAGR 5 Years
Sales Taxes	29,127	28,184	30,633	32,306	33,369	34,333	35,157	36,107	37,118	38,205	39,535	41,152	43,012	2.9%	1.1%
Property Taxes	56,572	51,228	56,469	58,220	61,794	65,682	69,838	74,079	78,413	83,040	88,271	93,860	100,149	5.6%	2.4%
Transient Occupancy Tax															
General Purpose	2,796	2,528	5,398	7,684	10,862	12,938	13,361	13,768	14,294	14,887	15,612	16,398	17,255	8.4%	6.0%
Infrastructure	2,383	5,899	5,657	9,238	12,719	14,966	15,456	15,927	16,536	17,222	18,061	18,969	19,961	8.0%	5.6%
Documentary Transfer Tax	10,627	7,137	8,125	7,391	7,182	7,423	7,677	7,948	8,235	8,534	8,863	9,190	9,519	2.6%	0.7%
Utility Users Tax	14,642	14,370	14,667	14,898	15,616	16,483	17,436	18,448	19,618	20,570	21,379	22,276	23,235	4.5%	2.2%
Other Taxes and Fines	683	1,434	1,434	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	116,830	110,780	122,383	131,522	143,327	153,610	160,710	168,062	175,998	184,242	193,505	203,629	214,916	5.0%	2.5%
Charges for Services	24,478	23,870	23,870	28,448	29,862	31,279	31,449	31,623	31,800	31,980	32,165	32,352	32,471	1.3%	1.1%
Permits and Licenses	7,888	8,406	8,406	9,455	9,532	9,840	10,041	10,158	10,400	10,650	10,905	11,163	10,854	1.4%	0.7%
Return on Investments	1,063	852	964	985	1,008	1,033	1,064	1,096	1,130	1,172	1,220	1,271	1,325	3.0%	1.1%
Rental Income	13,293	14,476	14,476	15,487	16,068	16,608	17,259	17,773	18,198	18,636	19,083	19,544	20,015	2.6%	1.4%
From Other Agencies	2,173	8,521	8,521	6,696	1,273	990	258	258	258	258	258	258	258	-27.8%	-27.8%
Charges to Other Funds	11,661	14,165	14,165	12,946	13,828	14,118	14,278	14,383	14,652	14,935	15,202	15,490	15,547	1.8%	1.1%
Other Revenue	2,387	2,260	2,260	2,261	2,202	2,202	2,203	2,204	2,205	2,206	2,207	2,207	2,208	-0.2%	-0.3%
Total Non-Tax Revenue	62,944	72,551	72,663	76,279	73,773	76,070	76,552	77,495	78,643	79,837	81,039	82,286	82,680	0.8%	0.2%
Operating Transfers-In	21,151	23,121	23,121	22,592	22,592	22,592	22,592	22,592	22,592	22,592	22,592	22,592	22,592	0.0%	0.0%
BSR Contribution (One-Time)															
Total Source of Funds	$200,925	$206,452	$218,167	$230,393	$239,692	$252,271	$259,853	$268,149	$277,233	$286,670	$297,136	$308,506	$320,187		

TABLE 7: General Fund Revenue Forecast Year to Year Percentage Change

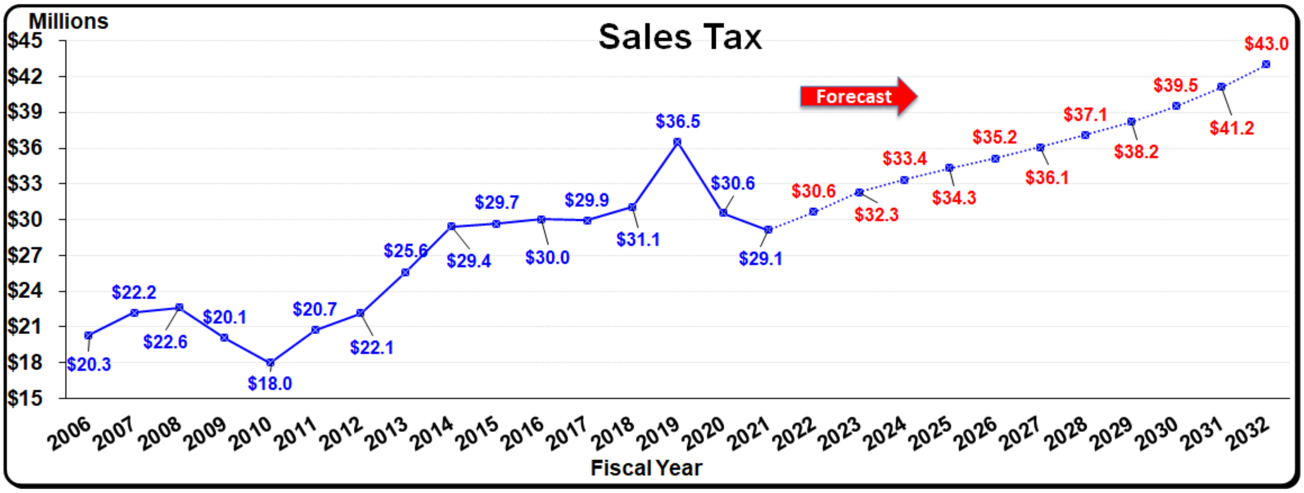
Revenue & Other Sources	Actual 2021	Adopted 2022	Projected 2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Sales Taxes		-3.2%	8.7%	5.5%	3.3%	2.9%	2.4%	2.7%	2.8%	2.9%	3.5%	4.1%	4.5%
Property Taxes		-9.4%	10.2%	3.1%	6.1%	6.3%	6.3%	6.1%	5.9%	5.9%	6.3%	6.3%	6.7%
Transient Occupancy Tax													
General Purpose		-9.6%	113.5%	42.3%	41.4%	19.1%	3.3%	3.0%	3.8%	4.2%	4.9%	5.0%	5.2%
Infrastructure		147.6%	-4.1%	63.3%	37.7%	17.7%	3.3%	3.0%	3.8%	4.1%	4.9%	5.0%	5.2%
Documentary Transfer Tax		-32.8%	13.8%	-9.0%	-2.8%	3.4%	3.4%	3.5%	3.6%	3.6%	3.9%	3.7%	3.6%
Utility Users Tax		-1.9%	2.1%	1.6%	4.8%	5.6%	5.8%	5.8%	6.3%	4.9%	3.9%	4.2%	4.3%
Other Taxes and Fines		110.1%	0.0%	24.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Subtotal: Taxes		-5.2%	10.5%	7.5%	9.0%	7.2%	4.6%	4.6%	4.7%	4.7%	5.0%	5.2%	5.5%
Charges for Services		-2.5%	0.0%	19.2%	5.0%	4.7%	0.5%	0.6%	0.6%	0.6%	0.6%	0.6%	0.4%
Permits and Licenses		6.6%	0.0%	12.5%	0.8%	3.2%	2.0%	1.2%	2.4%	2.4%	2.4%	2.4%	-2.8%
Return on Investments		-19.8%	13.1%	2.2%	2.3%	2.4%	3.0%	3.0%	3.1%	3.8%	4.1%	4.2%	4.3%
Rental Income		8.9%	0.0%	7.0%	3.8%	3.4%	3.9%	3.0%	2.4%	2.4%	2.4%	2.4%	2.4%
From Other Agencies		292.1%	0.0%	-21.4%	-81.0%	-22.2%	-74.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Charges to Other Funds		21.5%	0.0%	-8.6%	6.8%	2.1%	1.1%	0.7%	1.9%	1.9%	1.8%	1.9%	0.4%
Other Revenue		-5.3%	0.0%	0.0%	-2.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Non-Tax Revenue		15.3%	0.2%	5.0%	-3.3%	3.1%	0.6%	1.2%	1.5%	1.5%	1.5%	1.5%	0.5%
Operating Transfers-In		9.3%	0.0%	-2.3%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
BSR Contribution (One-Time)													
Total Source of Funds		2.8%	5.7%	5.6%	4.0%	5.2%	3.0%	3.2%	3.4%	3.4%	3.7%	3.8%	3.8%

Sales Tax

Sales tax receipts declined in FY 2020 and FY 2021 by 16.3 percent and 4.70 percent, respectively. However, the FY 2021 fourth quarter cash receipts increased by 28.2 percent over the prior year's same quarter. The general retail, food products which includes restaurants, and transportation which includes auto sales had 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 business-to-business sales which has been declining.

Sales Tax is anticipated to generate $30.6 million in FY 2022, a $2.5 million or 8.7 percent increase over the adopted level of $28.2 million, and $1.5 million or 5.2 percent over FY 2021 actuals of $29.1 million. In FY 2023, this revenue is anticipated to increase to $32.3 million, a $1.7 million or 5.2 percent increase over FY 2022 projected levels. Revenue in this category is experiencing growth; however, remains below pre-pandemic levels of $36.5 million in FY 2019.

TABLE 8: City of Palo Alto Sales Tax Revenues through FY 2032



Property Tax

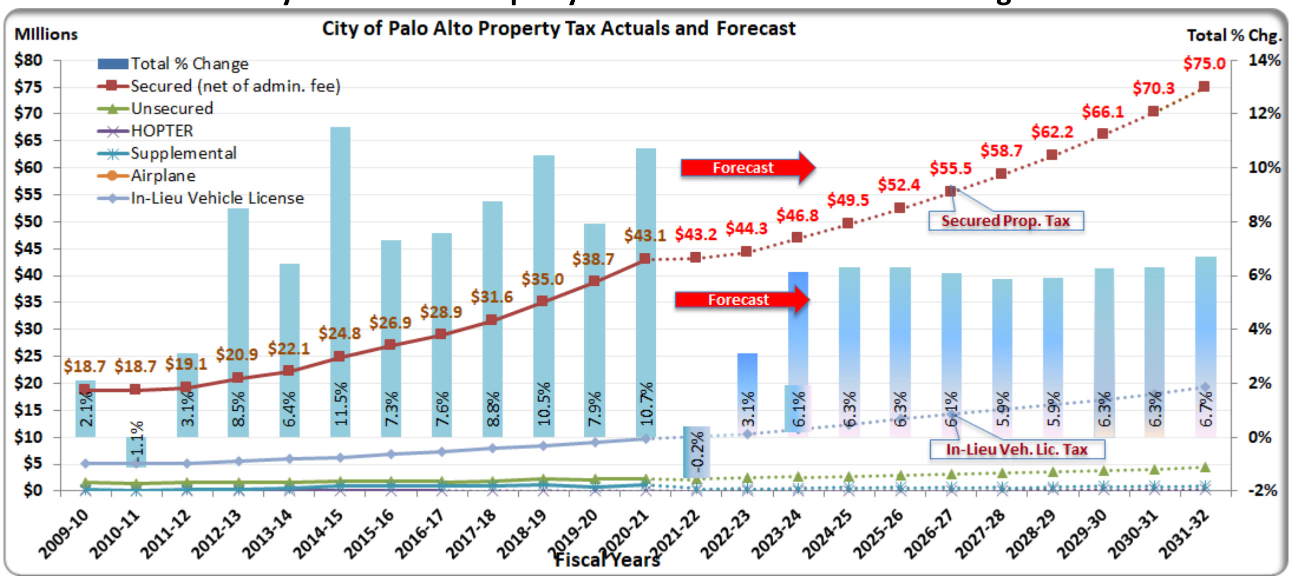
Property tax revenue is the General Fund's largest revenue source and represents approximately 25 percent of the total revenues. Historically, the 10-year compound annual growth rate (CAGR) was 8.2 percent with a low of –1.1 percent in FY 2011 and a high of 11.5 percent in FY 2015. During economic downturns, impacts to property tax occur a year later. As a result, the FY 2021 actual growth was 10.7 percent and FY 2022 is forecasted to be flat. In addition, fiscal years 2018, 2019, 2020, and 2021 included receipts of $1.4 million, $2.7 million, $3.9 million, and $5.5 million, respectively, for excess Educational Revenue Augmentation Fund (ERAF) distributions from the County of Santa Clara. The FY 2022 forecast includes $4.5 million for excess ERAF. 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.

As discussed in the preliminary first quarter (Q1) FY 2022 financial status report (CMR 13439) , five counties including, Santa Clara County, and the State were in a dispute over the calculation and disbursement of excess ERAF funds. The City had been reserving these funds, pending a resolution of the dispute beginning in FY 2021 and through prior near-term forecasts. The dispute between the counties and the State was settled in FY 2021 and, consistent with City Council direction, these funds have been recognized in the Budget Stabilization Reserve (BSR) and reallocated to the City's reserve: Utilities Transfer Litigation (Equity Transfer). In FY 2022, an additional $1.7 - $2.0 million above budgeted levels is anticipated as a result of the 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 that 20 percent of ERAF in FY 2022 is subject to this litigation. This forecast assumes a slightly higher 25 percent or $1.5 million reserve for potential loss starting in FY 2022 and beyond. It's uncertain if a similar percentage is at risk for the prior two years; 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 2022 due to the delayed impact of the (pandemic) recession. For example, the median sales price of single family residential in the first quarter of FY 2022 declined by 2.6 percent.

TABLE 9: City of Palo Alto Property Tax Actuals and Forecast through FY 2032



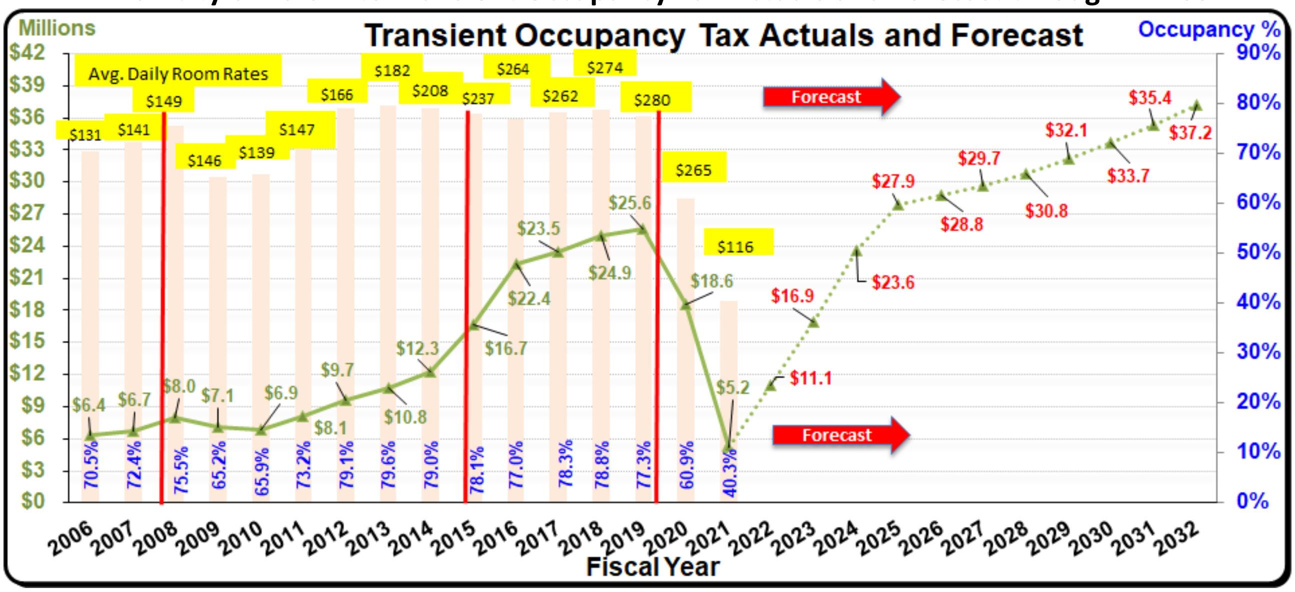
Property Tax is anticipated to generate $56.5 million in FY 2022, a $5.2 million or 10.2 percent increase over adopted levels of $51.2 million and remains consistent with FY 2021 actuals of $56.6 million. In FY 2023, this revenue is anticipated to increase to $58.2 million, a $1.7 million or 5.2 percent increase over FY 2022 projected levels.

Transient Occupancy Tax (TOT)

Revenue in this category is impacted by business and other leisure/non-leisure travel and has experienced significant reductions in prior years due to public health orders, travel restrictions, and diminishing business and personal travel plans resulting from the pandemic. As public health conditions improve and travel resumes, revenue in this category is anticipated to recover and possibly grow. This revenue remains low compared to pre-pandemic actuals of $25.7 million in FY 2019; however, strong growth was realized in the FY 2021 fourth and FY 2022 first quarters. In FY 2022, receipts are expected to generate approximately $11.1 million (57 percent below pre-pandemic levels) versus the FY 2021 actuals of $5.2 million (80 percent below pre-pandemic levels); a 23 percent improvement. The opening of the two Marriott hotels in the prior fiscal year and the re-opening of several hotels in the first quarter of FY 2022 are positive developments that will also drive recovery for this tax revenue.

Estimated TOT receipts of $11.1 million in FY 2022, would generate a $2.7 million or 32.1 percent increase over adopted levels of $8.4 million, and $4.9 million or 113.5 percent over FY 2021 actuals of $5.2 million. In FY 2023, this revenue is anticipated to increase to $16.9 million, a $5.8 million or 52.3 percent increase over FY 2022 projected levels. Year-to-date, daily average room rates increased by 37.7 percent from $120.76 per day to $166.24 per day while occupancy rate increased by 40.4 percent from 43.2 percent to 60.6 percent.

TABLE 10: City of Palo Alto Transient Occupancy Tax Actuals and Forecast through FY 2032

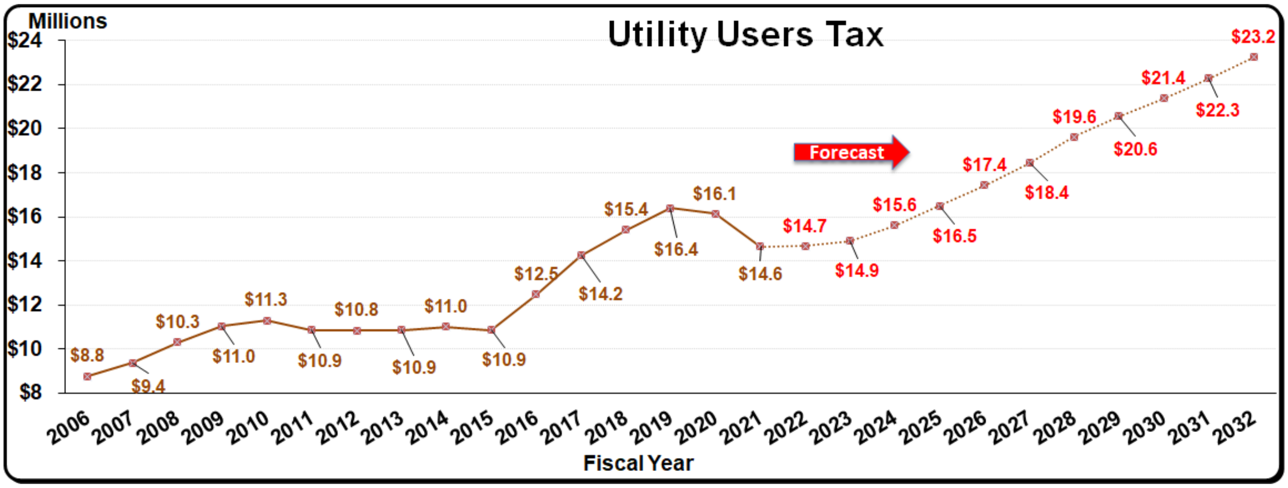


Note: Jan. 2008, TOT Rate went from 10% to 12%
Jan. 2015, TOT Rate went from 12% to 14%
April 2019, TOT Rate went from 14% to 15.5%

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 reduction programs and reduced workforces and business closures due to the pandemic. This revenue is showing early signs of recovery as public health orders ease and workers return to the office. UUT is anticipated to generate $14.7 million in FY 2022, a $0.3 million or 2.1 percent increase over adopted levels of $14.4 million, relatively constant with FY 2021 levels. In FY 2023, this revenue is anticipated to increase to $14.9 million, a $0.2 million or 1.6 percent increase over FY 2022 projected levels.

TABLE 11: City of Palo Alto Utility Users Tax Actuals and Forecast through FY 2032

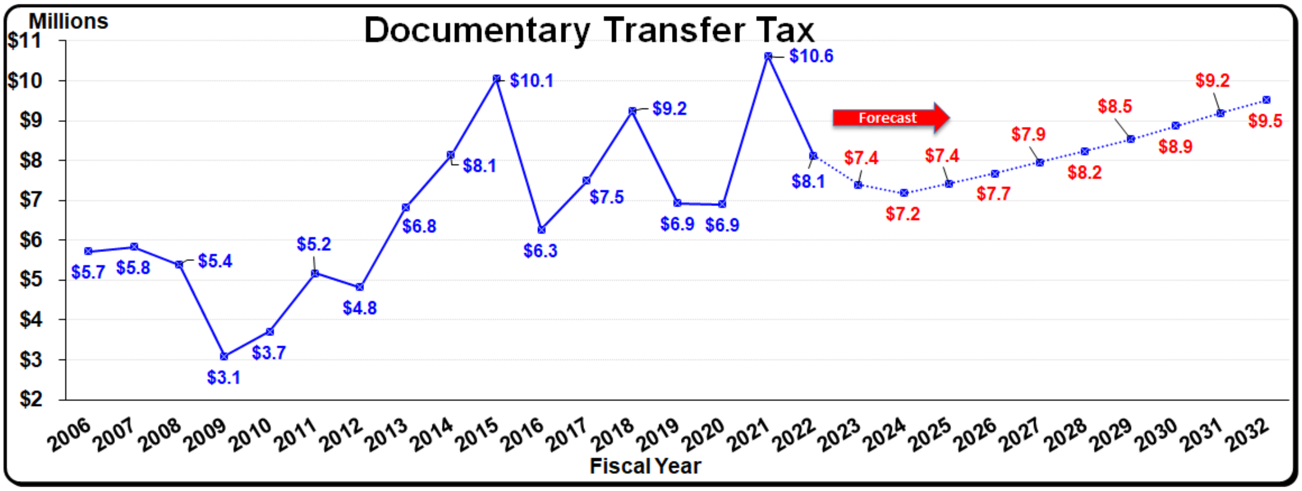


Documentary Transfer Tax (DTT)

Revenue in this category is highly volatile and dependent on sales volume and the mix of commercial and residential sales. In FY 2021, DTT experienced record receipts of $10.6 million. This milestone was a result of six large commercial transactions and robust residential sales. During economic downturns, some investors see it as an opportunity to expand their holdings. Revenue from July through October in FY 2021 is running 4.4 percent above the same period in FY 2020. DTT is anticipated to generate $8.1 million in FY 2022, a $1.0 million or 13.8 percent increase over adopted levels of $7.1 million, and $2.5 million or 23.5 percent lower than FY 2021 actuals of $10.6 million. In FY 2023, this revenue is anticipated to decrease to $7.4 million, a $0.7 million or 9.9 percent decrease over FY 2022 projected 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 October 2021 (283) are running higher than those through October 2020 (229) with the total value of these transactions increasing by 4.4 percent. However, though performance to date is higher than the FY 2021 peak revenue receipts, the FY 2021 DDT receipts is not expected to be repeated in FY 2022 since the major commercial sales receipts, which made up over half the DDT receipts in FY 2021, came in the latter half of the last fiscal year. 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 recession will impact property sales activity in FY 2022.

TABLE 12: City of Palo Alto Documentary Transfer Tax Actuals and Forecast through FY 2032



Rental Income

Rental Income of $14.5 million in FY 2022 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 23of $1.0 million. 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. This also assumes rentals of City space return to pre-pandemic levels in FY 2023. Impacts from the pandemic, including reductions related to the rent forgiveness program (CMR 12234) which provides up to three months of rent forgiveness for active non-profit tenants should be resolved in FY 2022. As of November 1, 2021, the program has resulted in 12 tenant applications for $255,000 of the $744,000 budgeted for rent relief. A further round of applications will occur prior to the program's sunset at the end of FY 2022. Additionally, staff are working with several tenants to resolve issues of past due rent, and the City Attorney's Office has become involved in ongoing discussions. It is assumed this revenue source will decrease during FY 2022 until past due rent issues are resolved.

The City is also considering using the former Los Altos Treatment Plant (LATP) site for Project Homekey and a water purification site. Should this occur, the site would no longer be available for rental as a laydown yard. Please see the General Expenses section of this report for additional information regarding future plans for the former LATP site.

Charges for Services and Permits and Licenses

Revenues in the 'Charges for Services' and the 'Permits and Licenses' categories are anticipated to be $28.4 million and $9.5 million, respectively, in Fiscal Year 2023. These amounts are approximately $5.6 million higher than the FY 2022 amounts, mainly due to adjustments to revenue from new Fire Department fees and adjustments to the Economically Sensitive Department Revenue Reserve, discussed below.

Revenues in these categories were impacted by changes in FY 2023, such as increases to reflect a full year of operation for the Junior Museum and Zoo, which includes a ticketed entry fee and membership program. 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, to secure co-pay free ambulance transport. These fees are still in development and are currently scheduled for implementation by Spring or Summer of 2022.

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 opening the Junior Museum and Zoo, and limited operations at community centers, recreational facilities, and the Children's Theatre. In total, $5.0 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 over three years, appropriating $2.5 million in FY 2023, $1.25 million in FY 2024, and $0 in FY 2025 and beyond.

The revenue estimates in these categories are primarily driven by the cost of staff to provide services to the community; therefore, revenues are impacted by the City’s personnel service costs and modeled to increase by rates consistent with 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 2023 Budget development process and bring forward adjustments as appropriate.

Charges for Service - Stanford Fire and Dispatch Services

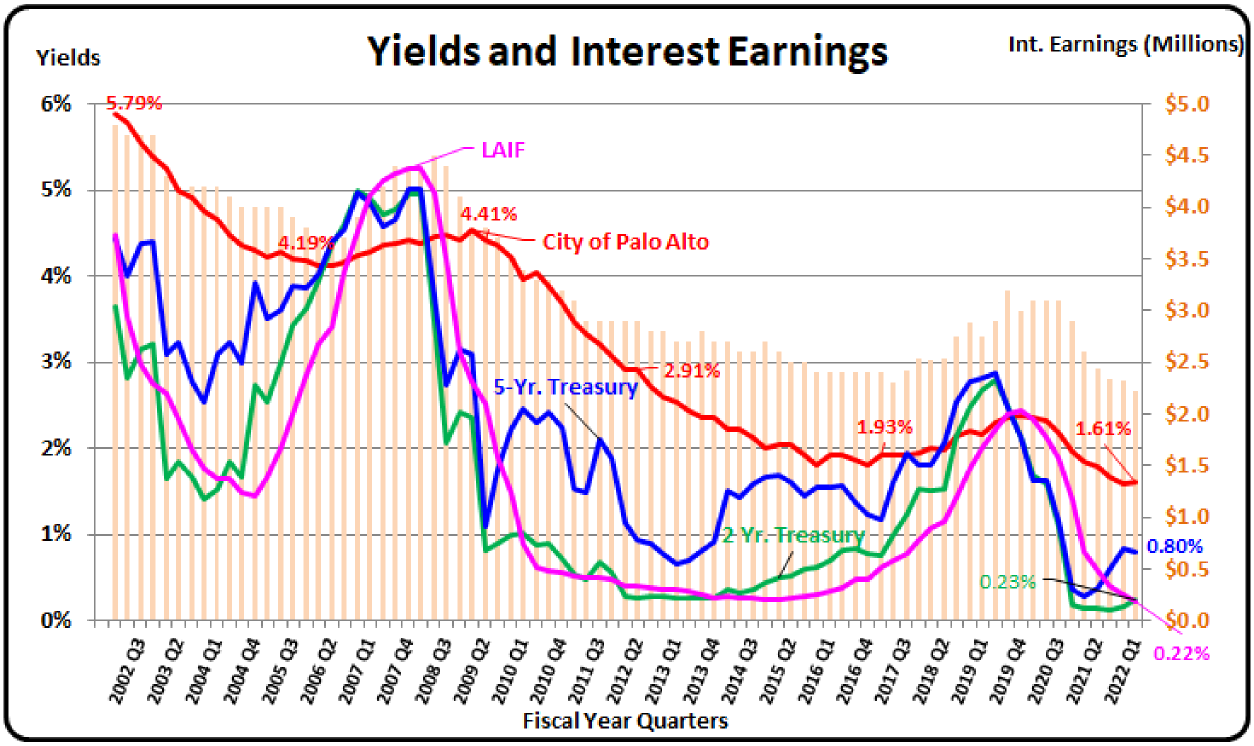
The City and Stanford have two separate agreements for the provision of fire response and emergency dispatch services. The fire response services agreement became effective in July 2018 and outlines service level terms and a new cost allocation methodology as the baseline for agreement costs. The term 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 2022. Similarly, changes to the revenue received for dispatching services have been aligned with the FY 2022 adjustments to the operating expenses in the Technical Services Division of the Police Department where the costs to provide these services are budgeted. Adjustments include applicable costs for the Public Safety Communications Manager position approved as part of FY 2022 preliminary first quarter adjustments. For fire revenue, additional adjustments may be applicable if a new labor agreement with IAFF is negotiated. Salary and benefits cost increases are assumed using the CCPI in the San Francisco Bay Area from the August-to-August period of 3.7% for the base year and 2.5% for out years.

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 2023 estimate for Charges to Other Funds of $13.0 million reflects a slight decrease of 8.45 percent from the FY 2022 Adopted amount of $14.2 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 2022 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. Staff had anticipated the decline in interest rates would occur sooner and at a faster rate than it has occurred, so the City experienced a higher than anticipated return on investments in FY 2021. In addition, prudent investments further resulted in higher investment yields and earnings.

The average portfolio rate of return for the first quarter of FY 2022 was 1.61 percent, and a 1.58 percent average yield as of the fourth quarter of FY 2021. The revised General Fund FY 2022 interest earning estimate of $0.95 million is $0.10 million higher than the Adopted Budget of $0.85 million. In FY 2023, the forecast reflects a relatively level interest rate environment with slight increases through the ten-year period.

TABLE 13: Palo Alto Historical Investment Portfolio Yield 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 $22.6 million, a $0.5 million decrease from the FY 2022 level of $23.1 million due to the removal of a one-time transfer of funding for animal services in FY 2022.

In accordance with a methodology approved by the City Council in June 2009, the equity transfer is calculated by applying a rate of return on the capital asset base of the Electric and Gas funds. This rate of return is based on PG&E's rate of return on equity as approved by the California Public Utilities Commission (CPUC). The transfer amount is calculated based on the Utility Department's projections from the Electric and Gas Five Year Financial Forecasts, as approved by the City Council in spring 2021 (CMR 12240). For more detail on the ordinance adopting the 2009 transfer methodology, see CMR 280:09, Budget Adoption Ordinance for Fiscal Years 2009 and 2010; and CMR 260:09, Finance Committee Report explaining proposed changes to equity transfer methodology.

This estimate 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 challenges 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 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. The results of this lawsuit will have important implications for Palo Alto, as well as for other municipal utilities and cities in California. In September 2021, the Council therefore authorized an appeal to seek guidance from the Court of Appeal on these novel legal questions. The City is also exploring a ballot measure to seek voter approval or modification of the City's general fund transfer so City voters can have the final word on how they want to finance City services, and at what level. Because the appeal is pending, the exact exposure to the City's General Fund cannot be estimated at this time. However, the City believes it is prudent to set aside funding to cover the $12.6 million remedy related to gas rates that the Superior Court identified in Phase II, plus interest, as well as the estimated future reduction in the gas equity transfer, should the current Santa Clara County Superior Court decision be upheld. While the process for calculating the equity transfer from the Electric and Gas Funds has not changed, the funding is now being held 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.

Expense Assumptions

As part of developing the FY 2023-2032 Forecast expenditure budget, the General Fund expense categories have been adjusted by removing FY 2022 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 2022 estimated expenditures, growth of 9.9 percent is expected in FY 2023.

TABLE 14: General Fund Expense Forecast and Year to Year Percentage Change

Expenditures & Other Uses	Actual 2021	Adopted 2022	Projected 2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	CAGR 10 Years	CAGR 5 Years
Salary	67,284	69,304	66,304	72,531	74,791	76,699	78,718	80,554	82,274	83,986	85,698	87,411	89,125	2.5%	1.1%
Benefits	58,509	62,245	63,745	66,247	68,738	71,045	71,867	72,088	73,581	74,650	76,004	77,392	76,430	2.1%	0.8%
Subtotal: Salary & Benefits	125,793	131,549	130,049	138,778	143,529	147,744	150,584	152,641	155,855	158,636	161,701	164,803	165,554	2.3%	1.0%
Contract Services	17,807	30,200	30,200	29,088	29,756	30,417	28,107	28,631	29,185	29,710	30,284	30,796	31,378	0.4%	-0.2%
Supplies & Material	2,234	2,980	2,980	3,085	3,160	3,234	3,308	3,382	3,456	3,530	3,604	3,678	3,752	2.3%	0.9%
General Expense	6,585	7,938	7,938	8,481	8,548	8,631	8,684	8,752	8,821	8,904	7,959	8,026	8,093	0.2%	0.3%
Rents & Leases	1,709	1,298	1,298	1,332	1,367	1,404	1,442	1,481	1,522	1,563	1,605	1,649	1,693	2.7%	1.1%
Facilities & Equipment	464	427	427	443	454	465	476	487	498	509	520	531	542	2.4%	1.0%
Allocated Charges	17,423	20,117	20,117	22,445	23,105	23,729	24,275	24,818	25,417	26,040	26,630	27,250	27,780	3.3%	1.0%
Total Non Sal/Ben Before Transfers	46,221	62,960	62,960	64,875	66,391	67,880	66,292	67,551	68,899	70,255	70,602	71,929	73,238	1.5%	0.4%
Operating Transfers-Out	4,326	4,296	4,296	4,431	4,462	4,493	4,529	4,561	4,598	4,636	4,669	4,707	4,746	1.0%	0.3%
Transfer to Infrastructure - Base	6,911	4,506	4,506	10,673	13,640	16,607	19,575	20,010	20,456	20,912	21,381	21,863	22,356	17.4%	6.5%
Transfer to Infrastructure - TOT	2,383	5,899	5,657	9,238	12,719	14,966	15,456	15,927	16,536	17,222	18,061	18,969	19,961	13.0%	5.6%
Total Use of Funds	185,634	209,210	207,468	227,995	240,741	251,691	256,437	260,691	266,344	271,661	276,414	282,271	285,855	3.2%	1.3%

Expenditures & Other Uses	Actual 2021	Adopted 2022	Projected 2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Salary		3.0%	-4.3%	9.4%	3.1%	2.6%	2.6%	2.3%	2.1%	2.1%	2.0%	2.0%	2.0%
Benefits		6.4%	2.4%	3.9%	3.8%	3.4%	1.2%	0.3%	2.1%	1.5%	1.8%	1.8%	-1.2%
Subtotal: Salary & Benefits		-0.2%	-0.2%	6.7%	3.4%	2.9%	1.9%	1.4%	2.1%	1.8%	1.9%	1.9%	0.5%
Contract Services		69.6%	0.0%	-3.7%	2.3%	2.2%	-7.6%	1.9%	1.9%	1.8%	1.9%	1.7%	1.9%
Supplies & Material		33.4%	0.0%	3.5%	2.4%	2.3%	2.3%	2.2%	2.2%	2.1%	2.1%	2.1%	2.0%
General Expense		20.6%	0.0%	6.8%	0.8%	1.0%	0.6%	0.8%	0.8%	0.9%	-10.6%	0.8%	0.8%
Rents & Leases		-24.1%	0.0%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%
Facilities & Equipment		-8.0%	0.0%	3.7%	2.5%	2.4%	2.4%	2.3%	2.3%	2.2%	2.2%	2.1%	2.1%
Allocated Charges		15.5%	0.0%	11.6%	2.9%	2.7%	2.3%	2.2%	2.4%	2.4%	2.3%	2.3%	1.9%
Total Non Sal/Ben Before Transfers		3.1%	3.1%	3.0%	2.3%	2.2%	-2.3%	1.9%	2.0%	2.0%	0.5%	1.9%	1.8%
Operating Transfers-Out		-0.7%	0.0%	3.1%	0.7%	0.7%	0.8%	0.7%	0.8%	0.8%	0.7%	0.8%	0.8%
Transfer to Infrastructure - Base		-34.8%	0.0%	136.8%	27.8%	21.8%	17.9%	2.2%	2.2%	2.2%	2.2%	2.3%	2.3%
Transfer to Infrastructure - TOT		147.6%	-4.1%	63.3%	37.7%	17.7%	3.3%	3.0%	3.8%	4.1%	4.9%	5.0%	5.2%
Total Use of Funds		12.7%	-0.8%	9.9%	5.6%	4.5%	1.9%	1.7%	2.2%	2.0%	1.7%	2.1%	1.3%

FY 2022 Preliminary First Quarter Adjustments
On October 25, 2021 the City Council received preliminary information on the City's financial condition as of the first quarter (Q1) of FY 2022. That report indicated a gradual improvement in the local economic outlook, similar to national trends. During that meeting, Council also approved several budgetary and staffing adjustments to realign resources with priorities identified by the City Council after the FY 2022 Adopted Budget (CMR 13439). Ongoing adjustments from FY 2022 Q1 are part of this forecast, including the addition of economic development coordination and management staffing (1.00 FTE Assistant to the City Manager) housing support operations program staffing (1.00 FTE Assistant to the City Manager), Development Center front desk staffing (1.00 FTE Administrative Associate III), and the restoration of the Public Safety Communications Manager (1.00 FTE). The City Council also expressed interest in staff bringing forward an additional action in FY 2022 to add a Code Enforcement Officer (1.00 FTE, approximately $170,000 including staffing and vehicle costs) to support enforcement of the ban on gas powered leaf blowers and address the backlog of code enforcement requests. Various one-time adjustments were also approved, which are detailed in CMR 13439. These one-time adjustments are contemplated in this forecast in that they impact the FY 2023 estimated beginning balance of the Budget Stabilization Reserve (BSR).

In addition to these actions, Council also approved the acceptance and appropriation of a Staffing for Adequate Fire Emergency Response (SAFER) Grant to reimburse the City for an additional 5.0 FTE Firefighter positions for three years (CMR 13643). These positions have been assumed in this forecast along with the ongoing costs associated with the positions once the grant funding ends in FY 2025.

Salary and Benefits
The table above depicts the estimated General Fund salaries and benefits costs. Consistent with prior years, the FY 2023 salaries and benefits costs represent approximately 60 percent of the General Fund budget expenditures.

Salary and Benefits are projected to increase $7.2 million or 5.2 percent from the prior year, from $131.5 million to $138.8 million. Discussed in the following sections, this is primarily attributable to increases in salaries ($3.2 million or 4.7 percent) and pension costs ($2.7 million or 7.8 percent).

Salary
Consistent with the City's salary budget methodology for recent budgets, positions are budgeted at the actual rate of pay of employees including benefit selections as of Fall 2021. 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 at the end of their agreement terms. The forecast assumes step increases for employees in applicable positions, including SEIU, IAFF, and PAPOA, and merit increases for Management and Professional employees. A general wage

adjustment of 2.0 percent is included for all employees and all years of the forecast since no MOA's are in effect. This is consistent with prior Council direction in previous long range financial forecasts to use the 2.0 percent increase as a forecasting assumption, not as a commitment to future negotiations.

Benefits

Pension: Pensions are budgeted based on CalPERS determined rates as of the June 30, 2020 valuation (CMR 13440) 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 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 41.8 percent in FY 2022 to 42.9 percent in FY 2023. In the safety plan, total costs are projected to increase from the current 69.6 percent in FY 2022 to 71.1 percent in FY 2023. 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 percent of the employer pension cost and that safety plan members will pick up 3 to 4 percent.

TABLE 15: CalPERS' Projected FY 2022-2032 Blended Retirement Rates

(percentage of payroll)

	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 20230	FY 2031	FY 2032
Miscellaneous	41.8	42.9	43.5	44.1	41.5	37.6	37.2	36.7	36.3	36.0	32.6
Safety	69.6	71.1	72.9	74.0	74.0	73.8	73.1	71.3	70.4	69.5	66.0

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"), and adopting a Pension Funding Policy. In January 2017 the City council authorized the establishment of a Pension Trust Fund with the Public Agency Retirement Service (PARS) (CMR 7553). Contributions were initially made to the Pension Trust on an ad-hoc basis, using one-time savings or excess revenues. In October 2018, the City Council directed staff to include in budget assumptions the NC for pension benefits at an equivalent of 6.2 percent discount rate and a transfer of the additional ("supplemental") funding beyond CalPERS actuarial determined contribution levels to the Pension Trust Fund (CMR 9740). Additional one-time contributions continue to be made each year if excess revenues or unspent savings are available, subject to City Council approval. This practice was reinforced in the development of a Pension Funding Policy, adopted by the City Council in November 2020 (CMR 11722). As part of policy goals, the City seeks to reach a 90 percent 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. Staff anticipates returning in Fall 2022 with this analysis. In this forecast, an approximate $5.2 million ($3.1 million in the General Fund) in supplemental contributions is assumed in FY 2023, relatively constant to prior year contribution levels. Through FY 2022, a total of $40.2 million in principal contributions will have been made to the Pension Trust.

In the General Fund, it is anticipated the City will spend a total of $37.3 million on total pension costs in FY 2023, including both CalPERS contributions and supplemental Pension Trust Fund contributions. This is approximately $2.7 million higher than the prior year costs of $34.6 million, or a 7.8 percent increase. These expenses represent approximately 16 to 17 percent of the General Fund's total expenses.

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 most recent actuarial study prepared by Bartel Associates, which is completed every two years. The most recent study was completed in May 2021 to inform the development of the FY 2023 and FY 2024 operating budgets. Consistent with City Council direction (CMR 11284), this forecast continues the practice to budget the cost for retiree healthcare at a more conservative 6.25 percent discount rate and transmit the amount above the required payment as an additional discretionary payment ("prefunding") to the California Employers' Retiree Benefit Trust (CERBT) Fund. In FY 2022, this additional contribution is approximately $2.2 million ($1.4 million General Fund). The City continues to budget for the full payment of the Actuarial

Determined Contribution (ADC) for retiree healthcare. 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. This implied subsidy effectively lowers the funding necessary to meet the ADC. The FY 2023 Budget estimates $9.3 million for ADC, an approximate $500,000 or 5.7 percent increase from FY 2022 levels of $8.8 million.

TABLE 16: Retiree Medical General Fund Contributions (Millions)

FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032
$9.3	$9.5	$9.8	$10.1	$10.1	$10.9	$11.2	$11.5	$11.9	$12.3

Workers' Compensation: The budget appropriation for workers' compensation includes an estimate for claims incurred and reserves for current filings at an 85 percent confidence level, based on actuarial studies completed by Bickmore. In FY 2021, claims expenditures decreased slightly by $340,000 or 5.3 percent from $6.4 million to $6.1 million from the prior year. Actuarial estimates completed in August 2020 informed FY 2022 budget levels of $5.9 million ($3.9 million in the General Fund). More recent actuary estimates completed in August 2021 project higher than expected levels for FY 2022 at $6.3 million ($4.2 million in the General Fund). Staff will continue to monitor expenditures in the fund and bring forward adjustments as necessary. Estimates for FY 2023 are $6.6 million ($4.4 million in the General Fund), representing a $0.8 million increase ($0.5 million in the General Fund) or 12.8 percent increase over the Adopted FY 2022 Budget of $5.9 million ($3.9 million in the General Fund). Estimates for workers' compensation increase in the forecast at rates consistent with general CPI increases.

Contract Services

This forecast assumes contract services of $29.1 million in FY 2023, a 3.7 percent decrease from the FY 2022 Adopted budget of $30.2 million. This decrease is driven primarily by the removal of one-time costs adopted in FY 2022 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 3.7 percent CPI cost increase in FY 2023 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 further department base budget requests as part of the FY 2023 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 in within the ten-year forecast period. A preliminary total estimate of $0.1 million for costs associated with the Boulware Park Improvements (PE-17500) and Library Automated Materials Handling (LB-21000) projects that are anticipated to come online in FY 2023. Additional cost increases are included throughout the ten-year forecast, primarily due to estimated operating impacts from the Public Safety Building (PE-15001), Fire Station 4 (PE-18004), Dog Park Installations (PG-18001), and Park Restroom Installations (PG-19000).

TABLE 17: FY 2023 – FY 2032 Committed Additions (Millions)

FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032
$0.1	$0.5	$0.6	$0.6	$0.6	$0.7	$0.7	$0.7	$0.7	$0.8

Supplies and Materials
The FY 2022 Adopted Budget for the General Fund included $3.0 million for Supplies and Materials, which is anticipated to increase slightly by a 3.7 percent CPI cost increase in FY 2023 to $3.1 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 as part of the FY 2023 budget process.

General Expense
This category includes costs for travel and meetings, telephone and non-city utilities, contingency accounts, bank card service charges, and subsidies and grants provided through the Human Services Resource Allocation Program (HSRAP). The FY 2022 Adopted Budget of $7.9 million is expected to increase to $8.5 million in FY 2023, primarily due to a $1.0 million increase for Project Homekey (discussed further below) and a 3.7 percent 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. These increases are partially offset by a $0.8 million decrease for the removal of the Budget Uncertainty Reserve in FY 2023. It is expected that the estimated CPI increases will be substituted with department base budget requests as part of the FY 2023budget 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). 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 starting in 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 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). A new Cubberley lease was approved by the City Council in June 2020 (CMR 11460) for a smaller portion of the Cubberley site with a correspondingly lower base rent payment(CMR 11386). 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 below. With the Cubberley Infrastructure funds set aside, the monthly base rent for the Cubberley premises is $228,000 throughout the term or $2.7 million annually. The monthly base rent may be reduced by $14,000 per month if the JMZ Building is returned to PAUSD and $6,000 per month if the S Building is returned. The Community Services Department is currently in negotiations with PAUSD to expand the Cubberley premises by renting additional space from the M Building. Separately, the City leases extended child daycare site from PAUSD on a two-year lease from July 2020 to June 2022. The combined monthly rent for the child daycare sites amounts to $59,000 plus $4,000 for utilities ($756,000 annually for rent and utilities).

Rents and Leases

The Rents and Leases expense category for FY 2023 is estimated to increase from the prior-year level by approximately 3 percent based previously negotiated lease increases and remain at $1.0 million. 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). 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). 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 increase from the FY 2022 Adopted level of $427,000 to $443,000 by a 3.7 percent CPI cost increase in FY 2023 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 budget category includes subscription payments for equipment like public safety radios as well as other non-capital equipment.

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 2022 Adopted Budget for the General Fund included $20.1 million for these expenses, including utilities usage, general liability insurance, technology costs, vehicle equipment maintenance and replacement costs and other charges. The FY 2023 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 2023 is anticipated to experience an increase of 11.6 percent to a total of $22.4 million. This change is primarily due to a general CPI cost increase of 3.7 percent across most allocated charges; however, several of these charges have increased more significantly due to anticipated cost increases for Liability Insurance and Technology services. In addition, the two-year reduction of vehicle replacement charges approved by Council as part of the FY 2021 Adopted Budget has been restored as of FY 2023, increasing that charge by $1.4 million.

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 2022 Adopted Budget included Operating Transfers Out of $4.3 million. In FY 2023, Operating Transfers Out are anticipated to increase to $4.4 million as a result of standard annual cost escalators of transfers between the General Fund and the Electric and Technology funds.

Transfer to Infrastructure

During the development of the FY 2022 budget, uncertainties from COVID-19 were anticipated to significantly decrease TOT revenues, which represents a significant portion of the General Fund transfer to the Capital Improvement Fund. The anticipated impact was reflected in the FY 2022 Adopted General Fund transfer to the Capital Improvement Fund, which was $8.5 million and comprised of a$2.6 million base transfer including interest earnings and $5.9 million from TOT revenue generated through an additional voter-approved 3.5 percentage point TOT increase. Incremental TOT increases from the voter-approved rate increase and new hotels are dedicated to the Capital Improvement Fund to support the 2014 Council Infrastructure Plan, consistent with City Council direction. As the local economy continues to recover from the COVID-19 pandemic, this forecast estimates transfers from TOT revenues in FY 2023 are currently projected to increase to $9.2 million and the base transfer to increase to $10.7 million for a total $19.9 million transfer to the Capital Improvement Fund. This forecast continues the goal established as part of the 2022-2026 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, described earlier in this document.

Budget Stabilization Reserve

The City's Budget Stabilization Reserve (BSR) serves as the primary General Fund reserve. By policy, the BSR is maintained in the range of 15 to 20 percent of General Fund operating expenditures, with a target of 18.5 percent. Any reduction to the reserve below 15 percent requires City Council approval. At the discretion of the City Manager, any BSR balance above 18.5 percent may be transferred to the Infrastructure Reserve (IR), which was established to provide funding for maintenance and rehabilitation of the City's capital assets. The BSR is used to fund unanticipated one-time costs as opposed to ongoing or recurring operating expenditures. The City's intent is to fund ongoing programs and services with ongoing dollars. Maintaining the BSR at 18.5 percent also provides flexibility 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 2021 Annual Comprehensive Financial Report (ACFR) CMR 13501, the City's current BSR balance is $43.3 million, approximately $4.6 million above the 18.5 percent target. In addition to the additional funding from FY 2021, this report estimates that FY 2022 could end the year with a surplus of $10.7 million, based on the current trends of a number of major tax revenue categories, compared to the FY 2022 Adopted Budget. This one-time funding surplus compared to the FY 2022 budget has not been factored into the 2023-2032 LRFF assumptions. Use of this funding is discussed further in the Conclusion section of this memorandum.

Assumptions NOT Included in Forecast

It should be noted that this forecast does not include several potential impacts to the FY 2023-2032 LRFF that are outlined below. 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). This project will rapidly deploy modular housing to provide interim housing opportunities for homeless individuals and families in the City of Palo Alto. As discussed previously, this LRFF includes the City's committed investment of $7.0 million in operating expenses ($1.0 million annually starting in FY 2023 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 up or down throughout the ten year period.

November 2022 Ballot Initiatives: In 2019, the City Council approved the Fiscal Sustainability Workplan (CMR 10267), which included the exploration of a revenue generating ballot measure. Work on this initiative was suspended in March 2020 as part of the City's pandemic response. Resumption of this effort was outlined in the Community and Economic Recovery Workplan and 2021 Council Priorities and on June 15, 2021, the Finance Committee (CMR 12299) recommended that the City Council approve the Ballot Measure Workplan. On August 16, 2021, the City Council (CMR 12381) approved the workplan for a revenue generating November 2022 ballot measure that was recommended by the Finance Committee and staff. The Ballot Measure Workplan contains three major components: analysis, polling, and outreach. Full implementation of this workplan will require significant resources, including internal staffing and consultant expertise as well as extensive stakeholder engagement.

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 green house gas (GHG) emissions to 80 percent below 1990 levels by 2030 (the "80 x 30" goal). In April 2021 (CMR 12009), Council reviewed the S/CAP Update Report, provided feedback on policy tools, directed the Mayor to form an S/CAP Ad Hoc Committee, directed staff to pursue near-term actions in parallel to the S/CAP Update, and directed staff further develop various elements of the S/CAP. The S/CAP Ad Hoc Committee launched in August 2021 and the City is currently in the process of finalizing the proposed S/CAP Goals and Key Actions as well as the Three-Year Work Plan, which was created at the direction of the April Council motion. The final S/CAP Report and Three-Year Work Plan will be brought to Council for acceptance in Spring 2022 and CEQA review will commence once the S/CAP Goals and Key Actions are finalized. 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 as well as stakeholder engagement.

Service reductions not restored to pre-pandemic levels: The base case LRFF assumes that the significant reductions taken in the FY 2021 and FY 2022 Adopted Budgets continue throughout the forecast period, unless otherwise restored by subsequent City Council actions, including those taken in FY 2022 Adopted and FY 2022 Q1. A summary of Q1 adjustments is included in this report in the section entitled FY 2022 Preliminary First Quarter Adjustments. Full restoration of remaining reductions is modeled in Alternative Scenario A. The following is a high-level summary of the reductions in FY 2021 in response to the initial economic impacts of COVID-19, as originally stated in the FY 2022-2031 LRFF (CMR 11954). For a detailed listing of adjustments, including FY 2021 and FY 2022 reductions and restorations and other FY 2022 actions, see relevant CMRs including the FY 2021 Budget Adoption (CMR 11330), FY 2022 Budget Adoption (CMR 12307), FY 2022 Q1 (CMR 13439), and listing of other budgetary amendments.

Community & Library Services: FY 2021 reductions included $0.3 million in program revenues and $4.9 million in expenses in the General Fund, including 16.1 full-time and 21.02 part-time staffing reductions (finalized in FY 2022). These actions reduced library hours at all branches, keeping smaller libraries (Children's, Downtown, and College Terrace) open three days a week and full-service branches (Mitchell Park and Rinconada) open six days per week. This includes greater cost-recovery through changes in service delivery, charges for services, and/or limiting operating hours for facilities such as the new Junior Museum and Zoo (JMZ), community centers, open space preserves, the Children's Theatre, and the Art Center. These actions also reduced or eliminated programming such as special events, art exhibits, human services activities, and teen programs.

Planning, Transportation, and Infrastructure: FY 2021 reductions included $2.1 million in program revenues and $6.1 million in expense in the General Fund, including 8.25 full-time and 1.44 part-time staffing reductions (finalized in FY 2022). Included were actions to reduce administration, code enforcement, front counter support, and inspection services. Understanding that this could delay services to the development community, the building inspection and plan review team was reorganized to minimize the impacts to lead times for inspections, progress on the Energy Reach Code, and the ability to meet next day inspections. The Crosstown and Embarcadero shuttle programs were eliminated, and the delivery of this service redesigned to reduce costs. Additionally, funding for tree trimming and vehicle replacement was reduced for one year and rate changes in various utility enterprise funds were suspended.

Public Safety: FY 2021 adjustments included an increase of $1.55 million in program revenues and a reduction of $7.3 million in expenses in the General Fund, including 33.27 full-time and 2.28 part-time staffing reductions (finalized in FY 2022). These actions included suspensions of specialized police units such as the traffic enforcement and investigation units to maintain minimal police patrol services and shift the priority of police services to urgent calls, lowering capacity to respond to nonurgent calls. Additional changes included limited officer training, promotional testing, uniform purchases and eliminated or changed to full cost recovery non-essential programming such as school resource officers. Curtailed dispatch, communication, and emergency preparedness services, as well as emergency incident response and training and work to adopt fees to increase revenue for first responder and ambulance subscription were also included in the actions.

Internal Services & Council Appointed Officers: FY 2021 reductions included $2.9 million in operating expenses in the General Fund, including 5.9 full-time and 0.96 part time staffing reductions (finalized in FY 2022). Internal Services departments include the Information Technology, Human Resources, and Administrative Services Departments as well as the Council and appointed officers (City Manager, City Attorney, City Auditor and City Clerk). Reductions in these areas align with the changes in services, increasing timeframes for assistance and review in areas such as recruitments, procurements, performance reporting, and risk management. Technology solutions will be constrained to only essential contracts and systems and support equipment needs as majority of our workforce continues to work from home. The City Council, Innovation and Special Events, and Human Recourses contingency accounts were eliminated in FY 2021 on a one-time basis.

<u>Significant code and ordinance updates:</u> Updates to several significant programs, codes, and ordinances such as the Seismic Inventory ordinance and program, Historic Building survey and ordinance, and a zoning code update are expected to be necessary in the near future. Depending on future Council direction and the results of program and survey updates, implementation is anticipated to require significant resources, including internal staffing and consultant expertise.

<u>Labor negotiations:</u> As of the timing of this report, there are no agreements in effect for FY 2023 and beyond. The City’s current agreements with safety units are set to expire on June 30, 2022. These safety units are the Palo Alto Peace Officers Association (PAPOA), the International Association of Fire Fighters (IAFF), Fire Chiefs Association (FCA), and Palo Alto Police Management Association (PAPMA). Additionally, the City's agreement with the Management and Professional group is set to expire June 30, 2022. Agreements with the Service Employees International Union (SEIU) extends through December 2021 and new labor agreements are anticipated with the Utilities Management and Professional Association (UMPAPA) whose contract expired June 30, 2020.

<u>CalPERS Pension Updates</u>: As of the timing of this report, the CalPERS board completed their Asset Liability Management (ALM) process which reviews capital market assumptions and strategic asset allocation and sets the discount rate for future periods. This comprehensive review is completed every four years. Most significantly, this study resulted in actions that reduce the discount rate from 7.0 to 6.8 percent, add 5 percent leverage to the asset allocation mix, and increase the normal cost paid by Public Employee’s Pension Reform Act (PEPRA) employees. Most PEPRA employees will see median increases ranging from 1.2% in miscellaneous plans to 1.5% in safety plans in their total normal cost. These changes, as well as preliminary 21.3 percent returns for the period ending June 30, 2021, will materialize in City finances beginning in FY 2024. Overall, CalPERS expects that many plans will see required

employer contributions that are comparable to or slightly lower than previously determined contribution requirements. Additional information can be found in the CalPERS news release issued on November 15, 2021: https://www.calpers.ca.gov/page/newsroom/calpers-news.

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 2022 Adopted Capital Budget anticipated that these projects would cost $259.8 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. On April 26, 2021, the City Council eliminated two South Palo Alto Tunnel Alternatives from consideration after receiving the final report and recommendations from the Expanded Community Advisory Panel (XCAP) (CMR 12185). Staff is currently in process to provide a detailed review of the alternatives in consideration and seeking Council direction for additional studies to further narrow alternatives in consideration for selection of a preferred alternative.

In FY 2022, staff plans to conduct additional studies as directed by the Council and work with the Rail Committee for the selection of preferred alternative(s). Once preferred alternatives are selected, the next phase will include preparing preliminary engineering and environmental documents, which is anticipated in FY 2023 for the three crossings. The Valley Transportation Authority (VTA) 2016 Measure B Caltrain Grade Separation funding will be available to the City for funding the next phases of the project including preliminary engineering and environmental review, right-of-way, design, and construction.

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. The City anticipates allocation of 50% of said funding. 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 2023 – FY 2032). 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.

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

Racial Equity Work: The Race & Equity Framework and action plan was approved in June 2020 (CMR 11441) and remaining funding of $0.5 million has been reappropriated to be available in FY 2022. 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 forthcoming and will likely require additional funding either for more consultant assistance and or an ongoing in-house Equity Officer position (which was discussed during the 2020 Ad Hoc Committee meetings). These recommendations are anticipated to be brought forward as part of the FY 2023 or 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 demolish the current shelter and build a state-of-the-art animal shelter for the City. The City anticipated that the cost of the rebuilding would be shared between the City and PIN; however, in November 2021 PIN announced a decision to end the operating agreement with the City in FY 2022. Due to the recent nature of this decision, this forecast does not contemplate alternative operating plans nor the necessary investments to execute the rebuild.

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. In FY 2022 the City Council directed a funding strategy for the Roth Building Rehabilitation Project, which consisted of utilizing $4.0 million from a variety of funding sources including the Stanford University Medical Center (SUMC) fund community and infrastructure funds, parks impact fees, and community center impact fees (CMR 12307). 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 that concept plan in excess of the dedicated Cubberley infrastructure funding included in the existing agreement between the PAUSD and the City are not assumed in this Forecast. 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.

Loans for special projects: From time to time the City's General Fund will assist other City operations with modest cash flow loans to bridge fiscal years. For example, the City provided over $3 million in loans to the Airport Fund as it works to secure significant grant funding from the Federal Aviation Administration (FAA) for capital improvement costs. As of 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. Additional loans from the General Fund are not assumed in this forecast.

Legislative Updates: Various actions at the state and federal level that could impact the City of Palo Alto have not been incorporated into this forecast due to the changing context and uncertainty of the quantitative impacts of potential legislative changes. This includes the Cadillac Healthcare Tax at the federal level, property tax changes at a state level, and state-level efforts focused on the provision of affordable housing. As uncertainty regarding the potential impact of various legislative initiatives is 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.

FY 2023 Budget Development Guidelines
As discussed earlier in this document, this preliminary forecast represents the initial steps of the FY 2023 budget development process. In the FY 2019 – FY 2028 Long Range Financial Forecast presented in December 2018, staff included budget development guidelines based on the trends that were identified and the anticipated fiscal condition of the City. Due to the clear overlap of projecting the City's fiscal condition 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.

As the City and the County continue to move through recovery from COVID-19, the local economy and major tax revenue categories are showing signs of rebounding. City operations, which were adapted to best support and serve the community during County Public Health Orders and State Public Health restrictions, are returning to in person delivery where possible. However, as mentioned in the preliminary FY 2022 Q1 financial status report (CMR 13439), there are several issues across the City impacting the ability to transition out of the pandemic that could continue into FY 2023:

- Staff turnover across City departments is slowing the ability to restore programs and services impacted by the pandemic, coupled with the addition of new projects and priorities identified by the Council subsequent to the 2021 priority setting and FY 2022 Budget Adoption.
- Challenges with recruiting and hiring, due to the number of vacancies and the services restored in the FY 2022 Budget, are also contributing to slower service restoration.
- Supply chain issues related to manufacturing and construction are impacting various programs across the City, including replacement of City fleet vehicles, and acquiring materials for construction projects.

This year, the FY 2023 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. Further, strategic work is underway focused on a Community and Economic Recovery Strategy. Key to the City Council's and staff's fiscal and recovery planning is the important work underway to understand the fiscal implications of a revenue generating ballot measure for the November 2022 election. This also includes the potential for City actions to affect economic recovery and associated impacts on City revenues. This, in turn, affects the level and nature of services the City can deliver to the community.

When the Fiscal Sustainability Workplan (CMR 10267) was approved by the City Council on April 22, 2019 drafting a budget development policy was listed as part of the "Newly proposed or potential activities proposed to be completed". The inclusion of Budget Development Guidelines in 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.

Conclusion

The financial impacts of the COVID-19 pandemic and health orders significantly restrained consumer spending, resulting in a weakened job market, and uncertainty; however, positive trends in major tax revenue categories that began in Q4 of FY 2021 and continue into Q1 of FY 2022 indicate that the economy is slowly recovering. This preliminary forecast provides context to begin discussions on how to approach restoring services back to pre-pandemic levels while keeping in mind the budget constraints still facing the City in the first couple years of the forecast.

The forecast does not assume restoration of the service changes experienced in FY 2021 and FY 2022, and as seen in Alternative Scenario A below, incoming resources are not enough to sustain full restorations in FY 2023 and beyond. Alternative Scenario B, examines a competitive market adjustment for labor, and demonstrates that this adjustment would cause a longer gap as compared to the base case forecast. As mentioned previously, there is one-time funding of $4.6 million from savings in FY 2021 and there is an anticipated surplus of up to approximately $10 million in FY 2022. This figure is above the preliminary estimate provided to the Council in the Preliminary FY 2022 Q1 Financial Status report in October 2021 of additional revenues of $5 million - $6 million and is primarily driven by updated Sales Tax figures. When combined, these one-time surplus funds from FY 2021 and projected in FY 2022 have not been factored into the 2023-2032 LRFF assumptions. The City Council provided staff direction as part of the Preliminary FY 2022 Q1 Financial Status report to bring forward recommended allocation of these surplus funds as part of the FY 2022 Mid-Year Budget Review, which staff anticipates bringing for Council review in the first quarter of the new calendar year.

With regard to the $4.6 million, since it is savings from FY 2021 and above the 18.5 percent BSR target, by City Council approved current policy, the funding would be allocated 50% to be transferred to the Section 115 Pension Trust and 50% transferred to the Capital Improvement Fund for infrastructure investment. Given the additional financial variables, additional options for allocation may include: increase funding in the Utility Transfer Litigation Reserve, restoration of services and/or investment in high priority projects, or left in the BSR to be discussed as part of the FY 2023 budget. Final recommended actions will be brought forward as part of the FY 2022 Mid-Year Budget Review as noted previously.

Alternative Scenarios for Consideration

Alternative Forecast Scenario A: Restoration of Service to Pre-COVID-19 Service Levels

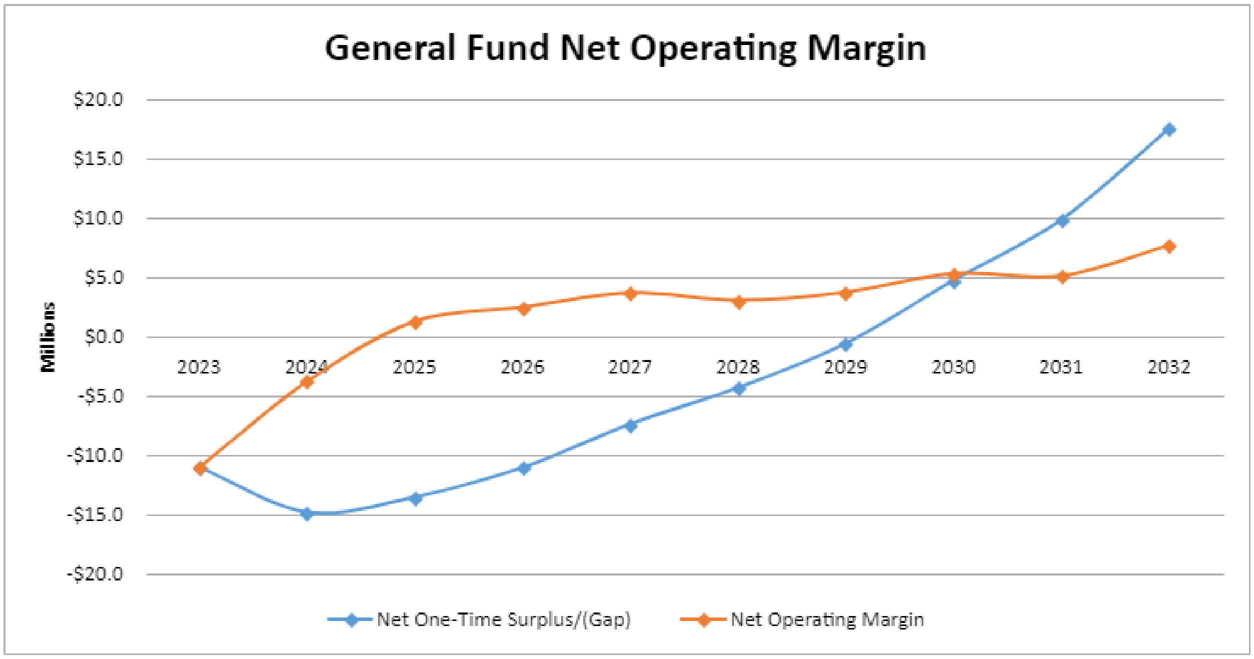
As discussed in the Assumption NOT Included in Forecast section above, the base case forecast does not include restoration of services that were impacted as a result of the COVID-19 pandemic, other than specific actions taken by Council in the preliminary FY 2022 Q1 financial status report (CMR 13439). Those items have been outlined in the FY 2022 Preliminary First Quarter Adjustments section of this memorandum. This alternative forecast models the impact of restoring City Services to the pre-pandemic levels in FY 2023. 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 18: FY 2023 – FY 2032 Long Range Financial Forecast
Alternative Forecast A

	Actual 2021	Adopted 2022	Projected 2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Total Revenue	$200,925	$206,452	$218,167	$230,393	$239,692	$252,271	$259,853	$268,149	$277,233	$286,670	$297,136	$308,506	$320,187
			5.7%	*5.6%*	*4.0%*	*5.2%*	*3.0%*	*3.2%*	*3.4%*	*3.4%*	*3.7%*	*3.8%*	*3.8%*
Total Expenditures	$185,634	$209,210	$207,468	$241,427	$254,509	$265,803	$270,902	$275,517	$281,541	$287,238	$292,380	$298,637	$302,630
			-0.8%	*16.4%*	*5.4%*	*4.4%*	*1.9%*	*1.7%*	*2.2%*	*2.0%*	*1.8%*	*2.1%*	*1.3%*
Net One-Time Surplus/(Gap)	**$15,291**	**($2,758)**	**$10,699**	**($11,034)**	**($14,817)**	**($13,531)**	**($11,048)**	**($7,369)**	**($4,308)**	**($568)**	**$4,756**	**$9,869**	**$17,557**
Cumulative Net Operating Margin (One-Time)													($30,493)
Net Operating Margin			**$0**	**($11,034)**	**($3,782)**	**$1,285**	**$2,483**	**$3,680**	**$3,061**	**$3,741**	**$5,323**	**$5,113**	**$7,688**
Cumulative Net Operating Margin													$17,557

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

TABLE 19: FY 2021 –2030 Long Range Financial Forecast Net Operating Margin
Alternative Forecast A



Compared to the Base Case, the General Fund would have a large gap of approximately $11.0 million in the first year of the forecast. This gap would shrink gradually until 2030, which would be the first-year revenues would be at a level to support the expenses. Although an immediate restoration of all services to pre-pandemic levels is not feasible as evidenced by this scenario, as mentioned previously in this report, thoughtful and measured restoration of high priority services that can be sustained by the recovering revenue will be brought forward for Council consideration as part of the FY 2022 Mid-Year Review as well as the FY 2023 Budget process.

Alternative Forecast B: Compensation Change Model, Near-term Adjustments

Consistent with City Council direction and past practice, the Base Case assumes a two percent general wage adjustment in the years beyond the terms of existing MOAs. This rate is used as a forecasting assumption and not a commitment for future negotiations. As of the timing of this forecast, there are no MOAs in effect. Therefore, the entirety of the forecast assumes a 2.0 percent wage increase.

This alternative scenario models the impact of a one-time adjustment in FY 2023 to increase compensation by an additional 2.0 percent above the two percent assumed in the Base Case to better align the workforce to be competitive in the market (4.0 percent total). As with other alternative models in the LRFF, this model is for forecasting purposes and is not a commitment to future labor negotiations.

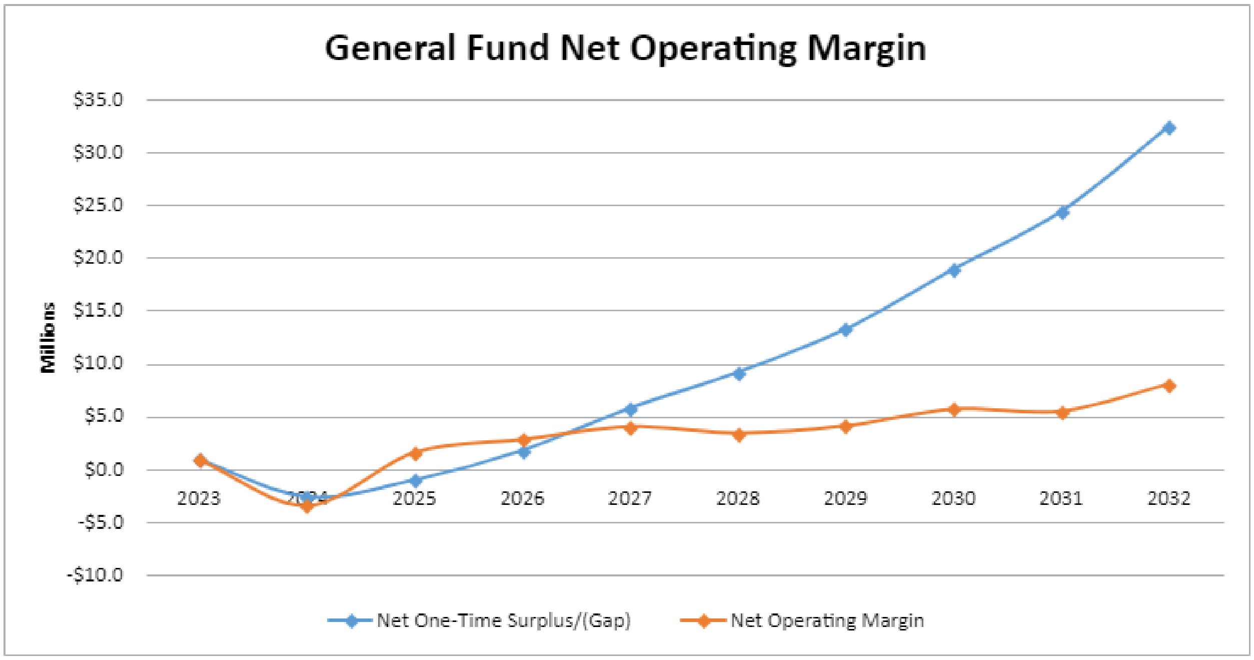
Similar to trends at the local and national level, the City is experiencing challenges in staffing a high level of vacancies due to labor shortages and an uptick in resignations that are contributing to a highly competitive labor market. As a service-driven organization, with approximately 60 percent of resources allocated to staff, the City is particularly vulnerable to the current workforce challenges. In this competitive environment, employees have more choices, and many are re-evaluating their career decisions with new perspectives. Recognition of the difficult work and continued dedication is important, and City management is working on flexible work arrangements (where feasible), advancing a positive work environment, and supporting other programs that express appreciation and reinforce Palo Alto's reputation as an employer of choice.

TABLE 20: FY 2023 – FY 2032 Long Range Financial Forecast
Alternative Forecast B

	Actual 2021	Adopted 2022	Projected 2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Total Revenue	$200,925	$206,452	$218,167	$230,393	$239,692	$252,271	$259,853	$268,149	$277,233	$286,670	$297,136	$308,506	$320,187
			5.7%	*5.6%*	*4.0%*	*5.2%*	*3.0%*	*3.2%*	*3.4%*	*3.4%*	*3.7%*	*3.8%*	*3.8%*
Total Expenditures	$185,634	$209,210	$207,468	$229,538	$242,315	$253,296	$258,074	$262,361	$268,047	$273,398	$278,186	$284,079	$287,699
			-0.8%	*10.6%*	*5.6%*	*4.5%*	*1.9%*	*1.7%*	*2.2%*	*2.0%*	*1.8%*	*2.1%*	*1.3%*
Net One-Time Surplus/(Gap)	**$15,291**	**($2,758)**	**$10,699**	**$855**	**($2,622)**	**($1,025)**	**$1,779**	**$5,788**	**$9,186**	**$13,272**	**$18,950**	**$24,427**	**$32,488**
Cumulative Net Operating Margin (One-Time)													$103,098
Net Operating Margin			**$0**	**$855**	**($3,477)**	**$1,598**	**$2,804**	**$4,009**	**$3,398**	**$4,086**	**$5,678**	**$5,477**	**$8,061**
Cumulative Net Operating Margin													$32,488

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

TABLE 21: FY 2023 – 2032 Long Range Financial Forecast Net Operating Margin
Alternative Forecast B



In FY 2023, the one-time increase of two percent adds approximately $2.8 million citywide ($1.5 million in the General Fund). Minor increases for a general 2.0 percent adjustment are forecasted in the out years. In this scenario, the initial surplus in FY 2023 is lessened compared to the Base Case and wider gaps between revenues and expenses occur in the out years of the forecast. The Base Case projected that by FY 2025, the City would begin to have a positive surplus; this alternative forecast extends the operating gap to FY 2026.

STAKEHOLDER ENGAGEMENT

The preliminary forecast for FY 2023 represents the beginning of the fiscal year 2023 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 2022, 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 2023 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 2023 Budget Development Guidelines

FY 2023 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 identified 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.

City of Palo Alto (ID # 13820)
Finance Committee Staff Report

Meeting Date: 12/7/2021

Title: Late Packet: Discuss Updates and Recommend Further Refinement of Potential Revenue Generating Local Ballot Measures

From: City Manager

This report will be a special late packet release on Thursday, December 2, 2021.

City of Palo Alto
Finance Committee Staff Report

(ID # 12394)

Meeting Date: 12/7/2021

Title: First Quarter Financial Report FY 2022

From: City Manager

Lead Department: Administrative Services

Recommendation
This report is informational and does not require an action by the Finance Committee.

Background
The purpose of this report is to provide information on the financial condition of the City's General and Enterprise Funds as of the end of the 1st quarter, September 30,2021 of fiscal year (FY) 2022. The figures presented here are unaudited.

On October 25, 2021, staff presented to Council preliminary FY 2022 Q1 financial status and discussed the preliminary highlights of the unaudited balances of FY 2021 that ended on June 30, 2021 and a status update of the City services (CMR 13439). This staff report is a follow up to the preliminary Q1 financial status that provides Q1 results and analysis.

Discussion
The FY 2022 1st quarter ended on September 30, 2021. This report summarizes the actual financial activity of the General and Enterprise Funds for the three-month period and compares those amounts to the same period of the prior year and to the FY 2022 Adjusted Budget. The economic recovery from the COVID-19 pandemic downturn began in the prior quarter with most impacted revenues showing solid upward trends.

Attachment A provides a breakdown of revenues by source and expenses by function, with separate columns for Adopted Budget and Adjusted Budget. The Adjusted Budget column includes prior year commitments that were carried forward into this fiscal year and amendments to the FY 2022 Adopted Budget through September 30. Encumbrances and actual expenses for the three-month period are also reported.

General Fund revenues (excluding operating transfers) for the 1st quarter of FY 2022 are $30.5 million and comprise 16.6 percent of the Adjusted Budget. In FY 2021 the City received $6.9 million from the American Rescue Program Act of 2021 (ARPA); however, this revenue was recognized in FY 2022 because the funds were allocated to be spent as part of the FY 2022

Adopted Operating Budget. Actual revenues for the first quarter, excluding ARPA funds, totaled $23.6 million which is 16.8 percent higher than the same period of the prior year. Cash receipts increased in all General Fund revenue categories compared to the FY 2021 1st quarter. This indicates the economy is now showing signs of economic recovery and growth from the height of COVID-19 pandemic, but it is not indicative of the annual expected receipts in FY 2022 due to timing of major revenues received over the fiscal year.

General Fund expenses for the 1st quarter, excluding pre-encumbrance and encumbrance amounts, are 0.2 percent lower than FY 2021 and are tracking at 20.8 percent of Adjusted Budget

The following is a detailed discussion of the most significant revenue and expense items.

Revenue Highlights for 1st Quarter FY 2022

The following is a table which highlights the City's major revenue sources for the 1st Quarter, compared to 1st Quarter of the prior year. Each quarter's revenue is expressed as a percentage of the Adjusted Budget for each year.

Table 1

General Fund Revenue
FY 2022 1st Quarter
(000's)

	1st Quarter Actuals			Adjusted Budget			
	FY 2022	FY 2021	% change	FY 2022	%	FY 2021	%
Property Tax	$55	$142	-61.3%	$51,228	0.1%	$52,000	0.3%
Sales Tax	1,976	1,696	16.5%	28,184	7.0%	20,500	8.3%
Charges for Services	5,327	3,837	38.8%	24,515	21.7%	25,984	14.8%
Transient Occupancy Tax	1,469	446	229.4%	8,428	17.4%	14,900	3.0%
Utility User Tax	3,473	3,325	4.5%	14,370	24.2%	15,100	22.0%
Permits and Licenses	1,872	1,560	20.0%	7,761	24.1%	7,770	20.1%
Documentary Transfer Tax	2,062	2,036	1.3%	7,137	28.9%	4,700	43.3%
All Other Revenue Sources	14,261	7,202	98.0%	41,650	34.2%	34,088	21.1%
Total Revenue	**$30,495**	**$20,244**	**50.6%**	**$183,273**	**16.6%**	**$175,042**	**11.6%**

Property tax revenue in the 1st quarter of the fiscal year is only a nominal amount as property tax receipts are paid by the County over three months beginning in the month of November and then again beginning in March. Total property tax revenue for FY 2021 was $56.6 million, $3.4 million or 6.4 percent higher than the FY 2021 adjusted budget. Robust property sales during the year resulted in higher than anticipated assessed value growth and a favorable settlement of dispute between the County of Santa Clara and the State for the calculation of the excess Educational Revenue Augmentation Fund (ERAF) distributions contributed to these increased receipts.

The FY 2022 budget amount is $51.2 million, 10.5 percent lower than the prior year's actual revenue. Since this budget was developed prior to the additional revenue receipts in FY 2021 were known, the FY 2022 current budget doesn't reflect this base increase. As a result, FY 2022 actuals are expected to be higher than the adjusted budget; however, since economic downturns impact property taxes in the second year, the FY 2022 revised forecast is expected to plateau or have a slight increase compared to the prior year's actual receipts, as discussed in the preliminary Q1 financial status update to the Council. Staff anticipates returning to Council as part of the Mid-Year Budget Review with recommended adjustments to this revenue category.

The excess ERAF distributions from the County of Santa Clara in fiscal years 2018, 2019, 2020, and 2021 receipts are $1.4 million, $2.7 million, $3.9 million, and $5.6 million, respectively. In FY2021, the dispute between the five counties including County of Santa Clara, and the State for the calculation of the Excess ERAF[1] resulted in a favorable settlement to the counties. However, as of the development of this report, In November 2021, the County informed the City that the California School Boards of Association and its Education Legal Alliance filed a lawsuit against the Controller of the State of California arguing the settlement in favor of the counties is unlawful. Staff is monitoring this and will report on significant developments.

Sales tax revenue cash receipts for the 1st quarter have increased by $280,000 or 16.5 percent, from the same period of last year. This only represents one month's sales tax activity due to delay in sales tax collection by the State and remittance to the City. The FY 2021 actual sales tax revenue was $29.1 million which is 3.1 percent higher than the $28.2 FY 2022 budget amount. While the outlook of the local activity appears positive and sales tax continues to perform well, the FY2022 estimate remains below pre-pandemic actuals of $36.5 million in FY 2019. As discussed in the preliminary Q1 financial status update to the Council, staff is evaluating the City's sales tax consultant's expectations of receipts to exceed FY 2022 budgeted levels by $2.5 million to $3.5 million. Staff anticipates returning to Council as part of the Mid-Year Budget Review with recommended adjustments to this revenue category.

Charges for services revenue is down $1.8 million or 38.8 percent, compared to the same quarter of last year is due to the following:

- Paramedic service fees increased by $341,000 over the same period of last year due to an increased number of trips and higher average amount billed per trip.
- Golf course revenue increased by $246,000 due to higher demand. All facilities are open, including the course, driving range, practice areas, and restaurant. The course is staffed and maintained under a management contract.
- Program and classes increased by $660,000. Programs and classes that were not offered due to pandemic restrictions were back and offered both in virtual and in-person.

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[1] 1 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. In a claim by the State, calculations for excess ERAF incorrectly shifted too much property tax from schools to local agencies. This has since been resolved in the favor of the local agencies.

- Plan check fees increased $145,000 due to more construction activities.

Transient occupancy tax (TOT) revenue of $1.5 million represents about one and half months of collections which is an increase of $1.0 million or 229.4 percent, compared to the same period in FY 2021. The increase is exceptionally high because this is compared to a time when a shelter-in-place order was in effect, and there was a high level of restriction to travelers. When compared to the pre-pandemic actuals of $3.2 million on the same period in FY 2020 revenues remain $1.7 million or 53.1 percent below pre-pandemic levels. As discussed in the preliminary Q1 financial status update to the Council, the July/August receipts may indicate a faster recovery than expected. Staff expects revenues to exceed FY 2022 budget estimates by up to $1.0 million and anticipates returning to Council as part of the Mid-Year Budget Review with recommended adjustments to this revenue category.

During the first two months of the first quarter, the open hotels average daily room and occupancy rates were $156.63 per day and 60.1 percent, respectively which is an increase of 34.8 percent and 26.5 percent over the same period of the prior year. For the open hotels, in August 2021, the occupancy percentage of individual hotels ranges from 27.1 percent to over 89 percent.

Utility User Tax receipts total $3.5 million, or 24.2 percent of the FY 2022 budgeted amount. This is $148,000, or 4.5 percent, higher than the prior year's receipts due to telephone UUT. This is in line with overall expectations assumed in the FY 2022 Adopted budget at this time.

Documentary transfer tax cash receipts for two and half months total $2.1 million, or 28.9 percent of the FY 2022 adjusted budget and are $26,000 or 1.3 percent higher than prior year receipts for the same period with the number of transactions being 27.2 percent higher. This revenue source is volatile since it is highly dependent on sales volume and the mix of commercial and residential sales. The prior year had a record receipt due to six major commercial sales which is not expected to be repeated in the current year. Staff will continue to monitor these receipts closely because significant fluctuations can occur anytime depending on the real estate sales activity.

Permits and licenses revenue is up by $312,000 or 20.0 percent, compared to the same quarter of last year primarily due to an increase in building fees for commercial remodel and repairs.

All other revenue sources cash receipts for the 1st quarter has increased $7.1 million or 98.0 percent, from the same period of last year primarily due to the $6.9 million received by the City from ARPA in previous year but recognized as revenue in FY 2022 because funds were allocated to be spent/replace lost revenues as part of the FY 2022 Adopted Operating Budget. All other revenue sources, excluding the $6.9 million, totaled $7.1 million which is almost equal to FY 2021.

Expense Highlights for 1st Quarter FY 2022

The following is a table which highlights the City's expenses by function for the 1st quarter, compared to 1st quarter of the prior year. Each quarter's expense is expressed as a percentage of the Adjusted Budget for each year.

Table 2

General Fund Expenses
FY 2022 1st Quarter
(000's)

	1st Quarter Actuals			Adjusted Budget			
Expenditures	**FY 2022**	**FY 2021**	**% change**	**FY 2022**	**%**	**FY 2021**	**%**
Police	$ 10,507	$ 10,274	2.3%	$ 43,319	24.3%	$ 40,590	25.3
Fire	9,137	8,608	6.1%	35,951	25.4%	33,917	25.4
Community Services	6,816	6,583	3.5%	32,098	21.2%	30,090	21.9
Public Works	3,935	4,014	-2.0%	19,980	19.7%	19,843	20.2
Planning and Development Services	3,507	3,566	-1.7%	19,855	17.7%	18,719	19.1
Library	2,055	2,198	-6.5%	8,976	22.9%	8,572	25.6
Administrative Services	1,934	1,755	10.2%	9,201	21.0%	8,645	20.3
All Other Departments	3,851	4,662	-17.4%	31,359	12.3%	25,555	18.2
Total Expenses	**$ 41,742**	**$ 41,660**	**0.20%**	**$ 200,739**	**20.8%**	**$ 185,931**	**22.4**

Total expenses for the 1st quarter of the fiscal year are up $82,000 or 0.2 percent from the same quarter of last year and are right in line at 20.8 percent of full-year budgeted amount versus 22.4 percent of the full-year budgeted amount in FY 2021. The increase is mainly due to increase in disability and workers compensation allocation charges, pension expenses, overtime, and paid leave partially offset with the decrease in regular salaries due to significant vacancies across departments.

Attachment A shows that the total expenses, including encumbrances for the 1st quarter are 29 percent of the adjusted budget primarily due to the purchase orders for Community Services and Planning and Development Services. The Community Services purchase requests / orders are for golf course management, landscape maintenance, childcare subsidy, senior services, consultant fees and others whereas Planning and Development orders are for grants and subsidies, consultant fees and others. These purchase requests / orders cover the entire year. From these encumbered funds, invoices are drawdown, or paid against them.

Police and Fire comprise 47.1 percent of the total General Fund expenditures for the 1st quarter, which is 4.0 percent higher compared to the prior year. Following is a table which highlights Police and Fire salaries and overtime for the 1st quarter.

Table 3
Police and Fire
Salaries and Overtime Expense
FY 2022 1st Quarter YTD
(000's)

	1st Quarter YTD Actuals			Adjusted Budget			
	FY 2022	FY 2021	% change	FY 2022	%	FY 2021	%
Police - Salaries	$4,241	$ 4,468	-5.1%	$17,499	24.2%	$17,321	25.8%
Police - Overtime	379	351	8.0%	944	40.1%	944	37.2%
Total Police	**4,620**	**4,819**	**-4.1%**	**18,443**	**25.1%**	**18,265**	**26.4%**
Fire - Salaries	3,219	3,513	-8.4%	13,676	23.5%	13,530	26.0%
Fire - Overtime	1,202	791	52.0%	1,931	62.2%	1,931	41.0%
Total Fire	**4,421**	**4,304**	**2.7%**	**15,607**	**28.3%**	**15,461**	**27.8%**
Total Public Safety Salaries & Overtime	**$9,041**	**$9,123**	**-0.9%**	**$34,050**	**26.6%**	**$33,726**	**27.1%**

The Police and Fire salaries decreased due to staff vacancies which resulted to higher overtime in the current fiscal year.

Police overtime is 8.0 percent higher than the prior year and 40.1 percent of adjusted budget due to backfilling vacancies and adding staffing resources to the 24/7 center as an operational necessity. As of this writing, the department has 11 vacancies: 9 police officers and 2 dispatchers and approximately 10 staff members on various categories of leave. On a combined basis, salaries and overtime are at 25.1 percent of budget through the 1st quarter of the fiscal year. The Department's overtime analysis is included in Attachment B.

The Fire overtime is 52.0 percent higher than the same period in prior year and 62.2 percent of adjusted budget. Overtime is generated when there are firefighters on leave and the department is required to backfill with overtime. The Department made deployment changes, browning out Fire Station 2 in August of 2020, however, position reductions were completed through attrition which took over six months. During that transition period in FY 2021 any available backfill staffing was used to cover vacancies on shift and did not require overtime. In this circumstance, overtime spending was unusually low. In FY 2022, the 8 positions have been vacated and eliminated and overtime spending has returned to typical levels. In addition, the Department entered into a tri-cities agreement to increase Fire Station 8 staffing during fire season that has generated additional overtime compared to FY 2021. On a combined basis, salaries and overtime are 26.6 percent of the budget through the 1st quarter of the fiscal year. The Department's overtime analysis is included in Attachment B.

General Fund Budget Stabilization Reserve (BSR) Balance

As reported to the Finance Committee on November 30, the General Fund ended FY 2021 with a Budget Stabilization Reserve of $49.1 million which is $10.4 million above the Council's 18.5 percent target of the FY 2022 Adopted expenses of $38.7 million. Use of these funds brings the BSR to $43.3 million or $4.6 million above the 18.5% target.

Enterprise Funds

Following is a summary of changes in net position for each of the Enterprise Funds for the three months ending September 30, 2021, including a comparison of results from the same period last year.

Table 4
City of Palo Alto
Enterprise Funds Change in Net Position
FY 2021 1st Quarter

	1st Qtr FY 2022	1st Qtr FY 2021	Increase (Decrease)	% Change
Water	$5,321	$6,689	($1,368)	-20%
Electric	1,943	3,644	(1,701)	-47%
Fiber Optic	170	356	(186)	-52%
Gas	(631)	(530)	(101)	19%
Wastewater collection	(32)	222	(254)	-114%
Wastewater treatment	660	1,316	(656)	-50%
Refuse	3,316	2,539	777	31%
Storm Drainage	788	737	51	7%
Airport	120	57	63	111%
Total Change in Net Position	**$11,655**	**$15,030**	**($3,375)**	**-22%**

Water Fund decreased $1.4 million from prior year due to decrease in operating revenues as a result of the lower water consumption. In response to California's drought, the Governor requested water customers to reduce usage by 15 percent compared to 2020. Click here for more information about [Water Resources – City of Palo Alto].

Electric Fund decreased $1.7 million from prior year due to lower operating revenues as a result of lower energy consumption and higher operating expenses.

Wastewater Collection Fund decreased $254,000 from prior year due to decrease in commercial retail revenues despite of the 3 percent rate increase effective September 1, 2021, as well as decrease in capacity fees.

Wastewater Treatment Fund decreased $656,000 due to timing of billing to the partners. Operating expenses are billed on a quarterly basis based on budget while true-up charges or final billing is calculated based on actuals at year-end.

Refuse Fund increased $777,000 from prior year due to increase in operating revenues as a result of higher commercial and industrial services and decrease in operating expenses such as contract services and rent. This fund completed its final payment associated with the landfill post-closure agreement, reducing the rent payment to General Fund.

Stakeholder Engagement
This effort to manage and monitor the financial status of City funds continues to be a citywide effort coordinated among all departments. Outside consultants for expertise on major revenues categories including Sales Tax and Property Tax are consulted regularly to provide updates to the forecasted revenue collections.

Resource Impact
At this time, this report does not recommend an action amending the City's financials; however, depending on trends and further input from Council, actions may be necessary later in the year to better align revenues with expected collections. The City continues to monitor activities closely. As discussed in the preliminary Q1 financial status update to the Council, staff will return to Council as part of the Mid-Year Budget Review with FY 2022 Q2 financial status information and recommended budget adjustments.

Environmental Review
The action recommended is not a project for the purposes of the California Environmental Quality Act.

Attachments:

- Attachment A General Fund 1st Quarter Report FY2022
- Attachment B Public Safety Overtime Analysis Q1 2022

ATTACHMENT A
CITY OF PALO ALTO
GENERAL FUND FIRST QUARTER FINANCIAL REPORT
FISCAL YEAR ENDING JUNE 30, 2022
(in thousands)

	BUDGET		*ACTUALS (as of 9/30/2021)*			
Categories	**Adopted Budget**	**Adjusted Budget**	**Pre Encumbr**	**Encumbr**	**Actual**	**% of Adj Budget***
Revenues & Other Sources						
Sales Tax	28,184	28,184	-	-	1,976	7%
Property Tax	51,228	51,228	-	-	55	0%
Transient Occupancy Tax	8,428	8,428	-	-	1,469	17%
Documentary Transfer Tax	7,137	7,137	-	-	2,062	29%
Utility Users Tax	14,370	14,370	-	-	3,473	24%
Motor Vehicle Tax, Penalties & Fines	1,434	1,434	-	-	72	5%
Charges for Services	24,515	24,515	-	-	5,327	22%
Permits & Licenses	7,761	7,761	-	-	1,872	24%
Return on Investment	852	852	-	-	204	24%
Rental Income	14,403	14,403	-	-	3,380	23%
From Other Agencies	10,277	10,291	-	-	6,977	68%
Charges To Other Funds	14,165	14,165	-	-	3,547	25%
Other Revenues	504	504	-	-	80	16%
Total Revenues	183,259	183,273	-	-	30,495	17%
Operating Transfers-In	23,121	23,151	-	-	5,780	25%
Encumbrances and Reappropriation	150	6,410	-	-	-	-
Contribution from Development Services Reserves	800	800	-	-	-	-
Total Sources of Funds	207,329	213,633	-	-	36,275	18%
Expenditures & Other Uses						
City Attorney	3,945	4,311	-	520	857	32%
City Auditor	972	1,001	200	41	32	27%
City Clerk	1,327	1,382	55	61	229	25%
City Council	433	465	-	38	63	22%
City Manager	3,319	3,436	0	129	613	22%
Administrative Services	8,923	9,201	1	280	1,934	24%
Community Services	31,052	32,098	698	5,589	6,816	41%
Fire	35,677	35,951	111	698	9,137	28%
Human Resources	3,878	3,913	52	27	846	24%
Library	8,903	8,976	80	368	2,055	28%
Office of Emergency Services	1,237	1,408	-	357	252	43%
Office of Transporation	1,747	1,821	0	50	336	21%
Planning and Development Services	17,673	19,855	292	4,037	3,507	39%
Police	43,116	43,319	88	824	10,507	26%
Public Works	18,755	19,980	83	1,172	3,935	26%
Non-Departmental	13,478	13,623	85	153	622	6%
Total Expenditures	194,435	200,739	1,744	14,343	41,742	29%
Operating Transfers-Out	4,296	4,296	-	-	1,075	25%
Transfer to Infrastructure	10,406	10,406	-	-	2,601	25%
Total Use of Funds	209,137	215,441	1,744	14,343	45,418	29%
Net Change to BSR	(1,808)	(1,808)			(9,143)	
Excess of Actual BSR based on the ACFR vs Adopted BSR FY2021 Year-End Estimate	-	13,127				
BSR Balance	35,962	47,281				
BSR % of Adopted Total Use of Funds	17.2%	22.6%				

* Adopted BSR reflects FY 2021 Year-End Estimate at the time of the FY 2022 Budget Adoption. Adjusted BSR reflects FY 2021 Year-End Actuals based on the ACFR, net of FY2022 Approved Adjustments to BSR.

Public Safety Departments
Overtime Analysis for Fiscal Years 2020 through 2022

	2020	2021	Q1 2022
POLICE DEPARTMENT			
Overtime Expense			
Adopted Budget **(A)**	$1,842,231	$944,186	$944,186
Modified Budget	1,842,231	944,186	944,186
Net Overtime Cost - see below	441,197	366,045	56,757
Variance to Budget	1,401,034	578,141	887,429
Overtime Net Cost			
Actual Expense	$2,566,590	$1,431,959	$378,529
Less Reimbursements			
California OES/FEMA (Strike Teams)	-	-	-
Stanford Communications	110,177	64,906	20,957
Utilities Communications Reimbursement	54,086	33,191	10,125
Local Agencies **(B)**	9,329	2,412	1,297
Police Service Fees	205,126	467,167	59,847
Total Reimbursements	378,717	567,676	92,226
Less Department Vacancies **(A)**	1,746,677	498,238	229,547
Net Overtime Cost	$441,197	$366,045	$56,757
Department Vacancies (number of days)	6,192	1,494	621
Workers' Compensation Cases	30	18	1
Department Disabilities (number of days)	700	1,324	115
FIRE DEPARTMENT			
Overtime Expense			
Adopted Budget **(C)**	$1,672,872	$1,931,121	$1,931,121
Modified Budget **(D)**	2,086,872	2,971,460	1,931,121
Net Overtime Cost - see below	1,831,059	1,792,228	1,173,049
Variance to Budget	255,813	1,026,424	758,072
Overtime Net Cost			
Actual Expense	$2,018,548	$2,840,968	$1,202,158
Less Reimbursements			
California OES/FEMA (Strike Teams)	114,000	887,531	-
Total Reimbursements	114,000	887,531	-
Less Department Vacancies **(C)**	73,489	161,208	29,110
Net Overtime Cost	$1,831,059	$1,792,228	$1,173,049
Department Vacancies (number of days)	173	1,942	76
Workers' Compensation Cases	33	17	5
Department Disabilities (number of days)	227	629	253

NOTES:

(A) The FY 2021/22 Police Department budget was reduced by 11.0 Police Officers and $900,000 in overtime.

(B) Includes Animal Control Services contract with Los Altos and Los Altos Hills.

(C) The FY 2021/22 Fire Department budget was reduced by the equivelant of 8.0 sworn positions. The overtime budget was increased over the prior year by approximately $250,000 to extend the cross-staffing of Medic-61.

(D) The FY 2021 Modified Budget includes overtime adjustments recommended as part of the FY 2021 Mid-Year review for Strike Team reimbursements ($1.0 million).

City of Palo Alto
Finance Committee Staff Report

(ID # 13728)

Meeting Date: 12/7/2021

Title: Discuss Updates and Recommend Further Refinement of Potential Revenue Generating Local Ballot Measures

From: City Manager

Lead Department: Administrative Services

RECOMMENDATION

Staff recommends that the Finance Committee recommend that Council direct staff to further refine a proposal to replace the General Fund Equity Transfer (GFET) at risk in a legal challenge considering the following options:

i. The form or forms of the proposal to poll on (percentage of gas utility gross revenues embedded within gas rates, percentage of gas utility gross revenues embedded within gas utility rates, or UUT modification to one or more utilities)

ii. Other provisions for the proposal, such as an escalation cap or provisions to gradually shift collections from the gas utility to electric utility

EXECUTIVE SUMMARY

This report continues the Finance Committee's discussion and work to explore the development of a potential revenue generating local measure for the November 2022 ballot, and seeks to refine components of a potential business license tax and weigh the tax structure of a utility on-bill tax. Specifically, the Finance Committee should consider regarding the utility on-bill tax, the City Council directed staff to model two methods to replace the gas GFET. This report outlines the two potential tax methods and compares key attributes for the Finance Committee's consideration and review. Staff is diligently working on modeling the scenarios for a potential business license tax and suggests reconvening early in calendar year 2022 to finalize this review. Following direction from the Finance Committee, staff will return to the City Council to deliberate on the first round of polling, initial review of modeling scenarios and the plan for stakeholder outreach and engagement component of the ballot measure workplan.

This CMR includes attachments that contain detailed discussion of the following:

- Utility on-bill tax refined calculations and discussion of options (**Attachment A**)
- Summary of Prior Work on Potential Revenue Generating Ballot Measures (**Attachment B**)

BACKGROUND

The City's efforts in advancing fiscal sustainability efforts have grown over the past decade. In 2019, several actions and plans were specifically outlined in the Fiscal Sustainability Workplan. The goal of the workplan was to continue to make proactive progress towards fiscal sustainability to maintain the quality of life that the City of Palo Alto supports through its services. Elements of the workplan included proactive funding contributions for the City's long-term pension and other post-employment benefits (OPEB) and strategies to structurally balance and contain cost in the City's General Fund on an ongoing basis.

The economic impacts of the COVID-19 pandemic, and efforts to contain and mitigate the spread of the virus resulted in a $40 million General Fund gap between revenues and expenses in the FY 2021 Adopted Budget. This gap was balanced through significant service reductions throughout the organization, concessions from the City's labor groups, as well as substantive reductions in the City's capital investments, impacting catch-up and keep-up costs and funding of new projects. Significant service reductions taken in FY 2021 persist this year due to both the current impacts of *Green v. City of Palo Alto*, a class action lawsuit that challenges the City's gas and electric rates under Proposition 26, and the recovery period of the pandemic. In addition, the City faces significant unmet needs in areas such as affordable housing and transportation, including but not limited to a significant capital investment in the railroad Caltrain train/grade crossings. This report represents the next step of discussions with the Finance Committee and City Council regarding a potential revenue generating ballot measure(s) to balance the project and services needs of the City with available resources.

In March 2020, the City Council, considering the uncertain economic impacts of the pandemic, paused efforts that were underway at that time to explore a revenue generating ballot measure. Resumption of this review was later outlined in the Community and Economic Recovery Workplan and Council Priority in 2021. On June 15, 2021, the Finance Committee reviewed the Workplan for the November 2022 Local Ballot Measure(s) and Affordable Housing Funding Referral (CMR 12299), where the Finance Committee recommended that the City Council:

- Approve the Ballot Measure Workplan, with a focus on development of a business tax and a utility use-based tax,
- Refinement of estimates, evaluation of a stakeholder outreach plan and polling, and
- Additional information regarding affordable housing.

These Finance Committee recommendations were considered by the City Council in their August 16, 2021 meeting (CMR 12381). Consistent with past practice, the City Council directed the Finance Committee be the main deliberative body for the development of the potential revenue generating ballot measure and, through an iterative process outlined in the Ballot Measure Workplan, that updates will be taken to the City Council for review through June 2022.

The Summary of Prior Work on Potential Revenue Generating Ballot Measures is included as Attachment B.

On September 21, 2021 (CMR 13469) and October 19, 2021 (CMR 13648), the Finance Committee directed staff to continue exploration of a business tax and utility tax by returning to the Committee with refined modeling and additional information. The Finance Committee was presented with refined modeling for the business tax and utility tax modeling and analysis, along with additional research discussing the key differences between a parcel tax and business license tax.

Following the two meetings with the Finance Committee, discussion on November 8, 2021 with the City Council (CMR 13687) considered the Finance Committee's recommendation to further explore a business license tax and a utility tax. The Finance Committee serves as the public body to review periodic progress reports and allow for structured public discussion for feedback and recommendations of the potential revenue generating ballot measure. In addition to direction regarding tax structure and modeling, the City Council also delegated the review of polls to the Finance Committee, provided that the overall ballot measure workplan stays on its timeline. The following is Council's direction to staff and the Finance Committee on November 8th:

A. *Direct staff to model a business license tax at monthly rates of $0.05 to $0.20 per square foot, with a preference for no sunset and an annual escalator, and with thresholds for square footage size and possible exemptions for:*
    i. *Small retail, measured by square footage;*
    ii. *Grocery stores;*
    iii. *No exemptions;*
B. *Direct staff to model two methods to replace the General Fund Equity Transfer (GFET) at risk in the Green case:*
    iii. *Seek voter approval in modifying the 2009 GFET formula to transfer a percentage of gas utility gross revenues;*
    iv. *Distribute the change across gas and electric as an increase in the percentage of Utility Users Tax (UUT); and*
C. *Direct staff to execute initial round of polling (**Attachment A**), delegate review of the polls to the Finance Committee, pending availability to stay on the workplan timeline, and incorporate the Council's feedback of the poll, including the modeling assumptions identified in Parts A and Parts B of the motion; and*
D. *Remove the parcel tax as an option from the polling questions.*

***MOTION PASSED** 6-1 (Tanaka no)*

Staff has launched the initial round of polling and results will be made available to the City Council estimated to be in January 2022. This staff report includes updated analysis and other information for a potential utility on-bill tax, refined for components as directed by the City Council on November 8th.

DISCUSSION & ANALYSIS

Staff has provided additional analysis in response to the direction by Council at its November 8, 2021 meeting. Staff was asked to model specific scenarios for a business license tax and a utility-related tax. This information is presented to inform Finance Committee recommendations to Council regarding the form of the utility on-bill tax proposals. This item is an incremental step in the process of reviewing fiscal sustainability measures through potential local revenue ballot measure(s). Expected early in calendar year 2022 will be an additional item reviewing more detailed scenario modeling for the potential business license tax based on square footage as well as adding the expected initial round of polling results as well. Staff does recommend, if agreeable to the Council, that if staff work is ready, a special Finance Committee meeting with the current members convene in January 2022 for continuity of this next incremental step as well as to ensure continued timely progress of this workplan.

<u>Utility On-Bill Tax (Attachment A)</u>

In the August 16, 2021 City Council meeting, the City Council directed staff to focus pursuit of a utility use-based tax to replace revenues at risk due to the *Green* case and explore the option to incorporate revenue to support the City's climate adaptability initiative. Significant detail on the options can be found in Attachment A. This attachment discusses two utility tax options, modeled to replace the current gas GFET. Under these options, the current gas GFET would end and potentially be replaced by:

1. Increasing or expanding the City's UUT(s) codified in chapter 2.35 of the City's municipal code, which would continue to appear as a line item on utility bills, or
2. Modifying the 2009 GFET formula to transfer a percentage of gas utility gross revenues. Under this option, the transfer would be embedded in utility rates.

On November 8, 2021, the City Council directed staff to perform further analysis of these two methods, focusing on either a percentage of gas utility gross revenues or an adjustment to the UUT for only the City's electric and gas utilities. Staff analyzed the key features of the two approaches to replace GFET revenue. Although both achieve the goal of recovering 100 percent of the GFET revenue currently at risk in the *Green* case, differences in revenue volatility (stability per the EASE Framework), distribution of tax between residential and non-residential customers, and impacts on sustainability efforts are key differences between these two approaches. Highlights of these key differences discussed in **Attachment A** are summarized below:

	Method 1: Increase Gas and Electric UUT	Method 2: Percent of Gas Utility Revenue
Recovers GFET revenue currently at risk	Both approaches recover 100% of GFET revenue currently at risk	
Revenue growth (Increase in annual revenue from FY 2023 to FY 2025)	Increase from $7.34 million to $8.76 million	Increase from $7.34 million to $8.61 million
	Note: due to expected utility cost and rate increases in FY 2023 to FY 2025, either of these methods would increase the GFET significantly faster than the current GFET methodology, which only is forecasted to increase from $7.34 million to $7.9 million through FY 2025.	
Revenue volatility[1]	+/- 4% to 6% variation in revenue each year based on utility use	+/- 10% to 15% variation in revenue each year based on utility use
Distribution of tax collection between residents and business/ non-Residential	Increases share of tax collection on business and non-residential taxpayers (20% residential, 80% business / non-residential)	No change from current GFET collection (40% residential, 60% business / non-residential)
Impact on sustainability efforts	Decreases cost-effectiveness of building and vehicle electrification	No impact to sustainability efforts
Impact of S/CAP goals on revenues	Achieving building and vehicle electrification goals outlined in April 2021 S/CAP impact analysis results in little change in revenue.	Achieving building and vehicle electrification goals outlined in April 2021 S/CAP impact analysis results in $3.9 million (46%) decrease in revenue.

Staff found a few notable differences between Method 1, modifying the UUT rate, and Method 2, assuming a percentage of gas utility revenues. Method 1 was less volatile, collected more tax from businesses than Method 2, decreased the cost-effectiveness of building electrification, and was significantly less affected by major shifts in electric and gas use associated with long-term S/CAP goals.

Included in **Attachment A** is a potential proposal that could take advantage of some of the features of both methods by adding a provision to Method 2 that the collection of GFET revenue would shift from gas to electric over time as gas revenues decline below a certain amount. If Method 2 were adopted with this provision in place, there would be no impact to building and vehicle electrification cost-effectiveness until electrification was well underway. This would impact gas revenues, but as that change occurred, the utility tax revenues would be collected more and more from the electric utility rather than the gas utility, avoiding the revenue decreases associated with achieving the Sustainability/Climate Action Plan (S/CAP) goals.

[1] Based on gas / electric sales revenue variations from projections over the last five years

Both approaches increased the amount of revenue transferred to the General Fund at a faster rate than the current GFET approach. The current GFET escalates at roughly 2.5% per year, while utility rates are expected to increase at a higher rate in the next few years. If Council wanted to limit the growth of either tax method to be more consistent with the rate of growth of the current GFET methodology, some alternatives are discussed in Attachment A in the section titled "Revenue Growth and Volatility of Various Utility Tax Methods vs. Current GFET."

For additional details, please see **Attachment A**.

Staff is looking for some specific feedback from the Finance Committee:

- Should staff continue to consider increasing the UUT, or solely consider a percentage of gas utility (or gas and electric utility) revenue?
- Should staff consider a measure to transfer revenue solely from the gas utility, or from both the gas and electric utilities?
  - If the latter, what percentage of revenues should staff collect from the gas utility?
  - If the former, should staff include a provision to gradually begin collecting revenue from the electric utility if gas revenues begin to decline due to electrification?
- Should staff consider a cap on total tax revenues collected or transferred?

Staff recognizes some of these questions will be further informed by the initial round of polling and expects to provide opportunity for the Finance Committee recommendation to be revisited in light of the initial polling results.

Conclusion & Next Steps

Further narrowing the focus of the potential revenue generating ballot measure is critical so that staff can continue advancing the Ballot Measure Workplan that was approved by Council in August. This staff report outlines refined analysis for the potential utility on-bill tax. As initial polling is completed and information provided to the City Council estimated in January 2022, additional exemptions and/or threshold considerations can be further refined as the ballot measure workplan proceeds and be tested through the second round of opinion research and outreach and engagement efforts.

With regards to the potential utility on-bill tax, consideration of differences between key features of each method, whether a modification to the electric and gas UUT or a percentage of gas utility revenue, should be considered, specifically in the areas of revenue stability/volatility, the distribution of tax collection between residential and non-residential customers, and impacts on S/CAP goals.

TIMELINE

The below table recaps the Ballot Measure Workplan, as approved by the City Council in August, with minor adjustments, based on the process and discussion thus far.

Ballot Measure Workplan Timeline	
November 2021 **COMPLETED**	*Council:* - Confirm potential revenue-generating proposals, including refined modeling and analysis - Direction to complete initial polling and initial stakeholder outreach
December 2021	*Finance Committee:* - Consideration of additional refinements and updates for potential revenue generating tax measure(s)
January 2022	*Recommended Special Finance Committee:* - Consideration of additional refinements and updates for potential revenue generating tax measure(s), business license tax *City Council:* Review the results of the first round of polling and the Finance Committee's recommendation from third round of staff analysis and seek direction to proceed with stakeholder outreach.
January to April 2022	*Finance and Council:* - Provide iterative policy decisions and direction based on staff work related to stakeholder outreach, polling, and draft legal documents - Second refined round of polling to be reviewed by Finance and Council decision on revenue-generating ballot measure(s) to pursue
June 2022	*Council:* - Final Approval of November 2022 Ballot Measures, including ballot measure language
August 2022	Language submitted to Santa Clara County Registrar of Voters
November 2022	Election

FISCAL/RESOURCE IMPACT

Implementation of this workplan to develop a revenue generating local ballot measure will require significant resources that include internal staff, consultant expertise, as well as stakeholder engagement. Resource needs will scale proportionately based on the ballot measure option and the complexity of the measure that the Finance Committee and City Council direct staff to pursue. It is important that the scope of the potential ballot measure(s) be clearly defined and effectively narrowed for staff to successfully progress through the workplan.

It is expected that this initiative will require an equivalent of approximately two full time dedicated staff positions and will have an impact on other projects. In addition, support is required from outside consultants and engagement with internal stakeholders in key departments. The City Council appropriated funding for this activity as part of the FY 2022 Preliminary 1st Quarter. Additional contracts and/or proposed budget amendments will be brought forward for approval as appropriate.

STAKEHOLDER ENGAGEMENT

The Ballot Measure Workplan integrates stakeholder engagement through constituent polling and stakeholder outreach. Staff, throughout the process and from previous conversations, has solicited input and feedback with the Finance Committee, the City Council, residents, and the business community. Staff received direction to proceed with initial polling at the November 8, 2021 Council meeting and plans to make available to the Finance Committee for review as soon as results are available. Based on the Ballot Measure Workplan, staff plans to seek the City Council's direction regarding initial stakeholder outreach. The City has engaged with Fairbank, Maslin, Maullin, Metz & Associates (FM3) perform polling, Lew Edwards for stakeholder engagement planning, and the Public Dialogue Consortium (PDC) for stakeholder engagement. The stakeholder outreach strategy has yet to be finalized and staff expects to return to Council with a strategy in January 2022.

ENVIRONMENTAL REVIEW

This activity is not a project under California Environmental Quality Act (CEQA) as defined in CEQA Guidelines, section 15378, because it has no potential for resulting in either a direct or reasonably foreseeable indirect physical change in the environment.

Attachments:

- Attachment A: Preliminary Utility Ballot Measure Options
- Attachment B: Summary of Prior Work on Potential Revenue Generating Ballot Measures

ATTACHMENT A

Preliminary Utility Ballot Measure Options

The City Council has directed staff, through the City of Palo Alto's conversations exploring a potential business tax, to pursue a utility users tax (UUT) and to explore the option to generate revenue to support the City's climate adaptability goals. This attachment transmits analysis related to a potential ballot measure to further the Finance Committee and City Council's conversations on this issue. In addition to potentially increasing the City's utility users tax, currently set at 5 percent, there are a variety of alternatives that the Finance Committee and City Council can consider in structuring such a tax, each of which relate to the broader question of whether and how to modify or replace the Council-adopted General Fund Equity Transfer (GFET) methodology.

At the September 21, 2021 Finance Committee meeting, the Committee directed staff to model a UUT increase applied to retail gas service charges to restore the amount at risk in the *Green v City of Palo Alto,* a class action lawsuit which challenged the City's gas and electric rates under Proposition 26. In *Green*, the trial court judge found that the City's electric rates are valid, but the City's gas rates include an element of tax requiring voter approval under California's Proposition 26 because they are set at a level sufficient to fund an annual transfer of approximately $7.7 million to the City's General Fund. Last month, City Council authorized an appeal to seek guidance from the Court of Appeal on a variety of legal questions that will impact Palo Alto and, potentially, municipal utilities across California.

The GFET is included in the City's utility rate model as an expense. With respect to electricity, the utility generates sufficient revenue from sources other than rate payers to pay for the GFET. Therefore, the electric GFET does not impact rates. With respect to gas, the GFET impacts the utility rate. The *Green* litigation has shifted the City's FY 2022 financial balancing strategy and has potentially significant, long-term budgetary impacts to the City's General Fund. If the gas GFET is excluded from Palo Alto's utility rate model, based on the FY 2022 Adopted Budget, approximately $7.4 million would no longer be transferred to the General Fund and would remain with the City's gas enterprise, reducing gas rates. **Finance Committee and City Council direction is needed on whether to seek to recover for the General Fund an equivalent amount, or some portion of the total, via a modified voter-approved GFET, an increase or expansion of the current 5 percent UUT, or some combination of both.**

This attachment discusses two utility tax options, modeled to replace the current gas GFET. Under either option, the current gas GFET would end and potentially be replaced by:

1) Increasing or expanding the City's electric and gas UUT(s) codified in chapter 2.35 of the City's municipal code, which would continue to appear as a line item on utility bills, and
2) Modifying the 2009 GFET formula to transfer a percentage of gas utility gross revenues. Under this option, the transfer would be embedded in utility rates.

This attachment also includes discussion of the following topics that were included in CMR 13514, Attachment B. Staff has included once again for ease of reference:

- Climate adaptability options that include impact on current rates and estimated generated revenue to support this initiative;
- General Fund Equity Transfer Methodology;
- Review of EASE framework as it pertains to utility users tax; and
- Utility user tax rates for cities in Santa Clara County and San Mateo County.

Method 1: Potential Modifications to the City's Gas Utility Users Tax, Chapter 2.35 of the Municipal Code

UUTs are very common across California, with the vast majority structured to create general fund revenue with majority voter approval. Roughly half of California residents and businesses pay a UUT. Enacted in 1987, the City's UUTs are applied to electricity, water and gas usage as well as telephone service. The tax rate applied to utilities is five (5) percent.

The first method of replacing the amount of the gas GFET, projected to be $7.5 million in FY 2023, would involve increasing the gas and electric UUT rates, which would **result in a 10 percent gas and electric UUT rate**, made up of a 5 percent tax on gas and electric to replace the gas GFET plus the current 5 percent rate.

Staff estimates that for every 1 percent increase to the gas and electric UUT rate, an additional $1,502,000 in UUT revenue would be generated. This calculation is based on estimated sales activity and utility rates in the FY 2022 Adopted Budget.

Table A1: Modification to City's Utility Users Taxes (Based on FY 2022 Budget and Rates)	
Estimated gas and electric UUT to replace GFET revenue	10%
Additional Revenue Generated by each additional 1% UUT change	$1,502,000

Under this approach, the amount of gas GFET currently collected via the City's gas utility rates would end, resulting in a lower average gas bill. Table A2 outlines the decrease for residential and commercial gas customers, based on rates that are effective December 2020. The average monthly gas residential bill would decrease from $45 to $37, which is 30 percent lower than PG&E's rates.

Table A2: Gas Residential and Commercial Monthly Bill Comparisons

Type	***Usage level (therms)***	***Palo Alto***	***PG&E***	***$ Difference***	***% Difference***	***Palo Alto Excluding Gas GFET***	***$ Difference***	***% Difference***
Residential	Median**	$45	$53	($8)	-14%	$37	($16)	-30%
Commercial	500	$685	$718	($33)	-5%	$562	($156)	-22%
Commercial	5000	$5,986	$6,831	($845)	-12%	$4,909	($1,922)	-28%
Commercial	10000	$11,875	$12,045	($170)	-1%	$9,738	($2,308)	-19%
Commercial	50000	$59,005	$51,419	$7,586	15%	$48,384	($3,035)	-6%

Table A2A calculates the average monthly bill for the Palo Alto and PG&E as detailed in Table A2, and layers on the current 5 percent UUT and exclusion of the gas GFET, as well as the 10 percent UUT.

Table A2A: Gas Residential and Commercial Monthly Bill Comparisons (with UUT)

Type	*Usage level (therms)*	*Palo Alto (w 5% UUT)*	*PG&E (w 5% UUT)*	*$ Difference*	*% Difference*	*Palo Alto Excluding Gas GFET w 10% UUT*	*$ Difference*	*% Difference*
Residential	Median**	$47	$56	($8)	-18%	$41	($15)	-37%
Commercial	500	$719	$754	($35)	-5%	$618	($136)	-22%
Commercial	5000	$6,285	$7,173	($887)	-14%	$5,400	($1,773)	-33%
Commercial	10000	$12,469	$12,647	($179)	-1%	$10,712	($1,935)	-18%
Commercial	50000	$61,955	$53,990	$7,965	13%	$53,222	($768)	-1%

Method 2: Potential Voter Approval of Transfer of a Percentage of Gross Utility Revenues

Another option is to leave the current UUT intact and seek voter approval to simplify the 2009 GFET methodology to impose a flat tax on gross utility revenues. The flat tax would be embedded in rates which mirrors the current practice as seen by customers. Collecting the projected annual $7.5 million gas transfer via this method would keep gas utility rates the same (in other words, they would not be reduced as shown in Table A2); because an amount equivalent to 18% of the gas utility's prior year's gross gas sales revenues would be embedded in customer rates, and then transferred to the General Fund. This would not require a change in utility rates and is consistent with how the GFET is collected now.

Several other cities with municipal utilities, including Burbank, Colton, Long Beach, Pasadena and Sacramento, structure their annual utility transfers as a percentage of gross revenues, which is then covered by utility revenues as a cost of providing service. Cities have been challenged over this practice, and this area of the law remains in flux.[1] However, California's Court of Appeal recently upheld Sacramento and Pasadena's voter-approved general fund transfer taxes, which were structured as an 11 percent and 12 percent tax, respectively, on the gross revenues of Sacramento's and Pasadena's city-operated utility enterprises.[2] Each of these taxes are embedded in the cost of providing utility services, and are not identified as a separate line item on the customer's utility bills.

[1] On December 1, 2020, the City of Long Beach lost its appeal to a challenge to its voter-approved 12 percent tax on its water and wastewater utilities, based on the theory that UUTs on services other than electric and gas are either invalid, or require 2/3 voter approval, as special taxes based on an incident of property ownership (here, on utility services). Fees for gas and electric service, however, are exempt from the California constitution's definition of property-related fee, and Long Beach's *gas* UUT was not part of this challenge.

[2] *Wyatt v. City of Sacramento*, (2021) 60 Cal.App.5th 373 (upholding 11% tax on gross revenues of city's water, sewer, storm drain and solid waste services); *Komesar v. City of Pasadena* (2021, Case No. B314666) (upholding 12% tax on gross revenues of city's electric utility). Long Beach's loss on appeal has produced a split of authority at the appellate level as to the legitimacy of all non-electric and gas UUTs statewide, which will require Supreme Court review to resolve.

Revenue Growth and Volatility of Various Utility Tax Methods vs. Current GFET

The current GFET methodology adopted in 2009[3] was based on the current depreciated value of the City's capital investments. It grew gradually based on utility investment, and growth was offset by depreciation. Because the two methods proposed for replacing the GFET are based on a percentage of revenues rather than utility investment they can grow more rapidly depending on the revenue increases adopted for utility rates.

Chart A1 below show the projected growth rate for GFET for FY 2023 to FY 2025. This is compared to the projected growth in revenue for the two GFET methods modeled. These growth projections are based on the FY 2022 Gas Financial Plan projections and FY 2022 Electric Financial Plan projections for the gas and electric utilities adopted in June of 2021.[4] As shown in the chart, transfers to the General Fund increase over the projection period relative to the current GFET methodology under both Method 1 (Increase to Gas and Electric UUT) and Method 2 (% of Gas Utility Revenue).

If there is interest in controlling the rate of escalation, there may be some possible approaches. A cap could be designated for the tax to be collected and escalated at an inflationary index. If Council adopted an increase to gas and electric UUTs, these rates could be designated as maximum rates, with rates to be set each year with the intent of collecting not more than the capped amount. If Council adopted a transfer of a percentage of gas utility revenues, the cap would be directly applied to the transfer itself (e.g. the City would transfer 18% of gas utility revenues per year, not to exceed an amount equal to the cap for that year). Included in the Chart A1 below is a series indicating how a cap set at the FY 2022 GFET amount escalated at inflation for the San Francisco Bay Area would compare to projected GFET growth under the current methodology and under Methods 1 and 2. The cap is set using the preliminary inflation assumptions embedded in the City's financial forecasts, assumed to be 3.7% for FY 2023 and 2.5% for FY 2024 and FY 2025.

[3] For more detail on the ordinance adopting the 2009 transfer methodology, see CMR 280:09, Budget Adoption Ordinance for Fiscal Years 2009 and 2010; and CMR 260:09, Finance Committee Report explaining proposed changes to equity transfer methodology.
[4] Council Staff Report #12240, June 21, 2021, https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/2021/id-12240.pdf

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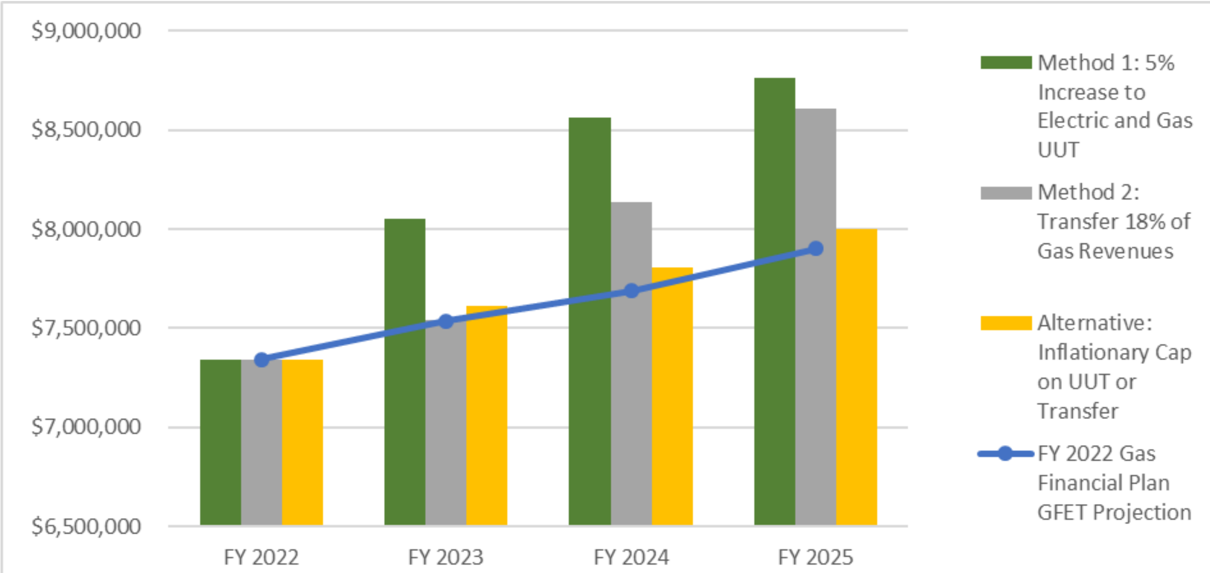
Chart A1: Growth in General Fund Revenues For Utility Tax Methods



In addition, revenues from either methodology would be more volatile than the current GFET methodology due to both changes in gas market prices and changes in gas sales year to year due to variations in winter temperatures. From FY 2015 through FY 2020 gas sales varied from 4% above to 5% below the average for that period. Market prices varied even more significantly, contributing to gas utility revenue changes varying from 11% above to 8% below the average for the period. It would not be unreasonable to assume a potential 10% to 15% potential annual swing in utility tax revenues due to the combined effects of these two factors. A major change to gas economics or problems with the regional gas transmission system can cause even greater shifts in market prices, and therefore revenues.

The revenues from both methods vary more significantly than the current GFET methodology and would require more active management by the City's Finance Department. But because the electric utility's sales revenues are more stable from year to year, the UUT method (Method 1) is less volatile than the percentage of gas utility sales (Method 2). Swings in electric sales revenue from FY 2015 through FY 2020 range from 6% below to 4% above the average for that period. Because the electric utility's taxable revenue is roughly four times as large as the gas utility's, replacing the gas utility GFET with an increase to the gas and electric UUT (Method 1) results in about 80% of the resulting revenue being based on less volatile electric utility revenue. This could significantly reduce the variability of this revenue source. However, setting a cap, as described above, would also limit the volatility of the percentage of gas utility sales methodology (Method 2). In addition, revenue volatility could be managed by the City's Administrative Services Department, which already manages revenue volatility created by the City's existing UUT. Table A3 below summarizes the volatility of the various methods and potential mitigation measures.

The last method of managing volatility could be to transfer a specific amount from the gas utility each year (e.g. $7.5 million) that escalates at Bay Area inflation or some other index rather than transferring a percentage of gas utility revenues. Staff knows of only one other agency that has taken this approach, the City of Alameda, which approved an annual transfer of $3.7 million, adjusted for inflation, from its electric utility in November 2016. The measure included a utility user's tax modernization and passed 73% to 27%.

Table A3. Estimated Revenue Volatility from Various Utility Tax Methodologies

	Method 1: Utility Users Tax on Gas and Electric Use	Method 2: Transfer of % of Utility Gross Revenues	Method 2 with Inflationary Cap on General Fund Transfer	Transfer of a Specific Amount from Gas Utility
Estimated volatility	+/- 4% to 6%	+/- 10% to 15%	Projected to be +0% to -4% by FY 2025, likely improving in later years.	None

Business / Non-Residential and Resident Impact of Utility Tax Alternatives

The City's electric utility and gas utility rely on residential and business / non-residential revenues in very different ways. Approximately 75% of electricity revenues come from business and non-residential customers, while about 50% of gas revenues come from business and non-residential customers. This means that Method 1, which involves replacing the GFET revenue with an increase to UUT for both electric and gas customers, could change the share of tax revenue collected from business / non-residential customers. Method 2, which continues the existing transfer, would not.

Impacts to Cost-Effectiveness of Building and Vehicle Electrification

The City has been updating its sustainability goals via the 2021 Sustainability and Climate Action Plan (S/CAP) update process, and decisions about utility taxes can have some effect on achieving these goals. A gas and electric UUT (Method 1) or a percentage of gross gas utility revenues (Method 2) will each affect the cost-effectiveness of building and vehicle electrification differently. A percentage of gross gas utility revenues methodology will not change the current cost-effectiveness of building and vehicle electrification. As shown above in Table A2A, the UUT methodology will lower gas bills. It would also increase electric bills 5%. The combination of these two changes would make building electrification less cost effective.

The change would only slightly lower the cost-effectiveness of EVs, since the increase in electric bills does not substantially offset the significant cost advantages of EVs in lower maintenance and fuel bills. But by significantly lowering gas bills, Method 1, the UUT, does make building electrification less cost effective. Staff was unable to do a comprehensive analysis of all building electrification measures, but Table A4, below, shows one example. The table shows the cost effectiveness of a heat pump water heater under both Method 1 and Method 2. While a heat pump water heater costs more to install, it is highly efficient, and due to Palo Alto's low electric rates relative to its gas rates, can save money on operation. Gas rates are expected to rise more rapidly than electric rates in the next ten years, giving the heat pump water heater an operational cost advantage over a gas water heater that partially offsets the higher up-front cost compared to a gas water heater. Method 1, by lowering the cost of gas and increasing the cost of electricity, would significantly decrease that cost advantage. In the example in Table A4, below, the cost of a gas water heater goes from being 87% of an electric heat pump water heater under Method 2 to 71% of an electric heat pump water heater under Method 1, increasing the cost barrier to electrification and the cost of incentives needed to help people electrify.

Note that these long-term forecasts of electric and gas rates are very uncertain and these are very rough estimates. The costs for gas water heaters and heat pump water heaters vary widely, and customer usage patterns vary. This example is intended to give some sense of how these two methods might perform under one set of assumptions, but individual project outcomes will vary widely.

Table A4. Estimated Impact of S/CAP Goals on Heat Pump Water Heater Cost-Effectiveness

	Method 1: Utility Users Tax on Gas and Electric Use		**Method 2: Transfer of % of Utility Gross Revenues**	
	Gas water heater	Heat pump water heater	Gas water heater	Heat pump water heater
Replacement cost	$1600	$4040	$1600	$4040
Cost of operation[5]	$2890	$2280	$3830	$2180
Total lifecycle cost	$4490	$6320	$5430	$6220
Gas vs heat pump water heater cost	Gas water heater cost is 71% of heat pump water heater		Gas water heater cost is 87% of heat pump water heater	

Impacts of S/CAP Goals to Utility Tax Revenue

Implementation of the City's S/CAP goals would also greatly change the composition of the City's energy use. A gas and electric UUT or a percentage of gross gas utility revenues would be affected differently. Table A5 below assumes 2030 projections of energy use with and without a significant fraction of gas uses transformed to electric uses due to S/CAP goals. It compares the utility tax revenues from both methodologies under the non-electrified and electrified scenarios. An increase to the gas and electric UUT (Method 1) preserves utility tax revenue significantly better than the percentage of gross gas utility revenues methodology (Method 2). Note that forecasts about the S/CAP and forecasts out to 2030 are very uncertain and these are very rough estimates. They are intended to give some sense of how these two methods might perform under one scenario, but should not be used for planning purposes.

Table A5. Estimated Impact of S/CAP Goals on Utility Tax Methods

	Method 1: Utility Users Tax on Gas and Electric Use	**Method 2: Transfer of % of Utility Gross Revenues**

[5] Net present value of gas bills or electric bills over 13 years, the life of the water heater.

Table A5. Estimated Impact of S/CAP Goals on Utility Tax Methods		
Projected 2030 Revenues **without** S/CAP Goals	$9.9 million	$8.4 million
Projected 2030 Revenues **with** S/CAP Goals	$10.1 million	$4.5 million
Net Gain / (Loss) Due to S/CAP	$0.2 million	($3.9 million)

Alternative to Method 1: % of Gas and Electric Utility Revenues

The Finance Committee and Council also discussed using the % of revenue methodology but spreading it across the gas and electric utilities instead of just the gas utility. This is similar to Method 1 (increasing the gas and electric UUT) in that it spreads the revenue across two utilities but differs in that the % of revenue methodology does not include any exemptions, unlike the UUT. This slightly changes the calculations. The table below shows what percentage of revenues would need to be collected from the gas and electric utilities to generate $7.5M in revenues to replace the GFET. Two columns are highlighted. The first, in which 25% of the revenue is collected from the gas utility, is roughly equivalent to raising the UUT by 5% (with small differences due to the lack of exemptions). The second, in which 100% of the revenue is collected from the gas utility, is equivalent to Method 2.

Table A6. % of Gas and Electric Utility Revenues, Alternative to Method 1 (UUT)					
	% of Revenue Collected from Gas Utility:				
	0%	**25%[1]**	**50%**	**75%**	**100%[2]**
% of Gas Revenues	-	5%	10%	14%	18%
% of Electric Revenues	5%	4%	3%	1%	0%
1. Roughly equivalent to Method 1, but collected via a % of utility revenue methodology instead of increasing the UUT					
2. Equivalent to Method 2, % of gas utility revenues					

One way to capture the benefits of Method 1 could be to implement Method 2 but add a provision that if gas utility revenues decline, the City may begin to collect revenue from the electric utility. This provision might be written as follows, for example:

> *In the event a decline in gas utility revenues results in the transferred amount falling below $7.5 million in FY 2023 (adjusted annually for inflation) the shortfall may be collected from the electric utility in the following year and in subsequent years by transferring a percentage of electric utility revenues, up to a maximum of 5%.*

Such a provision would prevent a decrease in utility tax revenues from this measure if gas usage decreases significantly due to climate action goals. However, in early years, unlike Method 1, it would not have any impact on building or vehicle electrification cost-effectiveness, nor would it change the percentage of revenue collected from homes versus businesses and non-residential uses.

Climate Adaptability Funding Options

In the August 16, 2021 City Council meeting, the City Council directed staff to focus pursuit of a utility use-based tax and explore the option to incorporate revenue to support the City's climate adaptability initiative. The City's FY 2022 Adopted Budget includes $9.7 million for UUTs assessed on utility usage for electric, gas, and water; the City's current UUT rate is 5 percent. Staff estimates that a 1 percent increase to the UUT rate, for both gas and electric, is estimated to yield an additional $2 million in UUT revenue in the General Fund, while a 1 percent increase in the gas utility only is estimated to yield $284,000. These calculations are based on sales activity and utility rates in the FY 2022 Adopted Budget. To illustrate, if the desired total UUT revenue is $30 million, a $20 million increase above the FY 2022 Adopted Budget, then the UUT rate, if applied to gas, electric, and water, would be approximately 15 percent, an additional 10 percent on top of the current 5 percent rate.

Furthermore, based on the City's Sustainability and Climate Action Plan (S/CAP) and the plan's goal to reduce natural gas usage, in applying the EASE Framework, the long-term stability of this revenue source decreases over time. Staff has included Chart A1, Forecast Gas Consumption, that was included in the Gas Utility Financial Plan (CMR 12240). This chart is a baseline forecast used for utility rate modeling and does not include reductions resulting from S/CAP key actions (i.e. approximately a 7 percent decrease from 2020 to 2030), which would further reduce revenue generated from a potential ballot measure. Further analysis by staff would have to be done to calculate the potential estimated impacts of the City's S/CAP goals in reducing use of natural gas and the impacts to potential utility tax to recover the amount of the gas GFET.

Review of the Equity, Administrability, Stability, and Economic Benefits (EASE) framework for a Utility Based Tax

The City Council and Finance Committee have used the EASE framework as the main means of evaluating potential tax ballot measures. A review of the EASE frameworks for both the UUT and tax on utility gross revenues is presented in Table A7 below.

Table A7. EASE Framework for Utility Users Tax

	Method 1: Utility Users Tax	**Method 2: Tax on Utility Gross Revenues**

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Table A7. EASE Framework for Utility Users Tax		
Equity	Utility Users Tax is a flat rate tax imposed on the charges made for metered utility and charges for service (includes customer charges, service charges, standby charges, charges for temporary services, demand charges, and annual and monthly charges. This tax is considered a proportional tax, a tax that takes the same percentage from all groups, since the flat tax rate is assessed based on the customer bill, the amount of tax paid by a customer directly correlates to the amount of utility commodity that is used. Because of different patterns of electric and gas consumption for different segments of the community, Method 1 and Method 2 can differ in the amount of tax collected from the business vs. residential sectors.	This tax can be a flat rate assessed on gross utility revenues (includes customer charges, service charges, standby charges, charges for temporary services, demand charges, and annual and monthly charges. Similar to the UUT, this tax is considered a proportional tax, a tax that takes the same percentage from all groups, since the flat tax rate is assessed based on the customer bill, the amount of tax paid by a customer directly correlates to the amount of utility commodity that is used. Because of different patterns of electric and gas consumption for different segments of the community, Method 1 and Method 2 can differ in the amount of tax collected from the business vs. residential sectors.
Administrability	This tax is administrated through the City's Utility Billing system and appears monthly on customer bills. The cost for administrating this tax is assumed in the City's Utility Department budget and is supported internally by City staff.	

Table A7. EASE Framework for Utility Users Tax	
Stability	The City's Sustainability and Climate Action Plan outlines a variety of work plan items that makes progress towards reducing the City's carbon impacts, greenhouse gas emissions, and resource consumption. Changes in resource consumption, particularly for gas will have a direct impact on the amount of UUT revenue collected by the City in the long term. As describe earlier in this attachment, these impacts can vary significantly between Method 1 and Method 2. The City's Sustainability and Climate Action Plan (S/CAP) update project includes a draft Three-Year Workplan that focuses on reducing use of natural gas that will impact the ability to generate revenues to restore the amount at risk from the *Green* litigation. In addition to the long-term reduction of gas use, month to month gas commodity costs and usage vary and although the market price of gas has dropped over the past decade, these variables may have a long-term stability of this tax revenue source if applied to gas utility usage. See below charts, excerpted from the Gas Utility Plan that was presented to the City Council in April 2021 (CMR 12240, Gas Utility Financial Plan)
Economic Benefits	This tax may deter certain business industries that have heavy resource consumption (i.e. industrial, manufacturing). Weighing this impact against the overall lower utility rates, specifically if utility rates are adjusted downward for the General Fund Equity Transfer, will offset this impact. Payment of the tax for customers is incorporated into the customer's monthly bill; the seamless administration of this tax minimizes disruption for the taxpayer.

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Chart A2: Forecast Gas Consumption

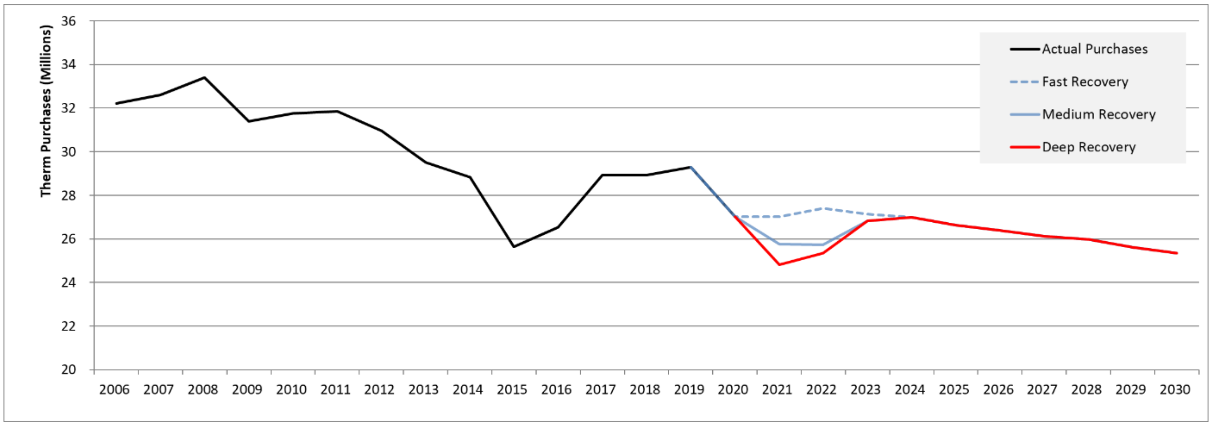

Chart A3: Gas Commodity Rates from July 2012 through January 2021

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Utility User Tax Rates for Cities in Santa Clara County and San Mateo County

The Utility User Tax rates for cities in San Mateo County and Santa Clara County are listed in Table A8, A comparison of Local Utility User Tax Rates obtained from the California State Controller. Average UUT rates in the region fall between 2 percent (City of Sunnyvale) and 6.5 percent (City of Pacifica). The City's 5 percent rate falls within the overall average of the region.

Table A8. Comparison of Local Utility User Tax Rates

	Electric		Gas	
	Residential	Commercial	Residential	Commercial
San Mateo County				
Daly City	5.0%	5.0%	5.0%	5.0%
East Palo Alto	5.0%	5.0%	5.0%	5.0%
Menlo Park	3.5%	3.5%	3.5%	3.5%
Pacifica	6.5%	6.5%	6.5%	6.5%
Portola Valley	4.5%	4.5%	4.5%	4.5%
Redwood City	5.0%	5.0%	5.0%	5.0%
	Electric		Gas	
	Residential	Commercial	Residential	Commercial
Santa Clara County				
Cupertino	2.4%	2.4%	2.4%	2.4%
Gilroy	5.0%	5.0%	5.0%	5.0%
Los Altos	3.5%	3.5%	3.5%	3.5%
Mountain View	3.0%	3.0%	3.0%	3.0%
Palo Alto	5.0%	5.0%	5.0%	5.0%
San Jose	5.0%	5.0%	5.0%	5.0%
Sunnyvale	2.0%	2.0%	2.0%	2.0%

Source: California State Controller, Cities Annual Reports

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In addition to the information discussed earlier in this staff report, below is staff's research of several pertinent utility tax measures in California, including the ballot questions, rate, and passage rates.

City	Ballot Question	Ballot Measure	Rate	Date	Approved?
City of Alameda	To maintain funding for essential services, such as police, fire, parks and libraries, without raising tax rates or electric charges, shall the City of Alameda amend its Charter to reaffirm the continuous annual transfer of approximately $3.7 million from Alameda Municipal Power to the City, adjust future transfer amounts for inflation, and modernize the existing Utility Users Tax ordinance to reflect new and evolving technologies so that all taxpayers are treated equally regardless of technology?	Measure K	This measure does not change the 7.5% tax rate. This measure would modernize the City's utility laws in two significant ways. First, it would amend the City Charter to reaffirm the annual transfer of approximately $3,700,000 (cash and services) from Alameda Municipal Power (AMP) to the City. Second, it would update the City's Utility Users Tax ("UUT") ordinance.	Nov. 2018	Approved. Yes: 72.92% No: 27.08%
City of Anaheim	Shall Section 1221 of the Anaheim City Charter regarding water and electric rates be amended to: update language regarding financial reserves, reaffirm and authorize the transfer of money to the City's general fund to support general City services, remove unnecessary language that duplicates a requirement of the California Constitution, and authorize programs to assist non-residential and residential customers?	Measure N	Rates shall be sufficient to pay basic expenses, as well as (Sec 1221(e)): 4% of operating revenue earned by water and electric utilities during prior fiscal year. Sec 1221 also put ratepayer discounts and customer assistance programs in the Charter, to be paid from rates.	Nov. 2014	Defeated. No: 50.1% Yes: 49.9%
City of Banning	To allow approximately $2,325,000 annually for unrestricted general revenue purposes such as police, fire, paramedics, parks, and senior services while stabilizing electric utility rates, shall an ordinance be adopted authorizing a transfer not to exceed 7.5% of annual electric utility gross revenues to the City's General Fund until December 1, 2021 and 5.5% thereafter, for unlimited duration, and establishing a rate freeze for 3 years, except as needed for financial emergency or bond covenants?	Measure P	Transfer 7.5% of annual electric utility gross revenues to General fund until Dec. 1, 2021, and 5.5% thereafter, and setting a rate freeze for 3 years, except for emergencies.	Nov. 2018	Defeated. No: 51.29% Yes: 48.71%

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City	Ballot Question	Ballot Measure	Rate	Date	Approved?
City of Burbank	To maintain essential City services/infrastructure like police, fire, parks, libraries, streets and street lighting, shall the measure be adopted amending the City of Burbank Charter to continue the past practice of transferring not more than 7% of Burbank Water and Power's gross annual sales of electricity, paid by retail electric rate payers, providing approximately $12.5 million annually to the City's General Fund until ended by voters, with all money spent to benefit Burbank residents?	Measure T	7% of gross annual electricity sales paid by retail rate payers, as a separate line item on the bill or embedded within rates and applied retroactively to 2016/17 fiscal year.	June 5, 2018.	Approved. Yes: 81.1% No: 18.9%
City of Colton	To add approximately $4,800,000 in funding annually for general city services such as police, fire, paramedics, parks, libraries and senior services while stabilizing electric utility rates; shall an ordinance be adopted authorizing a transfer not to exceed 20% of annual electric utility gross revenues to the City's General Fund reverting back to a 12.39% maximum on June 30, 2021, and establishing a freeze on electric utility rates for 5 years, except in cases of financial emergency?	Measure D	20% of Electric Utility's prior year gross revenues for 5 years.	June 2016	Approved. Yes: 76.2% No: 23.8%
City of Long Beach	To maintain general City services like 9-1-1 emergency response, police/fire protection, street/pothole repairs, senior services, parks and libraries, shall the City of Long Beach amend its Charter to authorize annual fund transfers from the City's water, sewer and gas utilities to the General Fund not to exceed 12% of utility gross revenues, generating approximately $25,500,000 annually for unrestricted general revenue purposes, requiring annual independent audits, until ended by voters?	Measure M	Up to 12% of gross revenues from water, sewer and gas utilities.	June 2018	Approved. Yes: 53.76% No: 46.24% Water and sewer charges challenged in *Lejins v. City of Long Beach*; appellate court held on Dec. 1, 2021 that both charges and transfers were unconstitutional violations of Prop. 218.
City of Pasadena	Shall the measure maintaining 911 response, fire, paramedic, public health, senior and homeless services, street repairs, and other services by amending the City Charter to continue collecting in electric rates and maintain the longstanding transfer, limited to 12% gross revenue, providing $18,000,000 annually to Pasadena's General Fund that does not increase taxes or utility rates until ended by voters, requiring financial audits with all funds locally	Measure P	12% of gross revenue of electric utility.	Nov. 3 2020	Approved: Yes: 83.57% Challenged in *Komesar v. City of Pasadena*, upheld.

ATTACHMENT A

City	Ballot Question	Ballot Measure	Rate	Date	Approved?
	controlled benefitting Pasadena residents, be adopted?				
City of Sacramento	In order to comply with Prop 218 . .. shall the City of Sacramento replace its current in-lieu franchise and property tax fees on water, sewer, drainage and garbage with a general tax which will not result in any changes to existing city utility rates??	Measure I	Tax of 11 percent on gross revenues from user fees & charges imposed by city enterprises providing water, sewer, storm drainage, & solid waste services	June 1998	Approved: Yes: 54.4% Challenged in *Wyatt v. City of Sacramento,* upheld.

ATTACHMENT B

Summary of Prior Work on
Potential Revenue Generating Ballot Measures

The City of Palo Alto has been discussing its options for potential revenue-generating ballot measures through 2019 and 2020. This work was suspended at City Council direction in March 2020 in order to marshal available resources to manage through the COVID-19 pandemic. A brief timeline of the CMRs and discussions with the Finance Committee and the City Council since April of 2019, when staff was formally directed to begin working on this project by the City Council, is included below for additional context. The date, the forum of the meeting (Finance Committee or City Council), the summary title, and the CMR number are included for ease of reference.

Timeline

4/22/2019 City Council, "2019 Fiscal Sustainability Workplan", CMR 10267

4/22/2019 City Council, "Approve Workplan for a Potential Revenue Generated Ballot Measure", CMR 10261

6/18/2019 Finance Committee, "Review, Comment, and Accept Preliminary Revenue Estimates for Consideration of a Ballot Measure", CMR 10392

8/20/2019 Finance Committee, "Evaluation and Discussion of Potential Revenue Generating Ballot Measures", CMR 10445

9/16/2019 City Council, "Evaluation and Discussion of Potential Revenue Generating Ballot Measures and Budget Amendment", CMR 10615

10/1/2019 Finance Committee, "Revised Workplan for Consideration of a Ballot Measure", CMR 10712

10/15/2019 Finance Committee, "Stakeholder Outreach, Initial Polling, and Discussion of a Potential Ballot Measure", CMR 10743

11/4/2019 City Council, "Potential Ballot Measure Polling/Outreach, Contract, Solicitation Exemption and Budget Amendment", CMR 10792

12/2/2019 City Council, "Structure and Scenarios of Initial Round of Polling for a Potential Local Tax Measure", CMR 10891

12/17/2019 Finance Committee, "Consideration, Evaluation, and Discussion of a Revenue Generating Local Tax Ballot Measure, Review of Refined Modeling, Analysis, Tax Structure and Recommendation to the City Council", CMR 10655

ATTACHMENT B

1/27/2020 City Council, "Update, Consideration, and Potential Direction on Possible Local Tax Measure for 2020 Election", CMR 11019

3/23/20 City Council, "Consideration of Analysis, Public Outreach, and Refined Polling and Further Direction on a Potential Local Business Tax Ballot Measure for 2020 Election", CMR 11161

3/23/20 City Council, "Consideration of Analysis, Public Outreach, and Refined Polling and Further Direction on a Potential Local Business Tax Ballot Measure for 2020 Election", *At-Places Memorandum*

6/15/2021, Finance Committee Staff Report, "Recommend the City Council Approve the Workplan for Pursuit of a Revenue-Generating Local Ballot Measure for the November 2022 General Election; Review and Potential Guidance to Staff on Affordable Housing Funding as Referred by the Council", CMR 12299

8/16/2021 City Council, "Approve the Workplan for Development of a Revenue-Generating Local Ballot Measure for the November 2022 General Election; Review and Potential Guidance to Staff on Affordable Housing Funds as Referred by the City Council", CMR 12381

9/21/2021 Finance Committee, "Discuss Updates and a Recommended Further Refinement of Potential Revenue Generating Local Ballot Measures," CMR 13514

10/19/2021 Finance Committee, "Discuss Updates and Recommend Further Refinement of Potential Revenue Generating Local Ballot Measures, and Review Draft Initial Polling Outline", CMR 13648

11/8/2021 City Council, "Discuss Updates and Recommend Further Refinement of Potential Revenue Generating Local Ballot Measures, and Review Draft Initial Polling Outline", CMR 13687