City Council
Staff Report

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

Meeting Date: January 13, 2025
Report #:2412-3846

TITLE
Review and Accept the FY 2026-FY 2035 Long Range Financial Forecast (LRFF) and FY 2026 Budget Development Guidelines as Recommended by the Finance Committee, CEQA Status – Not a Project

RECOMMENDATION
The Finance Committee and Staff recommend the City Council accept the General Fund Long Range Financial Forecast (LRFF) for Fiscal Year 2026-2035 (Attachment I) and the FY 2026 annual Budget Development Guidelines (Attachment A in Attachment I) and direct staff to use this forecast as the starting point for the initiation of the FY 2026 budget process.

EXECUTIVE SUMMARY
The FY 2026-2035 Long Range Financial Forecast (LRFF) was reviewed with the Finance Committee on December 3, 2024 (Attachment I) along with the annual Budget Development Guidelines (Attachment A in Attachment I) and were unanimously approved by the Committee.

The *Base Case Long Range General Fund forecast* projects a shortfall of $12.0 million in FY 2026, followed by shortfalls ranging from $7.9 million in FY 2027 down to $5.6 million in FY 2029. These amounts are fairly consistent with previous projections used as part of the two-year budget balancing strategy when adopting the FY 2025 Budget; however, the FY 2026 shortfall increased by $1 million due to various factors outlined in Attachment I. The proposed multi-year financial strategy addresses the FY 2026 shortfall of $12 million with uncertainty reserves of $6.1 million remaining for FY 2026 budget planning[1] and $5.9 million from the FY 2024 Year-end review[2]. This report summarizes the key discussion points with the Finance Committee and

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[1] FY 2025 Adopted Operating Budget: Page 10 General Fund Budget Balancing Strategy: https://www.cityofpaloalto.org/files/assets/public/v/1/administrative-services/city-budgets/fy-2025-city-budget/adopted/palo-alto-adopted-operating-budget-book_final2.pdf
[2] December 3, 2024 Finance Committee Meeting, FY 2024 Annual Comprehensive Financial Report (Staff Report 2404-2912): https://portal.laserfiche.com/Portal/DocView.aspx?id=111742&repo=r-704298fc&searchid=48b115cb-ca8e-4d8c-8fb4-bebeceeb6c24

includes additional information to provide context and/or additional data points of reference to the City Council. Lastly, Budget Development Guidelines inform the development of the FY 2026 budget; these are discussed at the end of the LRFF document (Attachment A in Attachment I).

Per City Council policy, items that are unanimously approved by the Finance Committee are placed as a consent agenda item for the City Council. Though this report was approved unanimously, staff and the Committee have placed this item on the City Council's action agenda for deliberation of the full Council in acknowledgement of the importance for financial planning in the continued variable economic conditions.

BACKGROUND

The LRFF is a preliminary ten-year forecast based on the most current information available, actual revenues for FY 2024, and projected results through FY 2025 at the point in time of release (December 2024). General Fund expenditures are based on current City Council approved service levels (Base Case) compared to projected revenues over the next ten years. This Forecast allows staff and City Council to look at both the short-term and long-term financial status of current service levels in the General Fund to inform daily policy decisions and evaluate long-term goals and ongoing challenges. The Committee and staff recommend use of the Base Case for the FY 2026 Budget planning.

- *Base Case Long Range General Fund forecast* projects a shortfall of $12.0 million in FY 2026, followed by shortfalls ranging from $7.9 million in FY 2027 down to $5.6 million in FY 2029. FY 2030 has a surplus of $2.0 million which continues to grow through FY 2035. This forecast maintains current service levels approved in FY 2025 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. These amounts are fairly consistent with previous projections used as part of the two-year budget balancing strategy when adopting the FY 2025 Budget; however, the FY 2026 shortfall increased by $1 million due to various factors outlined in Attachment I.

- *Alternate forecast scenario that reflects a 1% loss in economically sensitive revenue*. Compared to the Base Case, this scenario reduces revenues by $2.3 million in FY 2026 and maintains and increases the projected shortfalls over the next ten years, ranging from $14.3 million in FY 2026 to $0.8 million in FY 2030. FY 2031 begins a surplus of $5.8 million which continues to grow through FY 2035.

- *Alternate forecast that reflects a 1% compensation adjustment (1%) in FY 2026*. Compared to the Base Case, this scenario increases expenses by $1.1 million in FY 2026 and maintains and increases projected shortfalls over the next ten years, ranging from $13.1 million in FY 2026 to $6.8 million in FY 2029. FY 2030 begins a surplus of $0.8 million which continues to grow through FY 2035.

These alternate forecasts were calculated with 1% impacts to demonstrate funding levels that could be used to scale the scenarios for larger potential impacts. In addition, these scenarios were calculated separately to show the impacts of each scenario in isolation; however, aspects of both alternate forecasts may occur in conjunction in the future.

Consistent with the projections in the FY 2025 Adopted Budget, this LRFF reflects deficits in the near term with revenues falling below expenses. As previously recommended, the shortfall in FY 2025 will be addressed by the Uncertainty Reserve, that was proactively set aside during the prior year for this purpose. Development of the FY 2026 budget and planning for the subsequent years outlined in the forecast will need to be done strategically over the next several months to balance the increased service level desired by the community with the financial resources currently projected. With these variables, ongoing revenues are unable to keep pace with expenses over the next several years.

The LRFF is a tool to model financial forecasting assuming resources and services are operating at the current authorized levels. City staff will continue to review and refine these projections to establish the FY 2026 budget and use this forecast to begin internal planning for budget balancing solutions. Individual fiscal years will vary from this forecast such as changes in revenue estimates or operating transfers. These circumstances, specific to a given year, typically represent one-time resources that are factored into the annual budget planning process.

ANALYSIS
Finance Committee Review

As part of the Finance Committee's review of the LRFF, several topics were discussed more in depth and staff has provided additional information for context and/or additional data points for reference to the City Council.

- **Revenue categories volatility in the past** – The potential national economic conditions and shifting policies cause challenges in forecasting revenues for the upcoming period. Revenue categories in the city's budget have demonstrated significant volatility during periods of economic downturn such as the COVID pandemic and Great Recession. Historical data shows that during the Great Recession of 2008 and 2009, revenue decreases ranged from a sharp -4% in the first year to a more moderate -1% in the second year across certain major tax revenues that are more economic sensitive, particularly sales tax, transient occupancy tax, and documentary transfer tax. This pattern underscores the potential for varying magnitudes of revenue loss depending on the severity and duration of the economic disruption. For context, for FY 2026, a 1% decrease in these more economic sensitive major tax revenues is roughly equivalent to a reduction of $1.7 million of resources for the city. This experience band provides a useful framework for scaling potential revenue impacts, suggesting that while immediate losses can be substantial, the long-term effects may moderate with economic recovery. While staff currently do not forecast a recession, the city remains prepared for the possibility of revenue reductions through fiscal diligence and planning.

- **Vacancies** – For the FY 2026 to 2035 budgetary outlook, one significant assumption is the city's vacancy rate. Our financial forecast currently assumes a 5% vacancy factor, up from the previous 3%, which has tightened the overall budget. The City's current vacancy rate of 10% reflects a decrease from the pre-COVID level of 12%. Vacancy savings is typically used through alternative expenses such as overtime or contractual services to maintain or manage service levels or allow for flexibility to support Council priority workplans. Public safety vacancy savings is offset with overtime to maintain safety service levels. As of the date of this report, the Police department has zero vacancies and citywide recruitment and retention continue to improve. For context, in FY 2024, the budget assumed vacancy savings of 3%; at the end of FY 2024, net vacancy savings of $2 million translate to just approximately 1% of the salary and benefits expenditures. Setting the vacancy assumption too high could lead to unrealistic target and may result in expenditures exceeding budgeted amount if vacancies are not realized.

- **Uncertainty Reserve** – The Uncertainty Reserve (UR) was established as part of the FY 2023 Mid-Year Budget Review as a one-time source of funds of $14 million to bridge the funding needed to address community service needs in FY 2024 and FY 2025. The UR differs slightly from the Budget Stabilization Reserve (BSR) in that it can be approved for use with a simple majority vote rather than a 2/3 approval by Council. The UR is also meant to fund short-term budget gaps, while the BSR is meant to be maintained for emergency financial needs and critical budget adjustments needed throughout the fiscal year.

  As part of the budget development strategy for the FY 2024 and FY 2025 adopted budgets, the UR was used to fund shortfalls to maintain services and maintain the BSR at 20% in FY 2024 and 18.5% in FY 2025. Adoption of the FY 2025 Budget left $6.1 million in the UR to use for development of the FY 2026 Budget. Staff is recommending increasing the UR to $12.0 million by shifting $5.9 million in surplus savings from FY 2024 from the BSR to the UR. The $12.0 million UR could be used to balance the full $12.0 million shortfall projected in FY 2026 as part of the 2026-2035 LRFF. However, this course of action will eliminate the UR as a strategy to solve the projected $7.9 million gap in FY 2027, unless higher revenues, cost savings and/or other one-time resources are available.

- **Risk Mitigation Tools** – In addition to the UR discussed above, there are several other tools that staff will explore to reduce the anticipated shortfall in FY 2026 and maintain more fiscal stability in the outer years of the LRFF. These other tools may include:
    - Investigating and recommending updates to existing revenue sources and/or new revenue sources that the City has not collected previously. The City is currently conducting a citywide cost of service study to update its municipal fees and also to identify any revenue sources that are not currently collected. Depending on the nature of the new revenues, it will take time to conduct the necessary analysis, public outreach and implement the new revenue.
    - Reviewing implementation of policies related to the BSR and funding long term liabilities such as pensions and retiree healthcare, and potentially rebalancing the funding from these priorities to increase funding for current services. The BSR is recommended to be maintained at 18.5% of the General Fund expense budget, but the funding level could be reduced closer to the lower end of the targeted 15 to 20% range. Similarly, the proactive funding for long term liabilities could be reduced in order to fund current services; however, this would prolong the City's efforts to pay down the costs related to pension and retiree healthcare.
    - Using financing strategies such as Certificate of Participation (COP) to fund costs related to new capital infrastructure projects. These financing strategies could re-allocate funding dedicated to capital needs, such as reducing the base transfer from the General Fund to the Capital Fund and putting those funds towards operating services and maintenance/upkeep of current infrastructure. There would be associated costs for debt administration and longer-term repayment may ensure the City could maintain fiscal sustainability with this strategy.
    - Reviewing service delivery models, approaches and/or innovations to reduce costs or enhance capacity with current resources. While this analysis is performed in each budget development cycle, it will be re-emphasized.

- **Fiscal discipline** – Over the past couple years, the City has been strategically increasing service levels to invest in Council priorities. However, in order to maintain these service levels ongoing as the economy and financial resources stagnate coupled with potential higher uncertainty, continued fiscal discipline will need to be exercised throughout the FY 2026 budget development. Priorities not funded will need to be evaluated against current services to determine if the current services should be augmented with existing and/or additional resources. As stated in the 2026-2035 LRFF report, development of the FY 2026 budget and planning for the subsequent years outlined in the forecast will need to be done strategically over the next several months to balance the increased service level desired by the community with the financial resources currently projected.

The City needs to maintain fiscal discipline and agility while monitoring the upcoming federal policies and their impacts on national and local economies.

FISCAL/RESOURCE IMPACT

Financial implications from this report and input from the City Council will be considered in the City Manager's development of the Fiscal Year 2026 budget. Upcoming milestones related to the City's fiscal standing and the FY 2026 Budget Process include:

- February (Council) – FY 2025 Mid-Year Budget Review and Second Quarter Financial Report
- March/April (Finance Committee and Utilities Advisory Commission or UAC) – Five Year Utility Financial Plans and FY 2026 Utility Rate Recommendations
- April/May (Finance Committee) – Citywide Cost Allocation Plan and Municipal Fee Study
- May (Council) – FY 2026 Proposed Operating and Capital Budgets Published
- May (Finance Committee) – FY 2026 Proposed Budget Hearings, including Utility Rates, Municipal Fees, and Five-Year Capital Improvement Plan
- June (Finance Committee) – FY 2025 Third Quarter Financial Report
- June (Council) – Adoption of the FY 2026 Operating and Capital Budgets, Utility Rates, and Municipal Fees.

STAKEHOLDER ENGAGEMENT

The preliminary forecast for FY 2026 represents the beginning of the fiscal year 2026 budget development process. As in previous years, City Council discussion of the LRFF will provide guidance to staff in the budget development process. It is anticipated that conversations with City Council and the community will occur through public budget hearings in Spring 2025, according to the standard budget adoption process.

ENVIRONMENTAL REVIEW

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

ATTACHMENTS

Attachment I: FY 2026-2035 Long Range Financial Report (LRFF), CMR 2405-3068

APPROVED BY: Lauren Lai, Administrative Services Director

CITY OF PALO ALTO
Finance Committee
Regular Meeting
Tuesday, December 03, 2024

Agenda Item

2. Review and Forward Fiscal Year 2026-2035 Long Range Financial Forecast (LRFF) to City Council *Late Packet Report, Staff Presentation*

Finance Committee
Staff Report

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

Meeting Date: December 3, 2024
Report #:2405-3068

TITLE
Review and Forward Fiscal Year 2026-2035 Long Range Financial Forecast to City Council

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 2026-2035 and the FY 2026 annual Budget Development Guidelines (Attachment A) and direct staff to use this forecast as the starting point for the initiation of the FY 2026 budget process.

EXECUTIVE SUMMARY
Annually, the City presents a ten-year General Fund Long Range Financial Forecast (LRFF) in December that marks the beginning of the annual budget process. This preliminary forecast is based on the most current information available, actual revenues and expenses for FY 2024, and projected results through FY 2025 at the point in time of release. General Fund expenditures are based on current City Council approved service levels compared to projected revenues over the next year. The City service levels have increased during the 3-year period between FY 2024 to FY 2026, as the City continues to maintain a multi-year budget strategy, deliver excellent service level while supporting Council priority objectives and maintaining fiscal stability with anticipated upcoming volatility. The current outlook anticipates a modestly weak economy in 2025, followed by a gradual return to trend growth rates starting in 2026, assuming inflation continues to moderate, and consumer demand remains stable.

The **Base Case Long Range General Fund forecast** projects a $12.0 million shortfall in FY 2026, followed by shortfalls ranging from $7.9 million in FY 2027 to $5.6 million in FY 2029. FY 2030 has a projected surplus of $2.0 million which continues to grow through FY 2035. This forecast maintains current service levels approved in FY 2025 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. These amounts are fairly consistent with previous projections used as part of the two-year budget balancing strategy when adopting the FY 2025 Budget, however, the FY 2026 shortfall increased by $1 million due to the various factors discussed in detail below. The proposed multi-year financial strategy addresses the FY 2026 shortfall of $12 million with uncertainty reserves of $6.1 million from FY 2023 Mid-Year review and $5.9 million from FY 2024 Year-end review.

Staff modeled an **alternate forecast scenario that reflects a 1% loss in economically sensitive revenue** and the impact on the General Fund over the forecast period. Compared to the Base Case, this scenario increases the General Fund shortfall over the next ten years. FY 2026 changes from a shortfall of $12.0 million to $14.3 million, and revenues are not anticipated to be able to fund the annual expenditures until FY 2031.

Staff modeled an **alternate forecast that reflects a one-time compensation adjustment (1%) in FY 2026** and the impacts on the General Fund over the next ten years. Compared to the Base Case, this scenario increases expenses by $1.1 million in FY 2026 and increases projected shortfalls in the forecast, ranging from $13.1 million in FY 2026 to $6.8 million in FY 2029. FY 2030 has a projected surplus of $0.7 million which continues to grow through FY 2035.

These alternate forecasts were done separately to show the impacts of each scenario in isolation; however, aspects of both alternate forecasts may occur in conjunction in the future.

Consistent with the projections in the FY 2025 Adopted Budget, this LRFF reflects deficits in the near term with revenues falling below expenses. As previously recommended, the shortfall in FY 2025 will be addressed by the Uncertainty Reserve, that was proactively set aside during the prior year for this purpose. Development of the FY 2026 budget and planning for the subsequent years outlined in the forecast will need to be done strategically over the next several months to balance the increased service level desired by the community with the financial resources currently projected. With these variables, ongoing revenues are unable to keep pace with expenses over the next several years.

The LRFF is a tool to model financial forecasting assuming resources and services are operating at the current authorized levels. City staff will continue to review and refine these projections to establish the FY 2026 budget and use this forecast to begin internal planning for budget balancing solutions. Individual fiscal years will vary from this forecast such as changes in revenue estimates or operating transfers. These circumstances, specific to a given year, typically represent one-time resources that are factored into the annual budget planning process. More detailed guidelines or Budget Policies to inform the development of the FY 2026 budget are discussed at the end of this document (Attachment A).

Included in this report and subsequent documents are the following:

- The Economy: discussion of the current financial climate of the United States to the local economy of the City of Palo Alto (details can be found in Attachment B)
- Summary Long Range Financial Forecast including Revenue and Expense assumptions in FY 2026-2035 (details can be found in Attachments C and D)
    - Financial status of the General Fund as of the FY 2025 Adopted Budget

    - Brief discussion of FY 2024 surplus funding
    - Updated revenue assumptions based on current projections
- FY 2026 Budget Development Guidelines to inform the Budget process (Attachment A)
- Summary of Assumptions Not Included in Forecast (Attachment E)
- Alternate scenarios to the base case forecast to demonstrate financial impacts to the City from:
    - Impacts from a moderate recession
    - Impacts from a citywide 1% increase of salaries and benefits

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, and these assumptions are revised and refined as more information becomes available through the budget development process.

The LRFF contains a high-level comprehensive review of the costs to provide current City Council approved service levels, including current contracts, updates to salaries and benefits based on the current population of employees, and the current labor contracts in effect. The LRFF also reviews the status of the current economy and various economically sensitive revenues such as Sales Tax, Documentary Transfer Tax, Property Tax, and Transient Occupancy Tax to explain key trends in those areas. This Forecast allows staff and City Council to look at both the short-term and long-term financial status of current service levels in the General Fund to inform daily policy decisions and evaluate long-term goals and ongoing challenges.

<u>The Economy</u>
The economy continues to demonstrate resiliency to a formal recession and this forecast reflects a continued level of stagnation offset by inflation. Risks remain due to world conflicts and potential local economy impacts. At the national level, economic growth through the third quarter of calendar year 2024 has been driven by resilient consumer spending, although inflationary pressures remain elevated and borrowing costs continue to weigh on economic activity. The Federal Reserve's monetary policy actions have kept interest rates at historically high levels, with the federal funds rate holding near its highest levels in over two decades. The Fed is maintaining its tight stance in an effort to achieve a "soft landing", aiming for a slowdown in economic growth that avoids recession while containing inflation. Despite these efforts, inflation remains sticky, particularly in sections such as housing and services, leading to ongoing economic uncertainty. The current outlook anticipates a modestly weak economy in 2025, followed by a gradual return to trend growth rates starting in 2026, assuming inflation continues to moderate and consumer demand remains stable. Risks that will continue to be monitored include escalating political tensions, and political landscape shaped by the recent presidential election, all of which could lead to shifts in national economic policies in 2025 and beyond. These factors are creating heightened complexity in financial forecasting and budget development. The

City must navigate the challenge of addressing growing fiscal needs while ensuring long-term fiscal sustainability.

Nationally, as of October 2024, the consumer price index (CPI) which measures changes in the prices paid by consumers for a basket of goods and services, is 2.6%, down from 3.7% in October 2023, but still indicating persistent inflation. Assumptions in the LRFF report for general cost increases are using a CPI of 3% in FY 2026 and FY 2027 and 4% for FY2028 and beyond. The unemployment rate stands at 4.1% up from 3.7% in January of 2024, signaling a potential economic slowdown. Despite these pressures, GDP, a measure of all goods and services produced in the economy, grew at an annualized rate of 2.8% through third quarter of 2024, driven primary by strong consumer spending. The UCLA Anderson outlook predicts weak economic growth in 2025, with GDP growth expected to range from 1% to 2%, with a return to trend growth of 2% to 3% starting in 2026.

Locally, the economy continues to show resilience, with no recession expected due to strong employment. However, real personal income is projected to remain flat in 2024, with modest growth of 1% to 2% forecasted through 2025. California's unemployment rate has risen to the 5.3% slightly above the 5.0% level at the same time last year. It is important to recognize that while the local economy within the City may exhibit trends similar to those at the state or national levels, its unique economic makeup will result in distinct variations. Staff is using the current available information to inform this forecast, which will change as new information becomes available and adjustments may be necessary to reflect evolving conditions. Additional details on economic statistics such as Gross Domestic Product (GDP), unemployment, and Consumer Price Index (CPI) can be found in **Attachment B** in greater length.

ANALYSIS

Palo Alto serves a diverse community with a broad range of unique services that adds to the complexity of managing a balanced budget and healthy fiscal outlook. This annual General Fund Long Range Financial Forecast is being developed at a time of perceived economic stagnation and geo-political unrest. It is important to recognize that while the local economy within the City may exhibit trends similar to those at the state or national levels, its unique economic makeup may result in distinct variations. As new information becomes available, adjustments may be necessary to reflect evolving conditions.

As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document. Instead of a recession, this forecast assumes economic stagnation at the beginning of the ten-year period, in line with current projections from UCLA Anderson. Major tax revenues have rebounded from the impacts of the Covid-19 pandemic and projected to be at or above pre-pandemic levels through the ten-year forecast. Expenses are programmed to maintain service levels based on Council approval. As a result, some limited term programs are not extended through the entire ten-year forecast but discussed in this report to indicate that continuing the programs would require additional resources. Investments in Capital projects are consistent with the 2025-2029 Capital Improvement Plan with continued focus on completing the Council approved 2014 Infrastructure Plan projects as well as maintaining and upkeeping the City's current facilities and infrastructure. The Uncertainty Reserve that was established as part of the FY 2023 Mid-Year Review was used to balance the FY 2025 Adopted Budget, but as planned and approved by Council, still has funding available to solve the projected shortfall in FY 2026. Strategic planning and fiscal discipline will be needed to solve the estimated shortfalls in the subsequent years of the forecast.

Base Case

Table 1 displays the projected General Fund revenues and expenditures over ten years and the cumulative net operating margin. The *operating margin* reflects the variance between the projected General Fund revenues and expenditures for each year of the forecast or the annual surplus or shortfall. The *net operating margin* is presented on a one-time basis, as the annual surplus or shortfall for a given year, and on an incremental basis. The incremental forecast assumes that each shortfall is addressed completely with ongoing solutions in the year it appears and that each surplus is completely expended with ongoing expenditures. It is the City's goal to remain in balance on an ongoing basis, so the incremental figure is useful to illustrate the additional surplus and/or shortfall attributed to a particular fiscal year. To the extent a shortfall is not resolved, or a surplus is not expended on an ongoing basis, it is important to understand that the remaining budget shortfall or surplus will remain and be pushed to the following year. The Base Case financial forecast projects a shortfall of $12.0 million in FY 2026, followed by shortfalls ranging from $7.9 million in FY 2027 down to $5.6 million in FY 2029. FY 2030 has a projected surplus of $2.0 million which continues to grow through FY 2035. Based on these assumptions, the cumulative net operating margin, or ongoing surplus, during the forecast period is a surplus of $25.4 million.

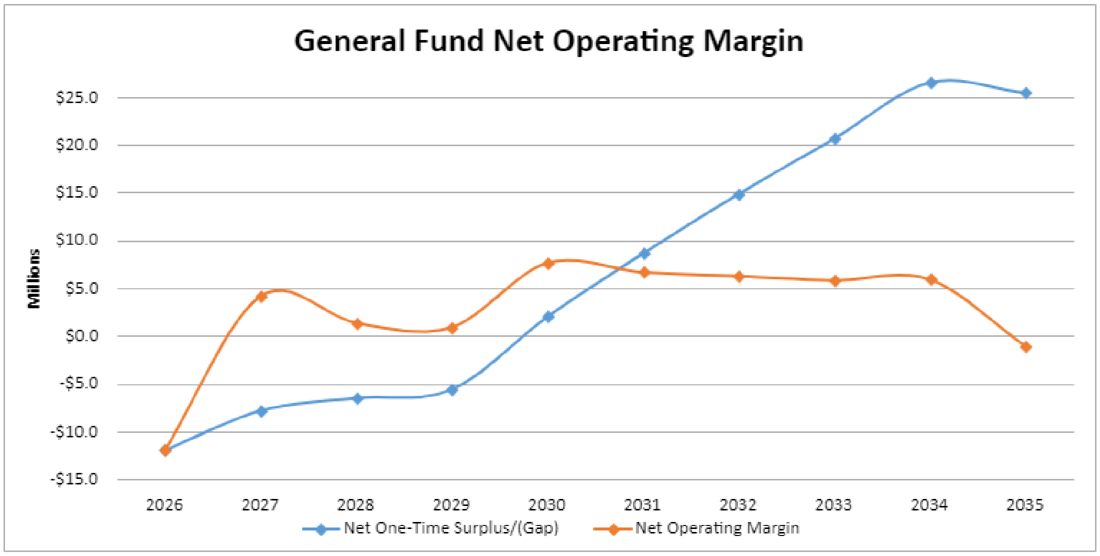
TABLE 1: FY 2026 – 2035 Long Range Financial Forecast (Base Case)

BASE CASE

	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Total Revenue	$254,799	$278,231	$287,554	$287,554	298,600	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
BSR Contribution (One-Time)	-	-	$3,247	$3,247	-	-	-	-	-	-	-	-	-	-
Reappropriated Funds (One-Time)	-	-	$16,093	$16,093	9,200	-	-	-	-	-	-	-	-	-
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$307,800	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
Year over Year increase (revenue only)					*3.8%*	*4.9%*	*4.1%*	*4.1%*	*4.6%*	*4.1%*	*3.8%*	*3.8%*	*3.9%*	*3.8%*
Total Expenditures	243,695	281,062	306,893	306,893	319,788	321,171	332,558	344,995	352,870	360,763	368,429	377,258	386,903	403,667
Total Use of Funds	$243,695	$281,062	$306,893	$306,893	$319,788	$321,171	$332,558	$344,995	$352,870	$360,763	$368,429	$377,258	$386,903	$403,667
Year over Year increase					*4.2%*	*0.4%*	*3.5%*	*3.7%*	*2.3%*	*2.2%*	*2.1%*	*2.4%*	*2.6%*	*4.3%*
Net One-Time Surplus/(Gap)	$11,104	($2,831)	$0	$0	($11,988)	($7,857)	($6,519)	($5,646)	$1,964	$8,589	$14,824	$20,612	$26,495	$25,401
Cumulative Net Operating Margin (One-Time)														$65,874
Net Operating Margin					($11,988)	$4,131	$1,339	$872	$7,610	$6,625	$6,235	$5,789	$5,883	($1,095)
Cumulative Net Operating Margin														$25,401

Net Operating Margin assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures

TABLE 2: FY 2026 – 2035 Long Range Financial Forecast Net Operating Margin (Base Case)



Revenue Assumptions

The FY 2024 Annual Comprehensive Financial Report (ACFR), scheduled for review by the Finance Committee on December 3, 2024, reported General Fund revenues as compared to the prior year; most major tax revenues experienced growth back to pre-pandemic levels due to the improved local economy, high price trends, and inflation (CMR 2404-2912[1]). Major tax revenues have continued to grow moderately through the first quarter (Q1) of FY 2024 and is projected to come in at the FY 2025 Adopted Budget level totaling 287.6 million. Further discussion of changes to specific categories can be found in Attachment C. Overall, revenues are projected to increase by $11.0 million in FY 2026, mainly in Property Tax, Transient Occupancy Tax, and Utility Users Tax. As part of the FY 2025 Mid-Year Budget Review, staff will be returning to Council to recommend using the FY 2024 budget saving to increase the budget uncertainty reserve to help mitigate impacts from a potential recession, as well as smooth the near-term shortfalls seen in this LRFF. A summary of revenue assumptions is discussed here, extensive information regarding each revenue category can be found in **Attachment C**.

Tax revenues constitute approximately 60% of General Fund resources. In FY 2026, the forecast projects a $7.6 million or 4.5% increase from FY 2025 projected levels ($169.8 million to $177.4million). This increase is primarily attributed to higher anticipated receipts across all categories, with Property Tax, Transient Occupancy Tax (TOT), and Utility Users Tax (UUT) accounting for the largest increases.

- *Property Taxes* makes up the largest source of General Fund's revenue, approximately 25%. In FY 2026, this revenue is anticipated to increase $3.1 million or 4.5% from FY 2025 ($68.6 million to $71.7 million). Steady residential property sales resulting in higher property tax assessed valuation is projected to continue to grow this source annually.

[1]Finance Committee, December 3, 2024; Agenda Item #2; Staff Report #2404-2912, https://cityofpaloalto.primegov.com/portal/viewer?id=9637&type=3

- *Transient Occupancy Taxes* are impacted by business and other leisure/non-leisure travel and experienced significant reductions in the past few years due to a number of factors resulting from the pandemic. However, this revenue was able to return to pre-pandemic levels in FY 2023. In FY 2026, this revenue is anticipated to increase $1.3 million or 4.6% from FY 2025 ($27.9 million to $29.1 million).
- *Utility Users Tax (UUT)* is levied on electric, gas, and water consumption, as well as telephone usage. Revenue in this category is impacted by consumption levels and has continued to recover as the local economy recovered and workers returned to the office starting in FY 2023. In FY 2026, UUT revenue is anticipated to increase by $1.6 million or 7.9% from FY 2025 ($19.9 million to $21.5 million).

The forecast for non-tax revenues projects a $3.5 million or 3.9% increase in FY 2026 from FY 2025 adopted levels. This increase is primarily attributable to charges for services and investment income. These increases are partially offset by decreases in limited term revenue from other agencies such as the Staffing for Adequate Fire and Emergency Response (SAFER) Grant Program and decreased reimbursement revenue from other funds for centralized and administrative services.

The changes by revenue category can be seen in Tables 3 and 4 below. Major tax revenue trends are shown in Table 5 and discussed in greater detail in **Attachment C**.

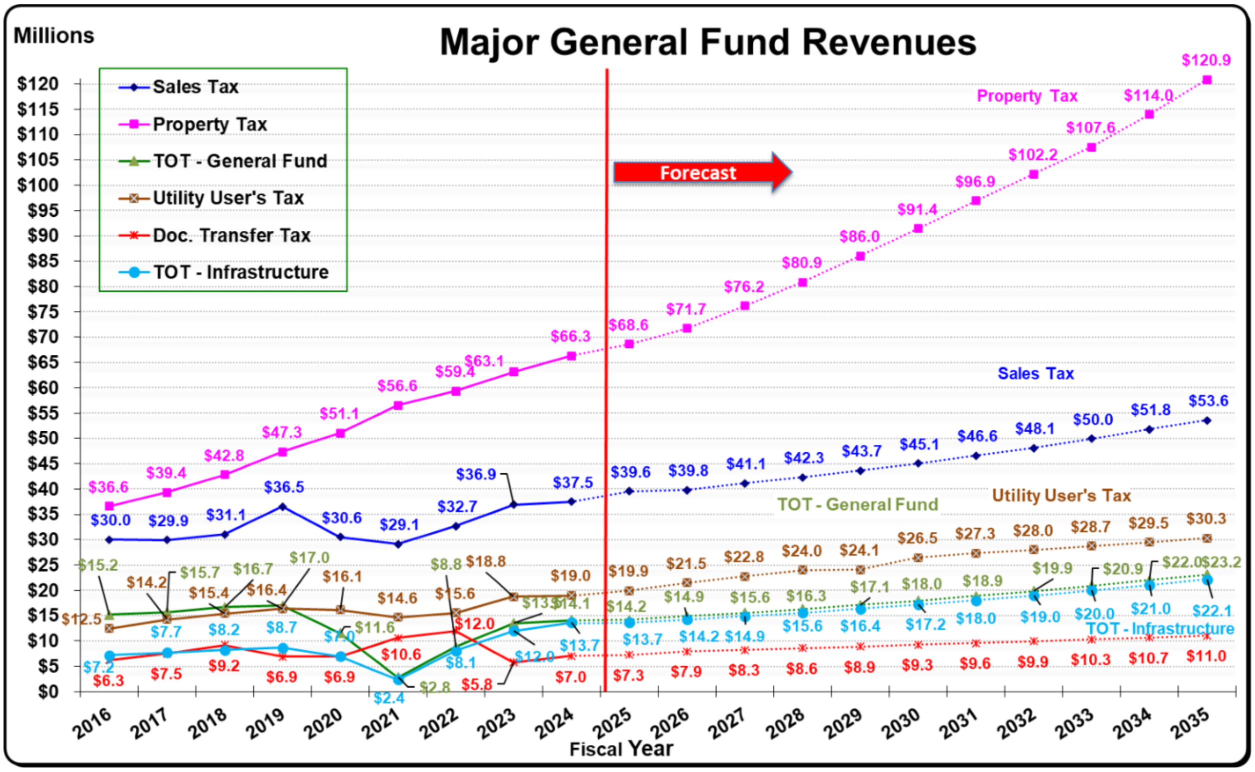
TABLE 3: General Fund Revenue Forecast

Revenue & Other Sources	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	CAGR 10 Years	CAGR 5 Years
Sales Taxes	36,926	37,482	39,577	39,577	39,827	41,105	42,342	43,688	45,095	46,633	48,065	49,954	51,922	53,718	3.0%	1.3%
Property Taxes	63,129	66,344	68,623	68,623	71,720	76,173	80,861	86,020	91,441	96,935	102,170	107,556	113,954	120,891	5.4%	2.5%
Transient Occupancy Tax																
General Purpose	13,471	14,115	14,188	14,188	14,897	15,567	16,317	17,122	17,972	18,877	19,864	20,907	22,005	23,159	4.5%	1.9%
Infrastructure	12,014	13,667	13,669	13,669	14,238	14,878	15,596	16,364	17,177	18,041	18,985	19,982	21,032	22,135	4.5%	1.9%
Documentary Transfer Tax	5,751	7,016	7,260	7,260	7,940	8,268	8,591	8,920	9,260	9,602	9,946	10,299	10,664	11,043	3.4%	1.5%
Utility Users Tax	18,763	19,013	19,943	19,943	21,512	22,783	24,028	24,120	26,477	27,346	28,030	28,741	29,503	30,298	3.5%	2.1%
Other Taxes and Fines	630	6,113	6,520	6,520	7,261	7,504	7,759	7,996	8,254	8,473	8,764	9,040	9,286	9,529	2.8%	1.3%
Subtotal: Taxes	150,684	163,749	169,780	169,780	177,395	186,278	195,494	204,230	215,676	225,907	235,824	246,479	258,366	270,773	4.3%	2.0%
Charges for Services	34,501	36,073	37,909	37,909	41,311	41,962	42,931	43,764	44,302	44,849	45,025	45,344	45,622	44,954	0.8%	0.7%
Permits and Licenses	7,994	11,396	11,410	11,410	11,615	11,787	12,071	12,352	12,557	12,737	12,822	12,966	13,061	12,532	0.8%	0.8%
Return on Investments	2,529	3,660	3,264	3,264	4,508	4,620	4,729	4,869	5,027	5,209	5,401	5,599	5,804	6,018	2.9%	1.1%
Rental Income	14,384	16,352	16,440	16,440	16,401	16,854	17,406	18,010	18,639	19,293	19,974	20,681	21,417	22,182	3.1%	1.3%
From Other Agencies	7,392	3,480	1,308	1,308	576	1,576	576	576	576	576	576	576	576	576	0.0%	0.0%
Charges to Other Funds	13,227	15,409	15,096	15,096	14,683	14,898	15,320	15,703	16,020	16,311	16,466	16,697	17,008	17,040	1.5%	0.9%
Other Revenue	2,133	4,252	3,198	3,198	3,009	3,020	3,037	3,043	3,049	3,054	3,060	3,067	3,073	3,077	0.2%	0.1%
Total Non-Tax Revenue	82,161	90,623	88,626	88,626	92,103	94,718	96,070	98,318	100,171	102,029	103,324	104,930	106,560	106,378	1.5%	0.8%
Operating Transfers-In	21,954	23,859	29,148	29,148	29,101	32,317	34,475	36,800	38,987	41,415	44,104	46,461	48,472	51,916	6.0%	3.0%
BSR Contribution (One-Time)			3,247	3,247												
Reappropriated Funds (One-Time)			16,093	16,093	9,200											
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$307,800	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068		

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

Revenue & Other Sources	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Sales Taxes		1.5%	5.6%	0.0%	0.6%	3.2%	3.0%	3.2%	3.2%	3.4%	3.1%	3.9%	3.9%	3.5%
Property Taxes		5.1%	3.4%	0.0%	4.5%	6.2%	6.2%	6.4%	6.3%	6.0%	5.4%	5.3%	5.9%	6.1%
Transient Occupancy Tax														
General Purpose		4.8%	0.5%	0.0%	5.0%	4.5%	4.8%	4.9%	5.0%	5.0%	5.2%	5.3%	5.3%	5.2%
Infrastructure		13.8%	0.0%	0.0%	4.2%	4.5%	4.8%	4.9%	5.0%	5.0%	5.2%	5.3%	5.3%	5.2%
Documentary Transfer Tax		22.0%	3.5%	0.0%	9.4%	4.1%	3.9%	3.8%	3.8%	3.7%	3.6%	3.5%	3.5%	3.6%
Utility Users Tax		1.3%	4.9%	0.0%	7.9%	5.9%	5.5%	0.4%	9.8%	3.3%	2.5%	2.5%	2.7%	2.7%
Other Taxes and Fines		870.4%	6.7%	0.0%	11.4%	3.3%	3.4%	3.1%	3.2%	2.7%	3.4%	3.1%	2.7%	2.6%
Subtotal: Taxes		8.7%	3.7%	0.0%	4.5%	5.0%	4.9%	4.5%	5.6%	4.7%	4.4%	4.5%	4.8%	4.8%
Charges for Services		4.6%	5.1%	0.0%	9.0%	1.6%	2.3%	1.9%	1.2%	1.2%	0.4%	0.7%	0.6%	-1.5%
Permits and Licenses		42.6%	0.1%	0.0%	1.8%	1.5%	2.4%	2.3%	1.7%	1.4%	0.7%	1.1%	0.7%	-4.0%
Return on Investments		44.7%	-10.8%	0.0%	38.1%	2.5%	2.4%	3.0%	3.2%	3.6%	3.7%	3.7%	3.7%	3.7%
Rental Income		13.7%	0.5%	0.0%	-0.2%	2.8%	3.3%	3.5%	3.5%	3.5%	3.5%	3.5%	3.6%	3.6%
From Other Agencies		-52.9%	-62.4%	0.0%	-56.0%	173.6%	-63.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Charges to Other Funds		16.5%	-2.0%	0.0%	-2.7%	1.5%	2.8%	2.5%	2.0%	1.8%	1.0%	1.4%	1.9%	0.2%
Other Revenue		99.4%	-24.8%	0.0%	-5.9%	0.4%	0.5%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.1%
Total Non-Tax Revenue		10.3%	-2.2%	0.0%	3.9%	2.8%	1.4%	2.3%	1.9%	1.9%	1.3%	1.6%	1.6%	-0.2%
Operating Transfers-In		8.7%	22.2%	0.0%	-0.2%	11.1%	6.7%	6.7%	5.9%	6.2%	6.5%	5.3%	4.3%	7.1%
Total Source of Funds		9.2%	10.3%	0.0%	0.3%	1.8%	4.1%	4.1%	4.6%	4.1%	3.8%	3.8%	3.9%	3.8%

TABLE 5: City of Palo Alto Major General Fund Revenues



Expense Assumptions

As part of developing the FY 2026-2035 Forecast expenditure budget, the General Fund expense categories have been adjusted by removing FY 2025 Adopted Budget one-time expenses and updating major cost elements such as salary and benefits costs. Table 6 below displays the expense forecast and when compared to the FY 2025 Adopted Budget, growth of 4.2% is expected in FY 2026. The overall annual growth is due mainly to increases in expense categories such as Salary and Benefits, Contractual Services, and Transfers to Other Funds.

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

- *Salary and Benefits* are projected to increase $8.4 million or 4.7% from the FY 2025 ($179.9 million to $188.3 million). This is primarily attributable to increases salaries ($4.5 million), retiree healthcare costs ($1.9 million) and pension costs ($1.4 million).
    - A general wage adjustment of 2% is included for all employees starting in either January 2025 or July 2025 for all years of the forecast since no MOA's would be in effect at that time.
    - A reserve is included for potential changes to future labor costs including, changes in vacancy rates, labor and benefit rate variability, and inflation assumptions.
    - A staff vacancy assumption of 5% is assumed, which is an increase from 3% assumption most recently a few years ago, creating a tighter budget forecast as the City continues to improve its actual vacancy rate through successful recruitment and retention programs.
- Long Term contributions to pension and other post-employment benefits reflect increases over the prior year and capital investments are being phased through the first three to five years of the forecast:
    - *Pension 115 Trust contributions* are calculated using a lower 5.3% discount rate for normal cost as compared to CalPERS 6.8%. Through FY 2025, it is expected that $87.4 million ($56.4 million in the General Fund) in supplemental principal contributions will be made to the Pension Trust. The FY 2026 budget estimates $14.1 million ($8.5 million in the General Fund) in supplemental contributions, a $0.2 million or 1.0% decrease from FY 2025 Adopted levels of $14.2 million. This slight reduction is the result of the economic and demographic assumptions used in the annual CalPERS Valuation reports, including but not limited to investment returns.
    - *California Employers' Retiree Benefit Trust (CERBT) Fund contributions for Retiree medical* costs are calculated using a lower 5.75% discount rate as compared to a 6.25% assumption. Through FY 2025, it is expected that $14.7 million in supplemental principal contributions will be made to the CERBT Trust. The FY 2025 Budget estimates $12.4 million in the General Fund for ADC, an approximate $1.9 million or 18.4% increase from FY 2025 levels of $10.5 million.
    - *Capital Infrastructure transfers* reflect the goal established as part of the 2022-2026 Capital Improvement Plan (CIP) to restore the base portion of this transfer to pre-pandemic levels by FY 2026. The local economy has recovered from the

COVID-19 pandemic, and estimated transfers from TOT revenues in FY 2026 are currently projected to increase to $14.2 million and the base transfer to increase to $17.2 million, along with estimated interest earnings of $2.0 million, for a total $33.4 million transfer to the Capital Improvement Fund.

- Inflationary assumptions in this long range reflect lower inflation being seen at present. A 3% annual inflation is assumed in FY 2026 and FY 2027 and increases to 4% in FY 2028 through the end of the ten-year forecast to estimate cost increases for non-salary services and equipment.
- Some limited term programs are not extended through the entire ten-year forecast, but discussed later in this report to indicate that continuing the programs would require additional resources. This LRFF also includes the City's committed investment of $7.0 million in operating expenses for the partnership with LifeMoves and *Project Homekey* site services ($1.0 million annually from FY 2025 through FY 2031). The timing of the funding was shifted as a result of $2.0 million from FY 2023 and FY 2024 being approved by the Council to be used to fund expenses related to the Homekey Facilities capital project (PE-24005). Staff will monitor operating funding needs in FY 2025 to align allocations based on the timing of the completion of PE-24005.

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

Expenditures & Other Uses	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	CAGR 10 Years	CAGR 5 Years
Salary	78,760	88,512	97,312	97,312	101,839	107,179	111,331	115,414	118,033	120,464	122,475	124,496	126,925	136,025	3.4%	1.5%
Benefits	67,956	75,750	82,565	82,565	86,482	87,284	89,783	93,298	94,578	95,883	96,904	98,426	100,343	102,044	2.1%	0.9%
Subtotal: Salary & Benefits	146,717	164,262	179,877	179,877	188,320	194,463	201,113	208,712	212,611	216,347	219,379	222,922	227,268	238,068	2.8%	1.2%
Contract Services	24,214	32,091	33,571	33,571	34,619	35,683	36,902	38,656	39,532	40,575	41,923	44,090	45,625	47,849	3.6%	1.3%
Supplies & Material	3,048	3,696	3,515	3,515	3,610	3,718	3,867	4,022	4,183	4,350	4,524	4,705	4,893	5,089	3.8%	1.5%
General Expense	7,515	14,480	22,139	22,139	18,190	10,449	11,211	11,471	11,716	11,968	12,252	12,273	12,816	13,108	-5.1%	-4.3%
Rents & Leases	163	1,338	1,415	1,415	1,453	1,493	1,533	1,575	1,617	1,661	1,706	1,753	1,801	1,850	2.7%	1.1%
Facilities & Equipment	446	557	656	656	536	552	574	597	621	646	672	699	727	756	1.4%	1.5%
Allocated Charges	22,564	25,639	26,882	26,882	30,353	31,421	32,611	33,801	34,950	36,039	37,139	38,287	39,458	40,776	4.3%	1.4%
Total Non Sal/Ben Before Transfers	57,949	77,800	88,177	88,177	88,761	83,315	86,697	90,121	92,619	95,238	98,215	101,806	105,320	109,428	2.2%	0.4%
Operating Transfers-Out	12,342	6,743	6,314	6,314	6,351	6,382	6,419	6,457	6,490	6,528	6,566	6,576	6,615	6,654	0.5%	0.2%
Transfer to Infrastructure - Base	14,673	18,590	18,857	18,857	22,118	22,133	22,732	23,341	23,973	24,608	25,284	25,972	26,668	27,382	3.8%	0.8%
Transfer to Infrastructure - TOT	12,014	13,667	13,669	13,669	14,238	14,878	15,596	16,364	17,178	18,041	18,985	19,982	21,032	22,135	4.9%	1.9%
Total Use of Funds	243,695	281,062	306,893	306,893	319,788	321,171	332,558	344,995	352,870	360,763	368,429	377,258	386,903	403,667	2.8%	1.0%

Expenditures & Other Uses	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Salary		12.4%	9.9%	0.0%	4.7%	5.2%	3.9%	3.7%	2.3%	2.1%	1.7%	1.6%	2.0%	7.2%
Benefits		11.5%	9.0%	0.0%	4.7%	0.9%	2.9%	3.9%	1.4%	1.4%	1.1%	1.6%	1.9%	1.7%
Subtotal: Salary & Benefits		12.0%	9.5%	0.0%	4.7%	3.3%	3.4%	3.8%	1.9%	1.8%	1.4%	1.6%	1.9%	4.8%
Contract Services		32.5%	4.6%	0.0%	3.1%	3.1%	3.4%	4.8%	2.3%	2.6%	3.3%	5.2%	3.5%	4.9%
Supplies & Material		21.3%	-4.9%	0.0%	2.7%	3.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
General Expense		92.7%	52.9%	0.0%	-17.8%	-42.6%	7.3%	2.3%	2.1%	2.2%	2.4%	0.2%	4.4%	2.3%
Rents & Leases		721.7%	5.8%	0.0%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.8%	2.7%	2.7%
Facilities & Equipment		24.8%	17.7%	0.0%	-18.3%	3.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Allocated Charges		13.6%	4.8%	0.0%	12.9%	3.5%	3.8%	3.6%	3.4%	3.1%	3.1%	3.1%	3.1%	3.3%
Total Non Sal/Ben Before Transfers		34.3%	13.3%	0.0%	0.7%	-6.1%	4.1%	3.9%	2.8%	2.8%	3.1%	3.7%	3.5%	3.9%
Operating Transfers-Out		-45.4%	-6.4%	0.0%	0.6%	0.5%	0.6%	0.6%	0.5%	0.6%	0.6%	0.2%	0.6%	0.6%
Transfer to Infrastructure - Base		26.7%	1.4%	0.0%	17.3%	0.1%	2.7%	2.7%	2.7%	2.6%	2.7%	2.7%	2.7%	2.7%
Transfer to Infrastructure - TOT		13.8%	0.0%	0.0%	4.2%	4.5%	4.8%	4.9%	5.0%	5.0%	5.2%	5.3%	5.3%	5.2%
Total Use of Funds		15.3%	9.2%	0.0%	4.2%	0.4%	3.5%	3.7%	2.3%	2.2%	2.1%	2.4%	2.6%	4.3%

Budget Stabilization Reserve

The City's Budget Stabilization Reserve (BSR) serves as the primary General Fund reserve. By policy, the BSR is maintained in the range of 15 to 20% of General Fund operating expenditures, with a target of 18.5%. As part of the FY 2025 Adopted Budget, the Council approved a targeted BSR of 18.5% or $54.4 million as part of the budget balancing strategy. Any reduction to the reserve below 15% requires City Council approval. At the discretion of the City Manager, any BSR balance above 18.5% may be transferred to the Infrastructure Reserve (IR) in the Capital

Improvement Fund and the City's Section 115 Pension Trust Fund, as outlined in the Retiree Benefit Policy. The BSR is used to fund unanticipated one-time costs as opposed to ongoing or recurring operating expenditures; ongoing revenue or expense trends are updated as part of the annual budget process to adjust ongoing needs. The City's intent is to fund ongoing programs and services with ongoing dollars. Maintaining the BSR at 18.5% or higher 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 2024 Annual Comprehensive Financial Report (ACFR) CMR 2404-2912[2], the City's current BSR balance is $65.9 million, approximately $8.9 million above the 18.5% target of $54.4 million for FY 2025. The proposed allocations are for the Capital Fund Infrastructure Reserve (IR) of $3.0 million and Budget Uncertainty Reserve of $5.9 million. While it is a departure from the current policy, this allocation provides flexibility to fund capital cost uncertainties and adequate funding to address the projected FY 2026 budget shortfall, ensuring the City maintains high quality service level. Staff anticipates returning to Council in February 2025 with the FY 2025 Mid-Year Review and recommendations in alignment with the allocation below for the appropriation of BSR funds above the 18.5% level. These actions will leave the BSR at $54.4 million per the 18.5% Council recommended level.

[2]Finance Committee, December 3, 2024; Agenda Item #2; Staff Report #2404-2912, https://cityofpaloalto.primegov.com/portal/viewer?id=9637&type=3

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

General Fund BSR Balance, June 30, 2024	**$65.9**
FY 2025 Approved Adjustments to the BSR Balance	
FY 2025 Adopted Budget	($2.6)
Subtotal: Approved Adjustments to the BSR Balance	***($2.6)***
Subtotal: BSR Balance, After Approved Adjustments	**$63.3**
FY 2025 RECOMMENDED Adjustments to the BSR Balance (to be appropriated in FY 2025 Mid-Year Budget Review)	
Transfer to Infrastructure Reserve (IR) in the Capital Improvement Fund	($3.0)
Increase Uncertainty Reserve	($5.9)
Subtotal: RECOMMENDED Adjustments to the BSR Balance	**($8.9)**
Current Projected FY 2025 BSR Level, (June 30, 2025)	**$54.4**

As mentioned previously, major tax revenues have continued to grow moderately through the first quarter (Q1) of FY 2025 in alignment with projections and are expected to come in at the FY 2025 Adopted Budget levels. In FY 2025, staff estimates total revenues to be consistent with the Adopted Budget of $287.6 million. Further discussion of changes to specific categories for FY 2026 can be found in Attachment C. Staff will continue to monitor revenues especially amongst significant sources with anticipated increases and decreases and provide another update in FY 2025 mid-year budget update (February 2025).

In addition to the BSR, funding of approximately $6.1 million remains in an Uncertainty Reserve that was established as part of the FY 2023 Mid-Year Review to fund the two-year budget strategy for FY 2024 and FY 2025. These funds are one-time in nature so once they are spent, they are not available for ongoing needs.

Assumptions NOT Included in Forecast

It should be noted that this forecast does not include several potential impacts to the FY 2026-2035 LRFF that are outlined in **Attachment E**. These items are known projects or areas of investment that are priorities but have not been fully developed in terms of costs and timelines. This is not intended to be a comprehensive list nor in any priority order.

FY 2026 Budget Development Guidelines

As discussed earlier in this document, this preliminary forecast represents the initial steps of the FY 2026 budget development process. Due to the clear overlap of projecting the City's fiscal condition and the need to shape service level expectations, staff recommends that the inclusion of Budget Development Guidelines be incorporated into the discussions at the beginning of an annual budget process. The FY 2026 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.

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

This forecast maintains current service levels approved in FY 2025 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 similar to where it was a year ago in terms of impacts from economic and geo-political uncertainty and evaluating potential impacts on the local economy. Expense savings and uptick in several revenue categories that occurred in FY 2024 caused a one-time surplus of $8.9 million. These revenue trends continue in the forecast, although increases in the near term may be flattened due to economic stagnation. Staff will return to Council in February 2025 with the FY 2025 Mid-Year Review, recommending that the $8.9 million surplus be allocated to the Infrastructure Reserve d ($3.0 million) and Budget Uncertainty Reserve ($5.9 million) to help bridge the FY 2026 budget gap, in accordance with Council policy allowing the City Manager to direct amounts exceeding the BSR target.

The LRFF Base Case assumes a weak economy in 2025, followed by a return to trend growth rates starting in 2026 and through the remaining ten-year forecast period. Revenue growth is anticipated to stagnate through the end of FY 2025, and potentially into FY 2026, as inflationary pressures remain elevated and borrowing costs continue to weigh on economic activity. As a result, the LRFF projects a shortfall of $12.0 million in FY 2026, followed by shortfalls ranging from

$7.9 million in FY 2027 to $5.6 million in FY 2029. FY 2030 has a projected surplus of $2.0 million which continues to grow through FY 2035. These amounts are fairly consistent with previous projections used as part of the two-year budget balancing strategy when adopting the FY 2025 Budget. Additionally, this LRFF projects $287.6 million in total revenues in FY 2025, consistent with the adopted budget.

Funding of approximately $6.1 million remains in an Uncertainty Reserve that was established as part of the FY 2023 Mid-Year Review to fund the two-year budget strategy for FY 2024 and FY 2025. This forecast includes the addition of $5.9 to the Budget Uncertainty Reserve, bringing the total amount of the reserve to $12.0 million, These funds are one-time in nature so once they are spent, they are not available for ongoing needs.

In addition to the Base Case Forecast, staff modeled alternate forecast scenarios that are discussed below. The first alternative reflects a 1% loss in economically sensitive revenue in FY 2026 compared to the Base Case, and increases the General Fund shortfall over the next ten years. FY 2026 increases from a shortfall of $12.0 million to $14.3 million, and revenues are not anticipated to be able to fund the annual expenditures until FY 2030. Staff also modeled an alternate forecast that reflects a 1% compensation adjustment and the impacts on the General Fund over the next ten years. The shortfall in FY 2026 increases by $1.1 million, the shortfall in FY 2027 grows to $9.0 million from $7.9 million in the Base Case. These alternate forecasts were done separately to show the impacts of each scenario in isolation; however, aspects of both alternate forecasts may occur in conjunction in the future.

Alternative Scenarios for Consideration

Alternative Forecast Scenario A: Economically Sensitive Revenue Loss

This alternative forecast models the impact of a 1% revenue loss on economically sensitive revenue. Since it is difficult to predict the timing of a recession, this scenario shows the cost of a revenue loss in FY 2026 and how it would impact the subsequent years of the forecast. The major taxes, charges for services, and permits and licenses revenue categories are typically impacted by economic changes, so the impact has been calculated on these revenue sources. The 1% loss from these revenue sources would reduce the overall revenue in FY 2026 by $2.3 million. The Base Case projected that by FY 2030, the City would begin to have a positive surplus; this alternative forecast changes the surplus of $2.0 million in FY 2030 to a shortfall of $0.8 million. In this alternative, the General Fund would have a shortfall of approximately $14.3 million in the first year of the forecast. The summary table for this alternative forecast and the Net Operating Margin graph for this alternative forecast are below.

TABLE 8: FY 2026 – FY 2035 Long Range Financial Forecast

Alternative Forecast A

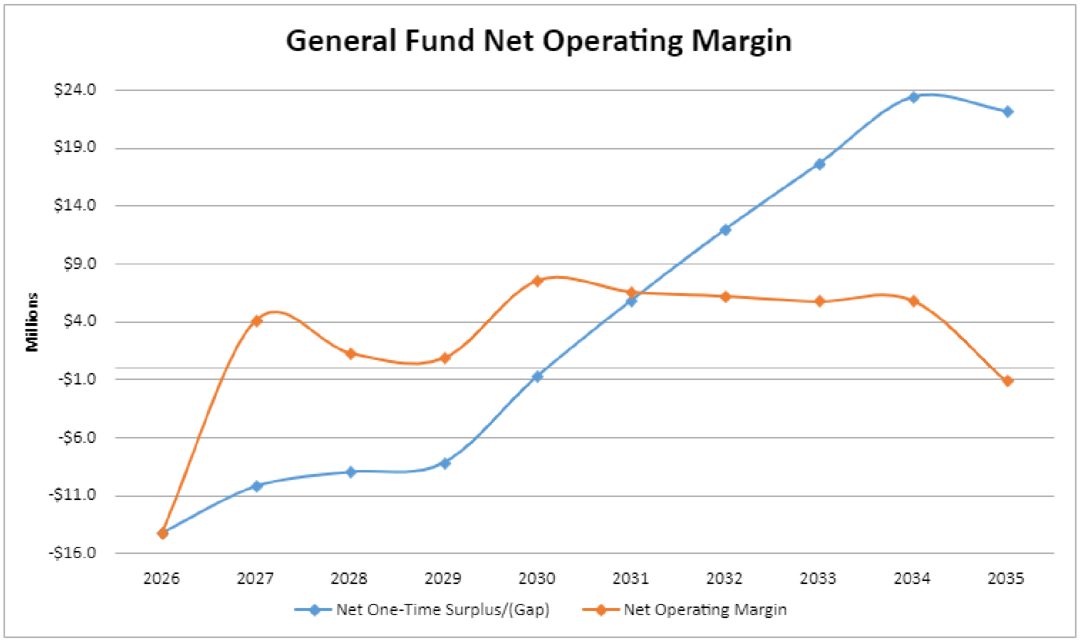
ALTERNATIVE SCENARIO: RECESSION (1% Loss of Economically Sensitive Revenue in FY 2026)

	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Total Revenue	$254,799	$278,231	$287,554	$287,554	296,297	310,914	323,534	336,745	352,109	366,516	380,316	394,823	410,228	425,785
BSR Contribution (One-Time)	-	-	$3,247	$3,247	-	-	-	-	-	-	-	-	-	-
Reappropriated Funds (One-Time	-	-	$16,093	$16,093	9,200	-	-	-	-	-	-	-	-	-
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$305,497	$310,914	$323,534	$336,745	$352,109	$366,516	$380,316	$394,823	$410,228	$425,785
Year over Year increase (revenue only)					*3.0%*	*4.9%*	*4.1%*	*4.1%*	*4.6%*	*4.1%*	*3.8%*	*3.8%*	*3.9%*	*3.8%*
Total Expenditures	243,695	281,062	306,893	306,893	319,788	321,169	332,555	344,992	352,868	360,760	368,426	377,255	386,900	403,664
Total Use of Funds	$243,695	$281,062	$306,893	$306,893	$319,788	$321,169	$332,555	$344,992	$352,868	$360,760	$368,426	$377,255	$386,900	$403,664
Year over Year increase					*4.2%*	*0.4%*	*3.5%*	*3.7%*	*2.3%*	*2.2%*	*2.1%*	*2.4%*	*2.6%*	*4.3%*
Net One-Time Surplus/(Gap)	$11,104	($2,831)	$0	$0	($14,292)	($10,255)	($9,021)	($8,247)	($759)	$5,757	$11,890	$17,567	$23,328	$22,121
Cumulative Net Operating Margin (One-Time)														$38,088
Net Operating Margin					($14,292)	$4,036	$1,234	$774	$7,488	$6,516	$6,133	$5,678	$5,761	($1,207)
Cumulative Net Operating Margin														$22,121

Net Operating Margin assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures

TABLE 9: FY 2026 –2035 Long Range Financial Forecast Net Operating Margin

Alternative Forecast A



Alternative Forecast B: One-time Compensation Adjustment, Additional 1%

Consistent with City Council direction and past practice, the Base Case assumes a 2% general wage adjustment in the years beyond the terms of existing Memorandum of Agreements (MOAs). As of the timing of this forecast, MOAs are in effect through January 2025 (Service Employees International Union) (SEIU) and June 2025 (all other full-time labor groups). To support ongoing efforts for competitive wages and other terms of employment, the Base Case forecast includes a reserve for potential changes in new labor agreements, pension, or other benefits. Offering competitive compensation plans aligns with industry standards for attracting and retaining a skilled and motivated workforce and better positions the City of Palo Alto as an employer of choice. This level of funding is intended to offset potential future costs and may differ from actual outcomes. Negotiations for new labor agreements are anticipated to occur in FY 2025 for new terms beginning in FY 2025 and FY 2026.

This alternative scenario models the impact of a one-time adjustment in FY 2026 to increase compensation by an additional 1% above assumptions in the Base Case; this is the first full fiscal year for new MOA terms with all labor groups. As with other assumptions in the LRFF, this model is for forecasting purposes and does not reflect future commitment.

The one-time compensation adjustment would increase expenditures in FY 2026 by $1.1 million. The Base Case projected that by FY 2030, the City would begin to have a positive surplus; this alternative forecast increases the operating shortfalls in the near-term, resulting in budget gaps ranging from $13.1million in FY 2026 to $6.8 million in FY 2029. The summary table for this alternative forecast and the Net Operating Margin graph for this alternative forecast are below.

TABLE 10: FY 2026 – FY 2035 Long Range Financial Forecast

Alternative Forecast B

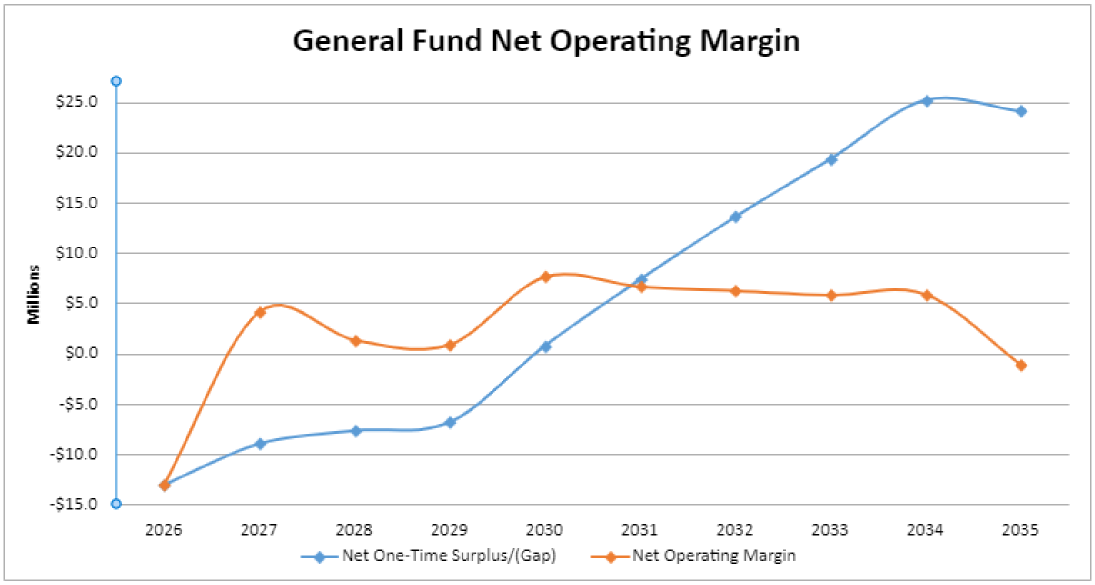
ALTERNATIVE SCENARIO: ONE-TIME COMPENSATION ADJUSTMENT (ADDITIONAL 1%) in FY 2026

	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Total Revenue	$254,799	$278,231	$287,554	$287,554	298,600	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
BSR Contribution (One-Time)	-	-	$3,247	$3,247	-	-	-	-	-	-	-	-	-	-
Reappropriated Funds (One-Time	-	-	$16,093	$16,093	9,200	-	-	-	-	-	-	-	-	-
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$307,800	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
Year over Year increase (revenue only)					*3.8%*	*4.9%*	*4.1%*	*4.1%*	*4.6%*	*4.1%*	*3.8%*	*3.8%*	*3.9%*	*3.8%*
Total Expenditures	243,695	281,062	306,893	306,893	320,878	322,305	333,725	346,198	354,097	362,014	369,705	378,560	388,231	405,021
Total Use of Funds	$243,695	$281,062	$306,893	$306,893	$320,878	$322,305	$333,725	$346,198	$354,097	$362,014	$369,705	$378,560	$388,231	$405,021
Year over Year increase					*4.6%*	*0.4%*	*3.5%*	*3.7%*	*2.3%*	*2.2%*	*2.1%*	*2.4%*	*2.6%*	*4.3%*
Net One-Time Surplus/(Gap)	$11,104	($2,831)	$0	$0	($13,078)	($8,991)	($7,686)	($6,849)	$737	$7,338	$13,547	$19,311	$25,168	$24,046
Cumulative Net Operating Margin (One-Time)														$53,542
Net Operating Margin					($13,078)	$4,087	$1,305	$837	$7,586	$6,601	$6,210	$5,763	$5,857	($1,121)
Cumulative Net Operating Margin														$24,046

Net Operating Margin assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures

TABLE 11: FY 2026 – 2035 Long Range Financial Forecast Net Operating Margin

Alternative Forecast B



FISCAL/RESOURCE IMPACT
Financial implications from this report and input from the Finance Committee and City Council will be considered in the City Manager's development of the Fiscal Year 2026 budget.

STAKEHOLDER ENGAGEMENT
The preliminary forecast for 2026-2035 represents the beginning of the fiscal year 2026 budget development process. Information provided in this report will be discussed with the City Council after the Finance Committee reviews and provides recommendations. 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 2025, according to the standard budget adoption process.

The community can track previous and upcoming FY 2026 budget discussions and information at www.cityofpaloalto.org/budget

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

ATTACHMENTS
Attachment A: FY 2026 Budget Policy Guidelines
Attachment B: The Economy
Attachment C: General Fund Base Case Revenue Assumptions
Attachment D: General Fund Base Case Expense Assumptions
Attachment E: Assumptions Not Included in Forecast

APPROVED BY:
Lauren Lai, Administrative Services Director

FY 2026 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) Review resource allocation for the City Council's existing priorities and identify priority funding needs.

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 the City Council.

ATTACHMENT B

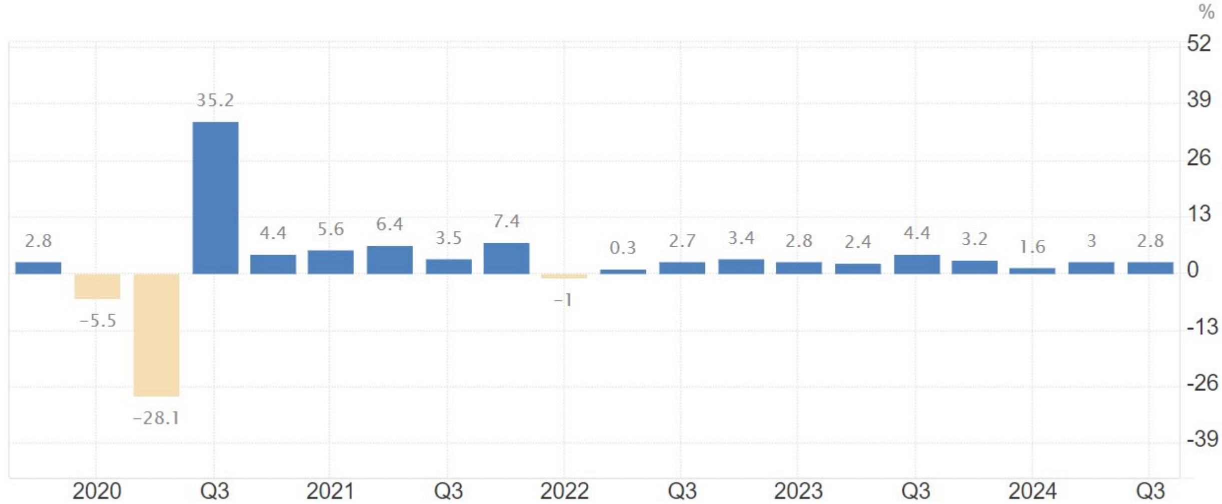
The Economy

At the national level, economic growth through the third quarter of calendar year 2024, was led by GDP (gross domestic product) growth and strong consumer (retail) spending despite lower yet still higher than preferred inflation rates and borrowing costs with interest rates. The gross domestic product (GDP), a measure of all goods and services produced in the economy, increased at an annualized rate of 2.8% in the third quarter of 2024, in between the first quarter of 1.6% and second quarter of 3.0% growth. As of October 2024, the consumer price index (CPI), which measures changes in the prices paid by consumers for a basket of goods and services, was 2.6%. This is lower than the 3.2% CPI from a year ago. Assumptions in the LRFF report for general cost increases are using a CPI of 3% in FY 2026 and FY 2027 and 4% for FY2028 and beyond. The unemployment rate, as of October 2024, is 4.1% which is up from 3.7% at the beginning of the 2024 calendar year and is consistent with a "soft-landing" economic slowdown. The unemployment rate in the past six months has been in the low 4% range as a result of the economy slowing down. As expected, the slowdown in economic growth intends to avoid recession for the purpose of stopping the economy from overheating and continuing to experience higher inflation. There are factors to monitor that could change the expected economic growth pattern such as the election results and changing national economic policies and geopolitical events.

The local economy continues to show sluggish performance in the calendar year 2024 with higher than U.S. growth expected in 2025 and 2026 led by technology and aerospace; however, recent election results has added additional market uncertainty to this outcome. The UCLA Anderson outlook states, "The California economy is expected to grow faster than the national economy in 2025 and 2026, but not by much. The risks to the forecast are political and geopolitical, and on the downside, the interest rates could potentially still disrupt the current expansion and, on the upside, international immigration and accelerated onshoring of technical manufacturing could increase growth."

According to the U.S. Bureau of Economic Analysis (BEA), the US economy expanded an annualized 2.8% in the third (calendar) quarter of 2024, below 3% in the second quarter. Personal spending increased at the fastest pace since the first quarter of 2023 (2.8%), boosted by a 6.0% surge in consumption of goods and a robust spending on services, mostly prescription drugs, motor vehicles and parts, outpatient services and food services and accommodations. Government consumption also rose more, led by defense spending, and investment in equipment increased. In addition, the contribution from net trade was less negative, with increases in both exports and imports, led by capital goods, excluding autos. On the other hand, private inventories dragged from the growth, and fixed investment slowed, led by a decline in structures and residential investment.

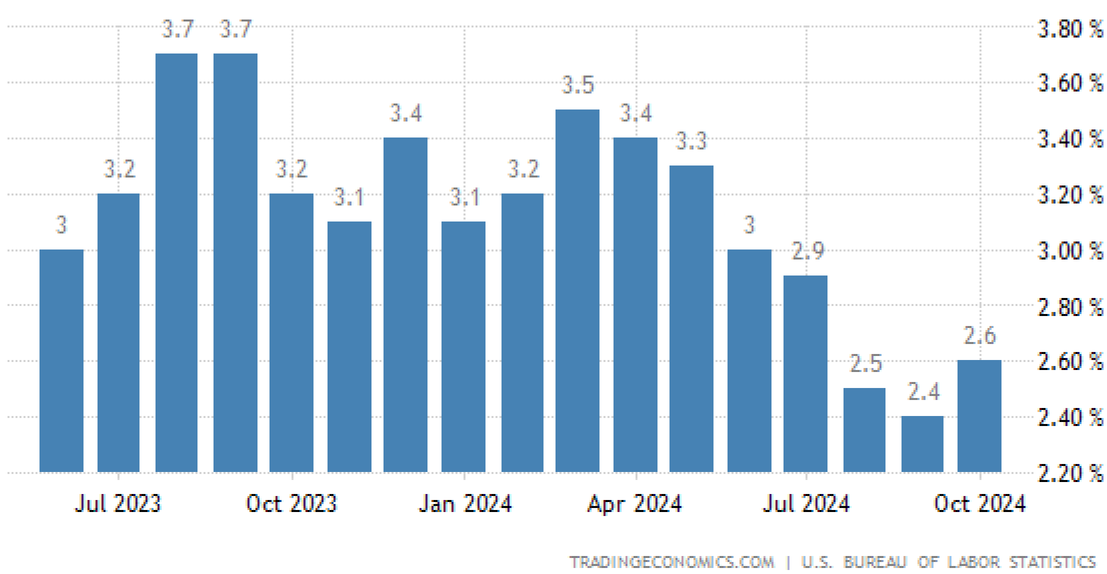
Table 1: National Gross Domestic Product (GDP)
Real GDP: Percent Change from Preceding Quarter



U.S. Bureau of Labor Statistic

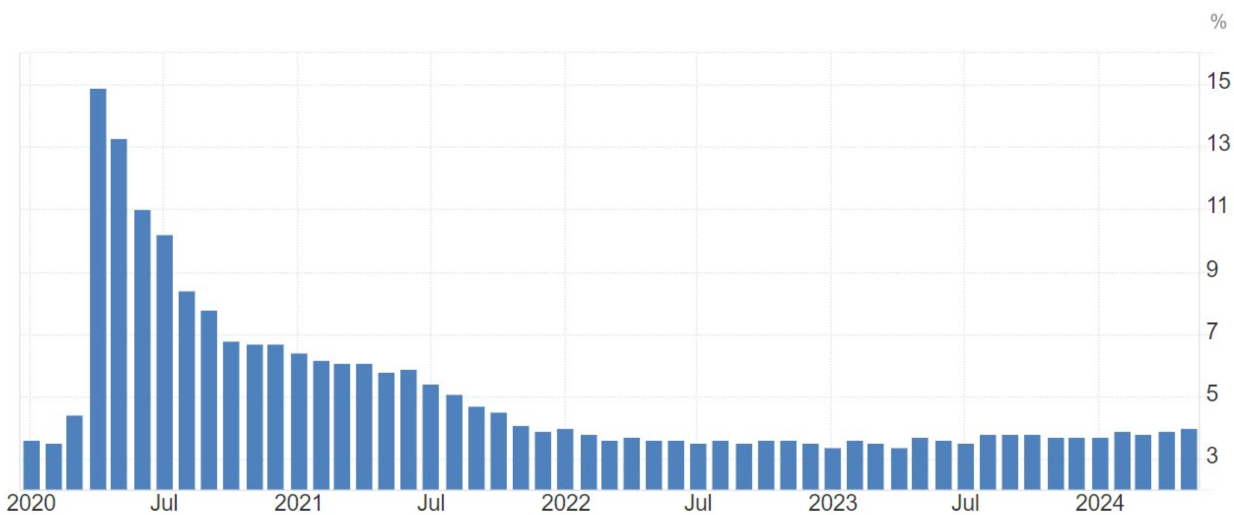
The national inflation rate remained steady but still slightly high compared to the 2% rate targeted by the federal reserve at 2.6% in October 2024, up from September (2.4%) which was the lowest rate since May 2020 (0.1%). It marks the first increase in inflation in seven months, as energy costs declined less, mainly due to gasoline and fuel oil while natural gas prices rose, the same as in September. Also, inflation for shelter steadied at 4.9%. On the other hand, inflation slowed for food and transportation and prices continued to fall for new vehicles and used cars and trucks. On a monthly basis, CPI rose by 0.2%, consistent with the previous three months. The index for shelter rose 0.4%, accounting for over half of the monthly increase. Meanwhile, core inflation remained steady at 3.3% as expected.

Table 2: National Inflation Rate (aka Consumer Price Index (CPI))



The nation's unemployment rate is 4.1% as of October 2024, compared to a record high of 14.7% at the height of the pandemic in April 2020. The number of unemployed individuals was broadly unchanged at 7 million. Among those without employment, permanent unemployment rose slightly to 1.8 million, while temporary layoffs were little changed at 846,000. In turn, long-term unemployment was little changed from the previous month at 1.6 million. In the meantime, the labor force participation rate eased by 0.1 percentage points to 62.6%. Per the State of California's Employment Development Department, the state's unemployment rate as of September 2024 is 5.3% with the prior year being 5% and the County of Santa Clara is 4.1%. 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 and Palo Alto is 4.2% and 3.5% respectively as of September 2024; last year it was 4% and 3.3%, respectively.

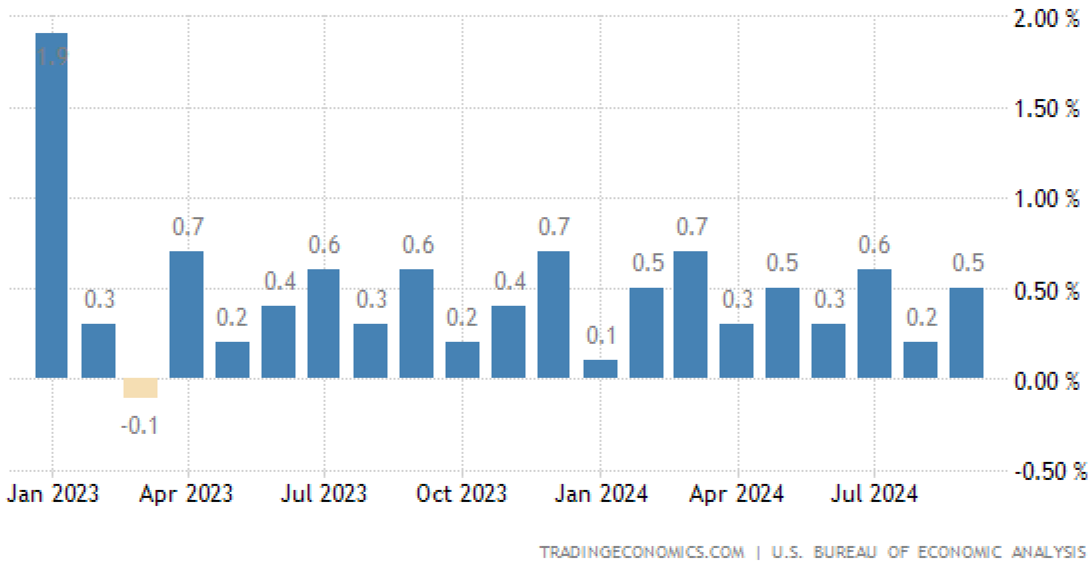
Table 3: U.S. Unemployment Rate



U.S. Bureau of Labor Statistic

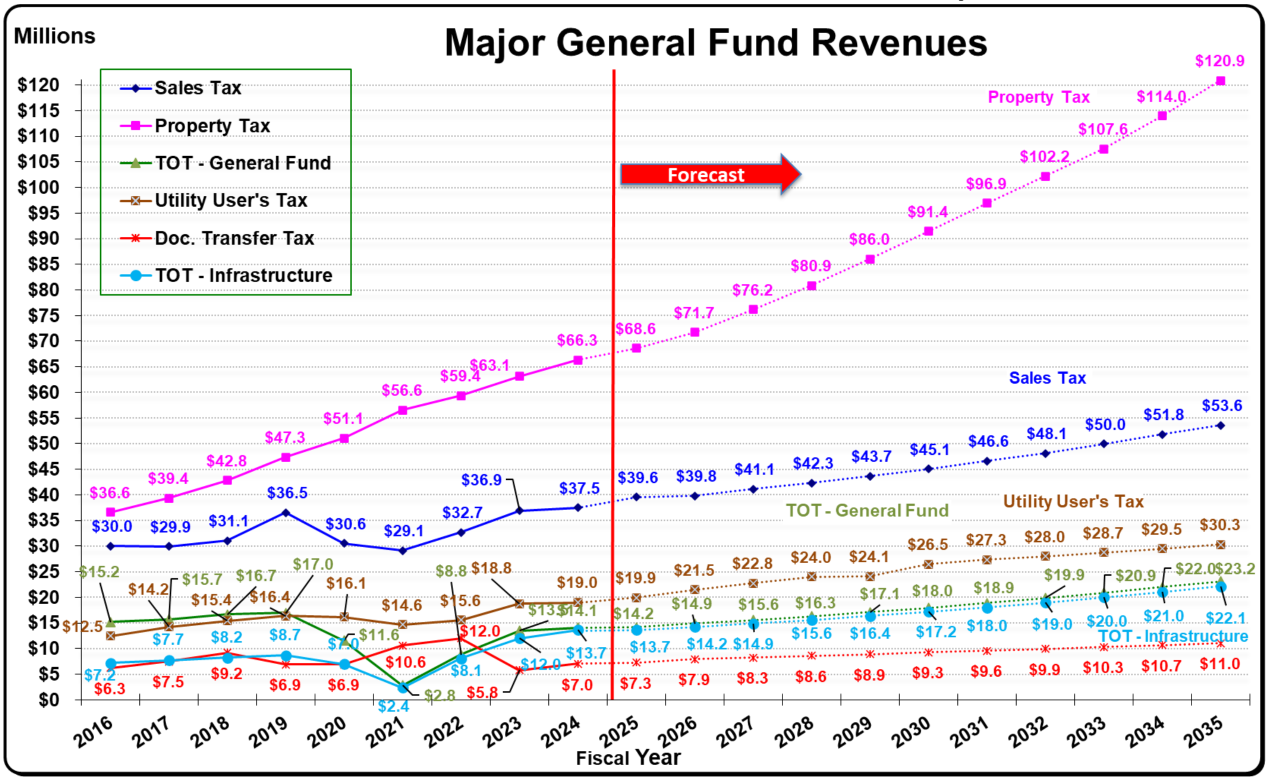
The elevated inflation rate has resulted in the continued erosion of purchasing power; however, there is still growth in U.S. consumer spending. Personal consumption expenditures (PCE) are the primary measure of consumer spending on goods and services in the U.S. economy. It accounts for about two-thirds of domestic final spending, and thus it is one of the main factors that indicates future economic growth. Strength in PCE spending tends to prompt additional business spending. Personal spending in the United States rose by 0.5% from the previous month to an annualized rate of $20.024 trillion in September 2024, accelerating from the 0.3% increase in the previous month, and ahead of market expectations of a 0.4% increase. The result extended the period of resilience of the US consumer to higher interest rates, adding leeway for the Federal Reserve to hold rates at a restrictive level to combat inflation. The rise was owed to higher spending in goods, amid increases for durable goods and non-durable goods, consistent with the jump in spending for services.

Table 4: Personal Consumption Spending Growth



ATTACHMENT C

Table 1: General Fund Base Case Revenue Assumptions

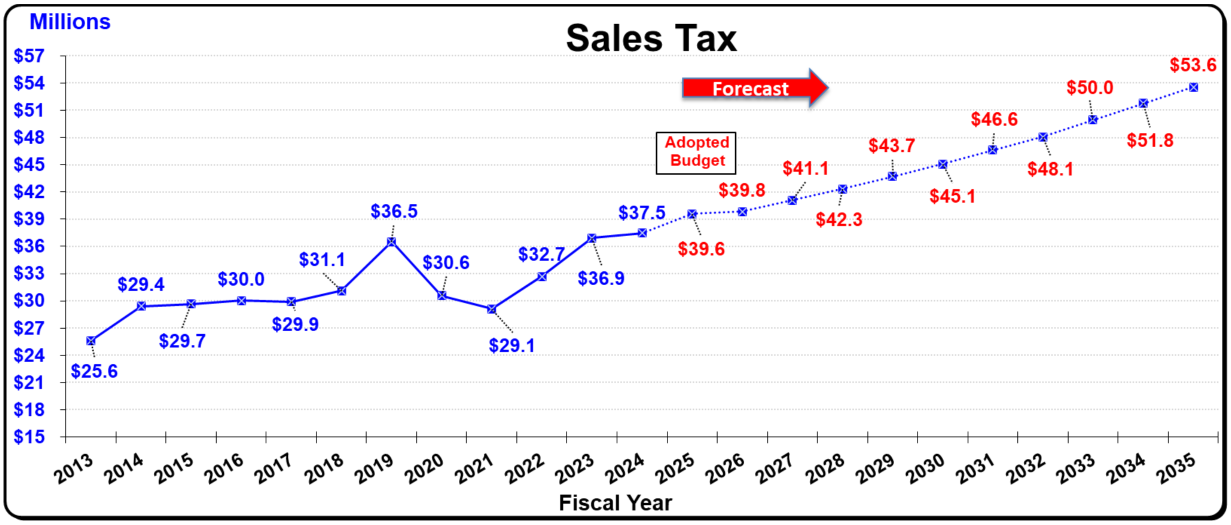


Sales Tax

Compared to FY 2019 pre-pandemic actuals of $36.5 million, sales tax revenue declined by $7.4 million, or 20.2%, during the pandemic in FY 2021. The recovery, which began in the last quarter of FY 2021, resulted in the FY 2022 and FY 2023 receipts increasing by $3.6 million or 12.3% and $4.2 million or 12.9%, respectively. The FY 2024 receipts increased by $0.6 million or 1.5%. With the economic “soft-landing”, the FY 2025 receipts is expected to be relatively flat; however, with the expected opening of a new car dealership at the end of this calendar year, a modest increase may develop compared to FY 2024. The general retail, food products (includes restaurants), transportation, and business to business (includes car leasing) categories experienced increases. This economic trend was mixed in the San Francisco Bay Area and in California. A few municipalities had single digit increases in FY 2024 while most had single or double digit decreases.

The FY 2025 Adopted Budget for Sales Tax is $39.6 million, a $2.1 million or 5.6% increase from FY 2024 actuals of $37.5 million. Staff continues to monitor the FY 2025 sales tax trends. Revenue for FY 2026 is projected at $39.8 million, a slight $0.2 million or 0.6% increase over the FY 2025 Adopted Budget due to many uncertainties surrounding the economy. The Base Case assumes 2.3% to 4% growth over the length of the forecast with a 10-year compound annual growth rate (CAGR) of 3.4%.

TABLE 2: City of Palo Alto Sales Tax Revenues through FY 2035



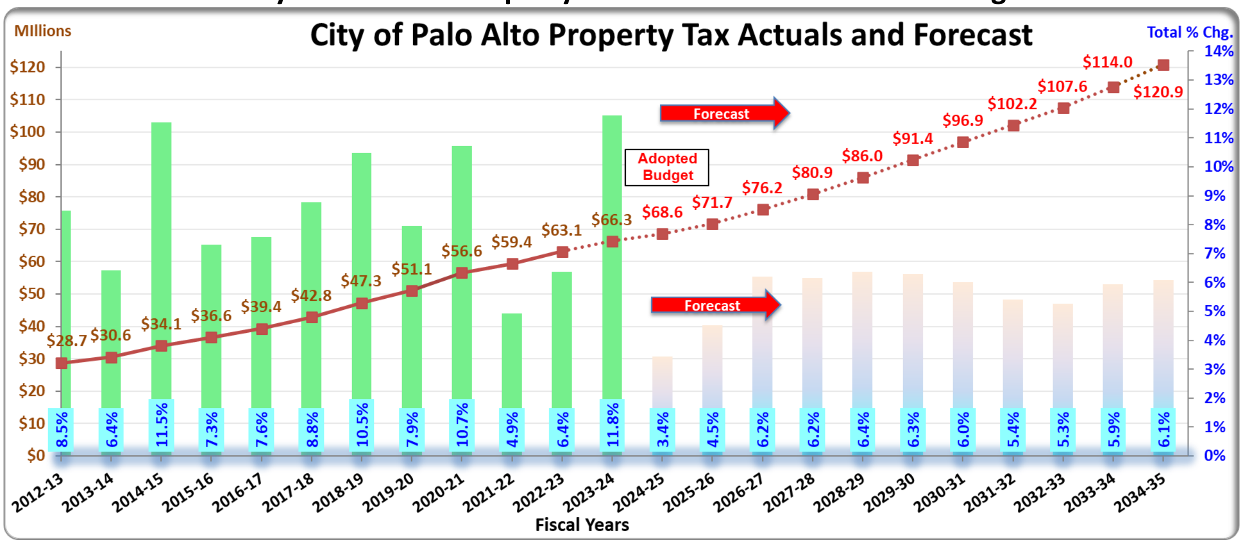
Property Tax

Property tax revenue is the General Fund's largest revenue source and represents approximately 25% of the total revenues. Historically, the 10-year compound annual growth rate (CAGR) was 8.1%, with a low of 4.9% in FY 2022 and a high of 11.5% in FY 2015. During economic downturns, impacts to property tax occur a year later, as a result, the $2.8 million or 4.9% growth in FY 2022 was the lowest in the past decade. This category also includes receipts for excess Educational Revenue Augmentation Fund (ERAF) distributions from the County of Santa Clara. ERAF is the fund used to collect and disburse property taxes that are shifted to/from cities, the County, and special districts prior to their reallocation to K-14 school agencies. When the state shifts more local property tax than required to support schools, these funds are returned and known as excess ERAF. As a result of the volatility of ERAF, it is not considered a permanent local revenue source even though it has performed strongly in the past decade.

ERAF Reserve: Since FY 2021, the City has engaged in several disputes over the calculation and disbursement of excess ERAF Funds. In response, the City established reserves for potential estimated losses at 25% of total Excess ERAF receipts. There were favorable resolutions with the State and Santa Clara County, followed by the State and California School Board Association, for two prior disputes. The associated reserves have been released to the Budget Stabilization Reserve (BSR) or consolidated for potential future at-risk amounts.

A few years ago,, the State Controller's Office issued a negative audit finding against Marin County. The state asserts that former Redevelopment Agency funds, which are now part of the regular property taxes, should be excluded from the excess ERAF calculation. Marin County is challenging this finding and the County of Santa Clara has filed a lawsuit. The estimate is, if this audit finding is sustained, 22% of excess ERAF is at risk for fiscal years 2021, 2022, 2023, and 2024. If the finding holds, the County of Santa Clara, as well as other Excess ERAF counties, would be negatively impacted in FY 2025 and beyond. In FY 2024, $5.6 million was set aside for the Reserve of excess ERAF for the at-risk amount. In addition, 22% or $1.5 million in FY 2025 budget has been reduced by this amount. Staff will continue to monitor the status of this audit finding and report on any significant developments.

TABLE 3: City of Palo Alto Property Tax Actuals and Forecast through FY 2035



Transfer of ownership has been a significant driver of past growth; however, that growth did moderate in FY 2024 which is expected to continue in FY 2025 due to the economic slowdown. For example, the median sales price of single family residential in the first (fiscal year) quarter of FY 2025 increased by 4% over the prior year.

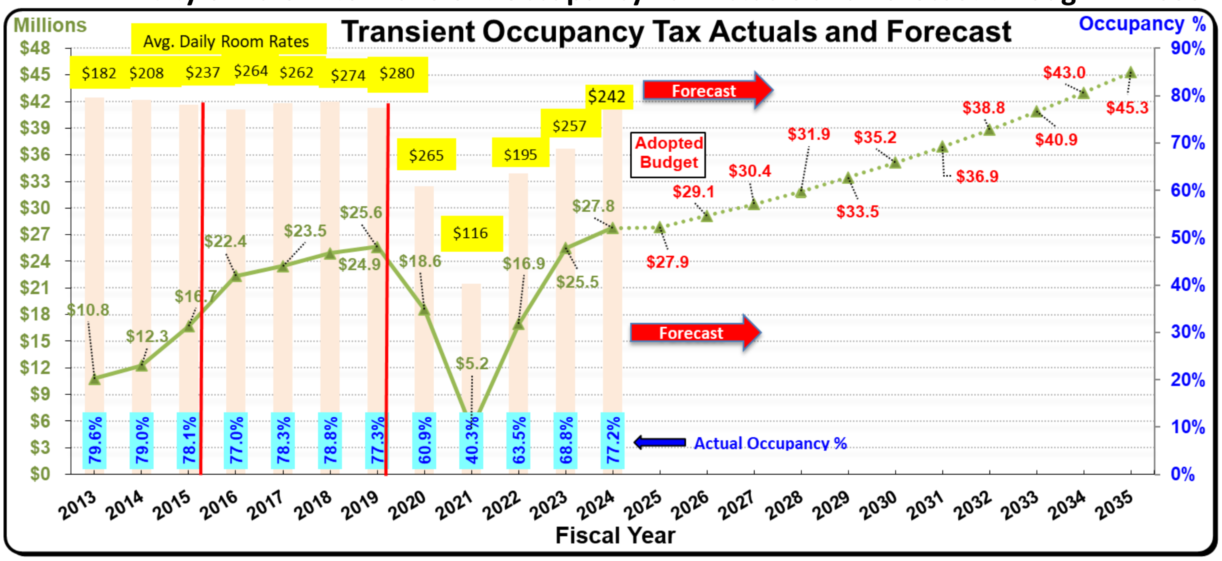
The FY 2025 Adopted Budget for Property Tax is $68.6 million, a $2.3 million or 3.5% increase over the FY 2024 actuals of $66.3 million. In FY 2026, this revenue is anticipated to increase to $71.7 million, a $3.1 million or 4.5% increase over the FY 2025 Adopted Budget amount. The Base Case assumes 5.2% to 6.4% growth over the length of the forecast with a 10-year CAGR of 5.9%.

Transient Occupancy Tax (TOT)

Revenue in this category is impacted by business and other leisure/non-leisure travel and experienced significant reductions in FY 2020 and FY 2021 due to public health orders, travel restrictions, and diminishing business and personal travel plans resulting from the pandemic. TOT revenue declined by $20.5 million or 79.8% in FY 2021, when comparing the FY 2019 pre-pandemic actuals of $25.6 million. As public health conditions improved and travel resumed, this revenue began to recover, significantly grew in FY 2022, and in FY 2023, currently, this revenue has recovered to pre-pandemic levels. The opening of the two Marriott hotels in mid and late FY 2021 and the re-opening of multiple hotels in FY 2021 and FY 2022 were positive developments that helped drive recovery for this tax revenue.

The FY 2025 Adopted Budget for TOT revenue is $27.9 million, a $0.1 million or 0.4% increase over FY 2024 actuals of $27.8 million. In FY 2026, this revenue is anticipated to increase to $29.1 million. Year-to-date (as of August 2024), daily average room rates increased by 0.5% from $220 per day to $221 per day while occupancy rate decreased by 9.9% from 76.6% to 69.0%. Revenue in this category is experiencing a near term stagnation; however, it's anticipated to grow in FY 2026 and beyond at a projected rate of 1.3% to 5.3% over the length of the forecast, or a 4.9% 10-year CAGR.

TABLE 4: City of Palo Alto Transient Occupancy Tax Actuals and Forecast through FY 2035

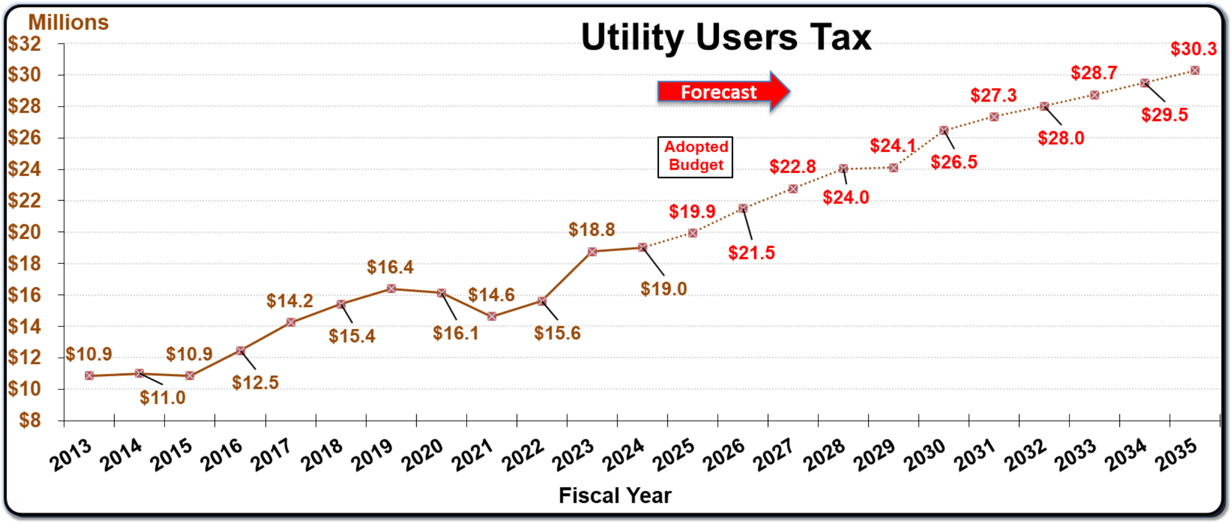


Note: January 2015, TOT Rate went from 12% to 14%
April 2019, TOT Rate went from 14% to 15.5%

Utility User's Tax (UUT)

The UUT is levied on electric, gas, and water consumption, as well as on telephone usage. Revenue in this category is impacted by consumption levels and has experienced reductions in prior periods due to water conservation programs and reduced workforces and business closures during the pandemic. This revenue has recovered as the local economy recovered and workers returned to the office in FY 2023. In addition, higher utility commodity costs resulted in sizable utility rate increases and higher UUT revenues. The FY 2025 Adopted Budget for UUT is $19.9 million, $0.9 million or 4.7% higher than the FY 2024 actuals of $19.0 million. In FY 2026, this revenue is anticipated to increase to $21.5 million, a $1.6 million or 7.9% increase over the FY 2025 budgeted amount. Revenue in this category is expected togrow at 2.5% to 9.8% over the length of the forecast, or a 10-year CAGR of 4.0%.

TABLE 5: City of Palo Alto Utility Users Tax Actuals and Forecast through FY 2035

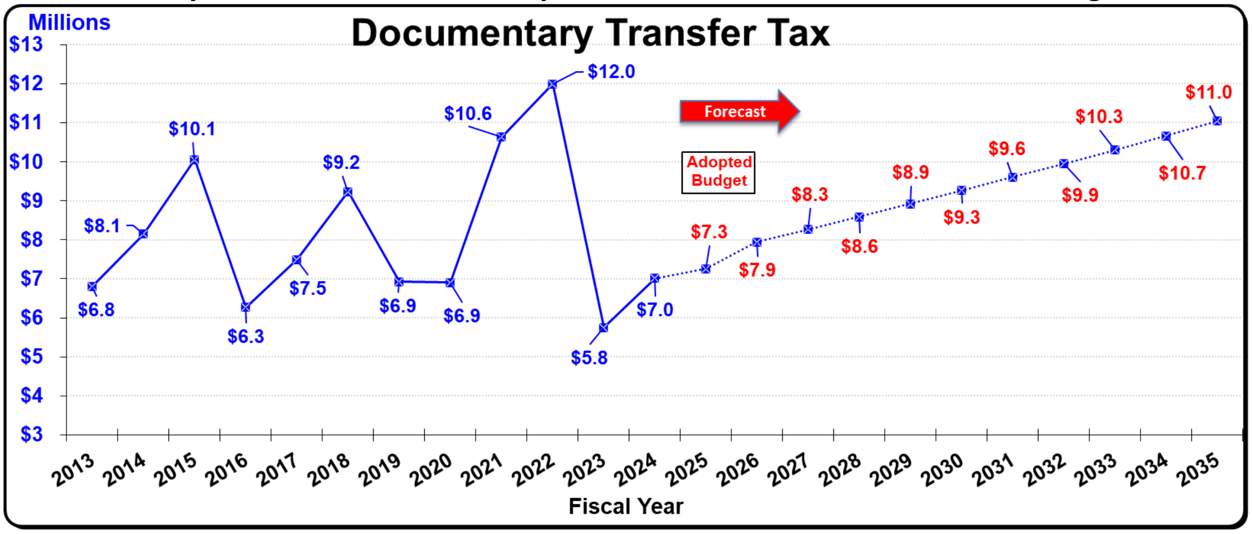


<u>Documentary Transfer Tax (DTT)</u>

Revenue in this category is highly volatile and dependent on sales volume and the mix of commercial and residential sales. DTT experienced record receipts in FY 2021 and FY 2022 at $10.6 million and $12.0 million, respectively,which was followed by a sharp decline in FY 2023 at $5.8 million. In both record years, the primary drivers werelarge commercial transactions, six in FY 2021 and nine in FY 2022, and robust residential sales. In FY 2023, sales activities normalized, dropping revenue to $5.8 million, but the FY 2024 receipts were $7 million, a 10.1% increase in transactions. The FY 2025 Adopted Budget for DTT is $7.3 million, $0.3 million or 3.5% higher than FY 2024 actuals. In FY 2026, this revenue is projected to increase to $7.9 million, a $0.6 million or 9.4% increase, from the FY 2025 budgeted amount of $7.3 million.

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 2024 (217) is 14.2% higher than October 2023, with the total revenue from these transactions increasing by 14.2%. The Palo Alto housing market remains strong, as discussed in the Property Taxes section, single family residential median sales price in Palo Alto has increased, which is an expected occurrence as the predicated economic soft landing and lower mortgage rate will impact property sales activity in FY 2025.

TABLE 6: City of Palo Alto Documentary Transfer Tax Actuals and Forecast through FY 2035



Business Tax (BT)

In November 2022, voters approved Measure K (Business Tax) to provide additional funding for critical public safety needs, transportation safety improvements and grade separations, and affordable housing and unhoused services. The first BT payment was due on January 1, 2024, for calendar year 2023. As a result, the FY 2024 receipt of $5.3 million represents a year and half of collection. However, the initial collection was based on a BT rate of 3.75 cents per square foot which will increase to 7.5 per square foot starting on January 1, 2025. The tax applies to non-exempt businesses above 10,000 square feet with an annual single business cap of $500,000. Both the rate and the cap will be increased annually by 2.5% beginning in FY 2027. A limited number of businesses have the option to offset this tax by their sales/use tax collection. After the initial first payment, filings will be submitted on a quarterly basis.

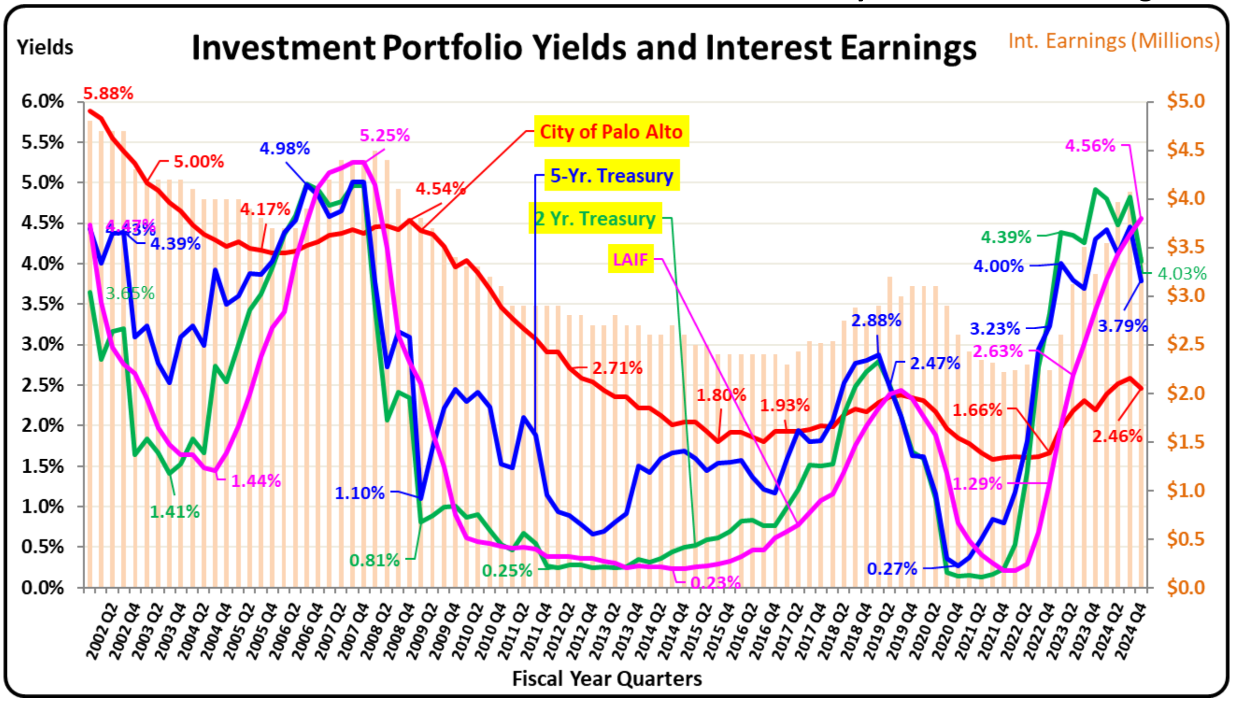
The FY 2025 Adopted Budget for BT is $4.8 million, a $0.5 million or 9.9% lower than the FY 2024 actuals of $5.3 million. In FY 2026, this revenue is anticipated to increase to $6.5 million. Revenue in this category, after an initial double-digit growth due to the rate increase, is expected to experience growth at 3% to 3.8% over the length of the forecast, with a 10-year CAGR of 5.6%. Since this is a relatively new revenue source, staff continues to monitor collections and will make revisions if needed as part of FY 2026 budget process.

Return on Investment

The return-on-investment category reflects the interest earnings on the City's investment portfolio. This category is a combination of past investments, new investments at current market rates, and available investable cash which fluctuates seasonally and annually. As of the timing of this LRFF, the Federal Open Market Committee (FOMC) has cut the federal funds rate twice totaling 0.75% to 4.75% (75 basis points). It is expected that further interest rates cuts will occur.

The actual FY 2024 interest earning was $3.7 million, higher than expected due an increasing interest rate environment. The average portfolio rate of return for the first quarter of FY 2025 was 2.46%, and a 2.59% average yield as of the fourth quarter of FY 2024. The adopted General Fund FY 2025 budget for interest earning is $3.3 million, and is projected at $3.8 million for FY 2026, with a 4.2% CAGR over the ten-year period.

TABLE 7: Palo Alto Historical Investment Portfolio Yields and Citywide Interest Earnings



Rental Income

Rental Income of $16.4 million in FY 2026 primarily reflects rent paid to the General Fund from the City's Enterprise Funds and tenants at the Cubberley Community Center. Rental income is projected to remain flat compared to the FY 2025 Adopted Budget. This revenue category will be further reviewed and revised subsequent to this forecast, typically based on the December-to-December California Consumer Price Index (CCPI) in the San Francisco Bay Area.

Charges for Services and Permits and Licenses

Revenues in the Charges for Services and the Permits and Licenses categories are anticipated to be $41.3 million and $11.6 million, respectively, in FY 2026. Together, these amounts total $52.9 million and are approximately $3.6 million higher than the FY 2025 Adopted Budget of $49.3 million. Increases in these categories are primarily due to revenue adjustments for the agreement with Stanford to provide Fire and Dispatch services, and higher forecasts for permit and plan review services processed through the Development Center.

The revenue estimates in these categories are based on current activity levels, and these revenue sources are primarily driven by the cost of staff to provide services to the community. To ensure alignment with target cost recovery levels, the City has engaged a consulting firm to assist with a comprehensive cost allocation plan and municipal fee study during FY 2025, with implementation anticipated in FY 2026. Staff will evaluate and bring forward recommendations to align fees with target cost recovery levels to cover general salary and benefits increases and CPI trends. These efforts aim to improve fee transparency and ensure equitable cost distribution across City services. One exception to this is 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.

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 extended through June 2023, with annual renewals in effect through June 2028 unless otherwise terminated. The agreement includes a 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 over the forecast period. Similarly, changes to the revenue received for dispatching services have been aligned with the operating expenses in the Technical Services Division of the Police Department where the costs to provide these services are budgeted. For fire and police revenue, additional adjustments may be applicable if new labor agreements are negotiated for the forecast period. Revenues for these services are based on current anticipated changes in salary and benefits costs within the Fire Department and Police Department Dispatch Unit.

Charges to Other Funds

The main source of revenues in this category is General Fund administrative cost allocation plan charges to the Enterprise and Internal Service Funds. Internal support departments such as Administrative Services, Human Resources, and Council Appointed Offices provide services to Enterprise and Internal Service Funds. The costs for these services are recovered through the administrative cost allocation plan charges. The FY 2026 estimate for Charges to Other Funds of $15.1 million remains flat compared to the FY 2025 budgeted amount. To ensure alignment with target cost recovery levels, the City has engaged a consulting firm to assist with a comprehensive cost allocation plan and municipal fee study in FY 2025, with targeted implementation in FY 2026. Staff will evaluate and bring forward cost allocation recommendations.

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 $29.1 million for FY 2026. While this matches the total for FY 2025, the prior year included a one-time $2.0 million transfer from the General Benefits Fund. This transfer was a refund of allocated charges paid by General Fund departments into the General Benefits Fund in prior years, which had accumulated in fund balance. Additionally, the Electric Fund equity transfer increased from $15.1 million to $18.3 million, while the Gas Fund equity transfer decreased from $10.9 million to $9.7 million, reflecting updated revenue forecasts for each fund.

In accordance with the methodology approved by the City Council in June 2009, the Electric Fund's equity transfer to the General Fund equity transfer has been calculated by applying a rate of return on the capital asset base of the Electric Fund. This rate of return is based on PG&E's rate of return on equity as approved by the California Public Utilities Commission (CPUC). The Gas Fund's equity transfer calculation was updated based on the passage of Measure L on the November 2022 ballot. As outlined in the ballot measure language, the Gas Fund equity transfer can be up to 18% of annual gross gas retail revenue. This LRFF increases the transfer to 18% in FY 2026, where it is projected to remain through 2035.

<u>Other Revenue and Revenue from Other Agencies</u>
Revenues in these two categories is projected at $3.6 million in FY 2026, $0.9 million lower than the FY 2025 adopted budget of $4.5 million. These two revenue categories mainly account for grants or reimbursements from the federal and state governments or other local jurisdictions. Other Revenue decreased slightly by $0.2 million in FY 2026 as a result of limited time funding in FY 2025 from LifeMoves, ,for reimbursement related to the Homekey Facility. Revenue from Other Agencies decreases by $0.7 million in FY 2026, because FY 2025 is the last year of the Staffing for Adequate Fire and Emergency Response (SAFER) grant funding awarded to the City in FY 2022.

ATTACHMENT D

General Fund Base Case Expense Assumptions

<u>Salary and Benefits</u>
Consistent with prior years, the FY 2026 salaries and benefits costs represent approximately 60% of the General Fund budget expenditures. Salary and Benefits are projected to increase $8.4 million or 4.7% from the prior year, from $179.9 million to $188.3 million. Discussed in the following sections, this is primarily attributable to increases in salaries ($4.5 million), retiree healthcare costs ($1.9 million) and pension costs ($1.4 million).

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 2024. Then, by position, salary costs are updated in accordance with applicable Memorandum of Agreements (MOA's) between the City and its labor groups and the Management and Professional Personnel and Council Appointees Compensation Plan(s).

In FY 2023, the City Council engaged with labor groups to negotiate new agreements for wages, benefits, and other terms and conditions of employment. These agreements extend through January 2025 (SEIU) and June 2025 (all other labor groups) for full-time staffing and include target market adjustments to align salaries with benchmark studies, Cost of Living Adjustments (COLAs), and other benefits such as a flexible compensation benefit.

The forecast assumes step increases for employees in applicable positions, including Service Employees International Union (SEIU), International Association of Fire Fighters (IAFF), and Palo Alto Peace Officers' Association (PAPOA), and merit increases for Management and Professional employees including Utilities Management & Professional Association of Palo Alto (UMPAPA). A general wage adjustment of 2% is included for all employees starting in either January 2025 or July 2025 for all years of the forecast since no MOA's would be in effect at that time. This is consistent with prior Council direction in previous LRFF reporting to use the 2% increase as a forecasting assumption, not as a commitment to future negotiations. The FY 2025 Budget includes MOA terms for a 4% COLA adjustment (all labor groups), 2% market alignment (Safety only), and increase in flexible compensation payment from $100 to $200 per month (all labor groups except SEIU).

A reserve is included for potential changes to future labor costs including changes in vacancy rates, labor and benefit rate variability, and inflation assumptions. Offering competitive compensation plans aligns with industry standards for attracting and retaining a skilled and motivated workforce and better positions the City of Palo Alto as an employer of choice. This level of funding does not reflect a commitment to future negotiations and may differ from actual outcomes. Negotiations for new labor agreements are anticipated to occur in the next year for new terms beginning in FY 2025-26. An alternative scenario is included in this report for increases beyond the assumptions described above.

Additionally, the budget includes vacancy savings that are expected to materialize as positions are vacated and new employees are hired through the normal course of business. As of the timing of this LRFF, the vacancy rate is approximately 10%. Vacancy savings from public safety positions are typically exhausted by uses such as backfill, hire ahead programs, and overtime. Consistent with changes in the previous LRFF, this forecast assumes a vacancy rate of 5% in all years. This results in additional savings of approximately $5.1 million in FY 2026 and increases to $6.5 million annually over the forecast period. Consistent with past practice, the vacancy assumption is lower than the actual vacancy rate to allow departmental use of those savings for other staffing strategies, such as filling staffing gaps by contracting for professional services, hiring ahead to allow overlap and smooth transitions, piloting new technologies to increase efficiency in the absence of staff, and supporting a summer internship program.

Benefits

Pension: Pensions are budgeted based on CalPERS determined rates as of the June 30, 2023 valuation for the City's miscellaneous and safety plans (CMR 2405-3062[1]). CalPERS determines the City's total contributions for a given Fiscal Year as the sum of two factors: Normal Cost (NC) and Unfunded Accrued Liability (UAL). Together the NC and the UAL expressed as a percentage of payroll is the 'blended rate' and is used to represent total costs in the discussion below.

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

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

The miscellaneous plan total costs are projected to decrease from the current 47.4% in FY 2025 to 43.7% in FY 2026. In the safety plan, total costs are projected to decrease from the current 83.1% in FY 2025 to 81.7% in FY 2026. These rates do not consider the employee pick-up of the

[1] Finance Committee, September 17, 2024; Agenda Item #1; CMR 2405-3062, https://portal.laserfiche.com/Portal/DocView.aspx?id=98648&repo=r-704298fc&searchid=1dfcc5e6-076e-444f-8151-446c5257fe0f

employer share; that pick-up materializes as savings in the City's pension costs. Consistent with applicable MOAs, the LRFF presumes that the miscellaneous plan will pick up 1 to 2% of the employer pension cost and that safety plan members will pick up 3 to 4%.

The FY 2024 and FY 2025 budgets were impacted by significant swings in investment gains and losses earned by CalPERS in the periods ending June 30, 2021 and 2022. The FY 2024 budget reflected significant investment returns of +21.3% (+6.8% target) and changes to economic and demographic assumptions resulting from the CalPERS Asset Liability Management (ALM) process and Experience Study completed in November 2021. As part of the ALM, the CalPERS board approved a reduction to the discount rate (from 7.0 to 6.8%), revised actuarial assumptions (price inflation from 2.5 to 2.3%), and a new asset allocation targeting 1/3 investment in private assets, 5% leverage, and reduced public equity exposure. FY 2025 on the other hand reflected an investment loss of -6.1% (+6.8% target), nearly offsetting the positive impacts experienced in the prior year's investment gains.

The current LRFF uses an investment return of 5.8% as indicated in the June, 30, 2023 valuation report. Since the issuance of the current valuation, CalPERS announced a preliminary investment return of +9.3% (+6.8% target) for the period ending June 30, 2024[2] which has been recently revised to 9.5%. These results will be included in the CalPERS valuation report issued in Fall 2025 to inform the development of the 2027-2036 LRFF and FY 2027 budget. The resulting liability from investment returns that did not meet target levels will be amortized over 20 years with a 5-year ramp-up period. To inform this LRFF, staff used the CalPERS Pension Outlook Tool to calculate the estimated impacts, resulting in additional costs of $0.2 million ($0.1 million in the General Fund) in FY 2026, and increasing to $1.2 million ($0.5 million in the General Fund) at the peak of the 5-year ramp in FY 2030.

In the General Fund, it is anticipated the City will spend a total of $51.1 million on total pension costs in FY 2026, including both CalPERS contributions and supplemental Pension Trust Fund contributions. This is approximately $1.4 million higher than the prior year costs of $49.7 million, or a 2.9% increase. These expenses represent approximately 16% of the General Fund's total expenses.

TABLE 1: CalPERS' Projected FY 2025-2035 Blended Retirement Rates

(percentage of payroll)

	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032	FY 2033	FY 2034	FY 2035
Miscellaneous	47.4	43.7	40.6	41.0	43.1	42.7	42.2	38.7	37.2	34.5	32.7
Safety	83.1	81.7	82.8	83.3	86.3	85.4	84.4	80.2	77.6	72.3	69.7

[2] CalPERS Reports Preliminary 9.3% Investment Return for 2023-24 Fiscal Year: https://news.calpers.ca.gov/calpers-reports-preliminary-9-3-investment-return-for-2023-24-fiscal-year/#:~:text=CalPERS%20today%20reported%20a%20preliminary,were%20valued%20at%20%24502.9%20billion.

Retiree Healthcare/Other Post-Employment Benefits (OPEB): Retiree Medical is based on the June 30, 2023 actuarial study prepared by Foster & Foster (previously Bartel Associates), which is completed every two years. The most recent study was completed in June 2024 to inform the development of the FY 2026 and FY 2027 operating budgets (CMR 2406-3140[3]). Consistent with City Council direction and the Retiree Benefit Funding Policy, this forecast continues the practice to budget the full payment of the Actuarial Determined Contribution (ADC) for retiree healthcare and uses alternative assumptions, such as a more conservative 5.75% discount rate (6.25% assumption), to transmit amounts above the recommended payment as an additional discretionary payment ("prefunding") to the California Employers' Retiree Benefit Trust (CERBT) Fund.

CalPERS blends active employees with pre-Medicare retirees and charges the same medical premium, even though younger employees on average consume less healthcare. The higher premium to younger employees thereby subsidizes older employees and retirees who, on average, have higher claims and premiums. The LRFF estimates $12.4 million in the General Fund in FY 2026 for ADC, an approximate $1.9 million or 18.4% increase from FY 2025 levels of $10.5 million in the General Fund. The implied subsidy is $2.9 million in FY 2026 and effectively lowers the funding necessary to meet the ADC.

TABLE 2: Retiree Medical General Fund Contributions

FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032	FY 2033	FY 2034	FY 2035
$10.5	$12.4	$12.8	$13.2	$13.6	$14.0	$14.5	$14.9	$15.4	$15.8	$16.3

Retiree Benefit Funding Policy (formerly "Pension Funding Policy"): 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 California Employers' Retiree Benefit Trust (CERBT) Fund, and adopting a policy that guides financial planning of these benefits (CMR 11722 as modified by 2212-0513[4]).

The City initially contributed to the Pension Trust in FY 2017 on an ad-hoc basis, using one-time savings or excess revenues. Beginning in FY 2019, the City Council directed staff to use a more conservative discount rate as compared to CalPERS for the Normal Cost (NC) portion of the payment and transferring the supplemental funding beyond CalPERS required employer contributions to the Pension Trust. This practice was reinforced with Council approval of the Retiree Benefit Funding Policy, and as of FY 2024 the City's NC discount rate is 5.3% as compared to CalPERS 6.8%. Additionally, one-time contributions continue to be made each year if excess

[3] City Council, June 17, 2024; Agenda Item #28; CMR 2406-3140 (Attachment D), https://portal.laserfiche.com/Portal/DocView.aspx?id=73983&repo=r-704298fc&searchid=2c9494ad-bd72-4ebd-b0f6-9b22ab7c6ca5

[4] City Council, November 30, 2020; Agenda Item #7; CMR 11722, https://portal.laserfiche.com/Portal/DocView.aspx?id=105077&repo=r-704298fc

revenues or unspent savings are available, subject to City Council approval. As part of policy goals, the City seeks to reach a 90% funded status by FY 2036.

Every four years, the City's Retiree Benefit Funding Policy requires that staff consult with an actuary to inform the City Council of progress the City has made towards achieving a 90% funded status goal and assess and respond to changes impacting the City's retiree benefit plans. This comprehensive review was most recently completed in FY 2023 and resulted in several policy revisions, most notably reducing the discount rate used to calculate supplemental contributions to the Pension Trust from 6.2% to 5.3% and extending actuary reporting from 3 to 4 years to align with the CalPERS ALM Study. Additionally, the title of the policy was revised from the Pension Policy to the Retiree Benefit Policy to recognize actions approved by the City Council to proactively plan for retiree healthcare plans in a similar manner to pensions, including the use of a lower 5.75% discount rate (CMR 2212-0513[5]). The most recent actuary analysis projects that the City will meet a 90% funded goal for pension plans by FY 2034 (miscellaneous plan) and FY 2036-37 (safety plan); the City's practice of transmitting excess one-time savings will help reach these goals sooner.

In this forecast, approximately $8.5 million in the General Fund in supplemental contributions to the City's Pension Trust is assumed in FY 2026. Through FY 2025, a total of $87.4 million ($56.4 million in the General Fund) in principal contributions are expected to be made to the Pension Trust for pension benefits. Through FY 2025, it is expected that $14.7 million in principal contributions will be made to the CERBT Fund for retiree healthcare benefits.

Healthcare: Consistent with the most recent labor agreements between the City and its bargaining units, 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).

Workers' Compensation: The budget appropriation for workers' compensation includes an estimate for claims incurred and reserves for current filings at an 85% confidence level, based on actuarial studies completed by Bickmore. Actuarial estimates completed in August 2023 informed FY 2025 budget levels of $7.6 million (approximately 72% in the General Fund). More recent actuary estimates completed in August 2024 project expense levels to increase, but the allocation between the General Fund and other funds to remain consistent. Staff will continue to monitor expenditures in the fund and bring forward adjustments as necessary. Claim estimates and reserves for FY 2026 are $9.0 million, representing a $1.4 million or 18.4% increase from the FY 2025 Adopted Budget. Estimates for workers' compensation increase in the forecast at rates consistent with general CPI increases.

[5] City Council, February 6,2023; Agenda Item #3; CMR 2212-0513, https://portal.laserfiche.com/Portal/DocView.aspx?id=61647&repo=r-704298fc&searchid=d3b87446-2f24-46e1-a412-fa0ae4a0ee58

Contract Services

This forecast assumes contract services of $34.6 million in FY 2026, a 3.1% increase from the FY 2025 Adopted budget of $33.5 million. This increase for FY 2026 is driven primarily by known contractual increases and a general 3% CPI cost increase on contracts that do not have defined annual increases, based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust contract funding needs as part of the FY 2026 budget process.

Contract Services - Committed Additions

The Committed Additions included in this forecast account for anticipated operating and maintenance (O&M) costs in the General Fund for capital projects anticipated to come online within the ten-year forecast period. Costs for projects that came online in FY 2025 have been annualized into the ongoing General Fund operating budget as part of the LRFF. The preliminary total estimate is $50,800 for costs associated with the following projects anticipated to come online in FY 2026: Dog Park Installation (PG-18001), Fire Station 4 (PE-18004), Library Automated Materials Handling (LB-21000), and Park Restroom Installation (PG-19000). Additional cost increases of 3.0% annually are included throughout the ten-year forecast based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period. Timing and analysis of the funding needs for these projects will be evaluated as part of the FY 2026 Budget process and development of the 2026-2030 Capital Improvement Plan (CIP).

TABLE 3: FY 2026 – FY 2035 Committed Additions (Millions)

FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032	FY 2033	FY 2034	FY 2035
$0.05	$0.05	$0.07	$0.11	$0.12	$0.12	$0.14	$0.14	$0.16	$0.16

Supplies and Materials

The FY 2025 Adopted Budget for the General Fund included $3.5 million for Supplies and Materials, which is anticipated to increase by a 3.0% CPI cost increase in FY 2026 to $3.6 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. This annual increase is adjusted to 4% starting FY 2028 through the ten-year forecast period. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for supplies and materials as part of the FY 2026 budget process.

General Expense

This category includes costs for travel and meetings, telephone and non-city utilities, contingency accounts and reserves, bank card service charges, and subsidies and grants provided through the Human Services Resource Allocation Program (HSRAP). The FY 2025 Adopted Budget of $22.1 million is expected to decrease to $18.2 million in FY 2026, primarily reflecting a planned year over year reduction in appropriations for Green Case settlement payouts and the anticipated use of the Budget Uncertainty Reserve to balance the FY 2026 budget. This reserve was partially used to balance the FY 2025 Adopted Budget ($6.1 million), leaving approximately $6.1 million to partially fund the anticipated gap in FY 2026 ($12.0 million). The reduction is partially offset by a 3.0% annual CPI cost increase on smaller items that do not have a set annual budget, based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for general expense items as part of the FY 2026 budget process.

General Expense – Project Homekey: On September 27, 2021 the City Council directed staff to apply for Project Homekey funding in conjunction with LifeMoves to build an emergency shelter at the former Los Altos Treatment Plant (LATP) site (CMR 13595[6]). This project will 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. The site will be operated for at least fifteen years as interim housing per the program's durational requirement. This project will utilize a combination of funding sources including the Project Homekey Program for capital expenses and donations, grant funds, and City support for ongoing operations expenses. This LRFF includes the City's committed investment of $7.0 million in operating expenses ($1.0 million annually FY 2025 through FY 2031). 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: Recently, a tentative agreement between the City and PAUSD has been developed that will amend the City's leased portion of the Cubberley site. Although this agreement still needs to be approved by the City Council, this report assumes a reduction to the annual lease costs for Cubberley to $2.0 million plus the ongoing $0.8 million for child daycare sites and utilities. As part of the original lease agreement, the City Council approved creation of the Cubberley Infrastructure Improvements Fund supported by an annual $1.9 million transfer from the General Fund, which is classified as an Operating Transfer-Out and discussed in further detail in that section of this report below.

Rents and Leases

The Rents and Leases expense category for FY 2026 is estimated to increase from the FY 2025 Adopted Budget level by approximately 2.7% to $1.45 million. This is based on current lease terms that include previously negotiated lease increases This category includes the lease agreement for Development Services staff at locations outside City Hall (285 Hamilton and 526

[6] City Council, September 27,2021; Agenda Item #10; CMR 13595: https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2021/09-september/20210927/210927accsm-amended-final.pdf

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[7]). The lease was amended in September 2022 to extend the term initially for 12 months with the right to automatically extend for four successive 12-month periods, potentially through January 31, 2028 (CMR 14713). In June 2021, the City entered into a seventh amendment for the Development Services office lease at 285 Hamilton Avenue to extend the term from February 2022 to January 2025 (CMR 12334[8]). 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
Along with funding for various equipment needs across departments, this budget category includes subscription payments for equipment like public safety radios. The Facilities and Equipment expense category is expected to decrease from the FY 2025 Adopted level of $656,000 to $536,000 due to the elimination of one-time funding to replace fire equipment budgeted in FY 2025. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for equipment needs as part of the FY 2026 budget process.

Allocated Charges
Allocated Charges represent expense allocations by the City's Enterprise and Internal Service Funds for services and products they provide to other departments. The FY 2025 Adopted Budget for the General Fund included $26.9 million for these expenses, including utilities usage, general liability insurance, technology costs, vehicle equipment maintenance and replacement costs, and other charges for services provided by other City departments and funds. The FY 2026 allocated charges in the LRFF update the revenues and expenses for these various allocations based on the information available at the time of the LRFF development. FY 2025 is anticipated to experience an increase of 14.0% to a total of $30.7 million. This increase is primarily due to anticipated higher costs associated with technology services and utilities for City facilities such as water, electricity, and gas.

Operating Transfers Out
Operating Transfers Out include transfers from the General Fund to Debt Service Funds, the Technology Fund, and various other funds but excludes transfers to the Capital Improvement Fund, which are detailed in the following Transfer to Infrastructure section. The FY 2025 Adopted Budget included Operating Transfers Out of $6.3 million. In FY 2026, Operating Transfers Out are anticipated to increase to $6.4 million due to increases in the technology surcharge transferred to the Technology Fund to cover the General Fund's portion of new technology costs. Consistent with the FY 2025 Adopted Budget, a total of $2.0 million across the University Avenue, California

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[7] City Council, December 14, 2020; Agenda Item #5; CMR 11426, https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2020-2/id-11426.pdf?t=59979.32

[8] City Council, June 21, 2021; Agenda Item #15; CMR 12334, https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/2021/id-12334.pdf

Avenue, and Residential Permit Parking Funds is factored into this LRFF. Staff will continue evaluating these funds as part of the FY 2026 budget development and will bring forward recommendations as needed to keep the parking permit funds solvent.

Transfer to Infrastructure
Recovery from the COVID-19 pandemic is reflected in improved revenue levels in the FY 2025 budget compared to the FY 2024 budget. The total General Fund transfer to the Capital Improvement Fund budgeted in FY 2025 is $30.2 million compared to the $24.7 million transferred in FY 2024. This is comprised of a $14.5 million base transfer, interest earnings of $2.0 million, and $13.7 million from TOT revenue generated through voter-approved rate increases and new hotels that is dedicated to the Capital Improvement Fund to support the 2014 Council Infrastructure Plan, consistent with City Council direction. Estimated transfers from TOT revenues in FY 2026 are currently projected to increase to $14.2 million and the base transfer to increase to $17.2 million, along with estimated interest earnings of $2.0 million, for a total $33.4 million transfer to the Capital Improvement Fund. This forecast continues the goal established as part of the 2022-2026 Capital Improvement Plan (CIP) to restore the base portion of this transfer to pre-pandemic levels by FY 2026. This budget category also includes the separate $1.9 million transfer to the Cubberley Property Infrastructure Fund. This transfer to the Cubberley Property Infrastructure Fund supports facility systems maintenance needs at the Cubberley Community Center facility as well as capital improvement projects to maintain and upkeep the facility.

ATTACHMENT E

Assumptions Not Included in Forecast

It should be noted that this forecast does not include several potential impacts to the FY 2026-2035 LRFF that are outlined below. These items are known projects or areas of investment that are priorities but have not been fully developed in terms of costs and timelines. This is not intended to be a comprehensive list nor in any priority order.

Project Homekey: Homekey Palo Alto is a modular interim housing shelter for unhoused individuals and families codeveloped by the City of Palo Alto and LifeMoves. This LRFF includes the City's committed investment of $7.0 million in operating expenses ($1.0 million annually for seven years) to fund Homekey Palo Alto. The City's costs for this project could fluctuate throughout the ten-year period, but some of those costs could be funded by business tax revenue for affordable housing and homeless services that has not been fully allocated. Upon the completion of the 7 years, ongoing funding remains to be determined.

Housing Growth Impacts: On August 20, 2024, the City's FY 2023-31 Housing Element[1] was certified, outlining the condition of the City's current housing and future needs of its residents through citywide housing goals, objectives, and policies. The City is required to ensure adequate planning for its "fair share" of affordable and market rate housing, and must demonstrate a strategy for removing barriers to increase housing production and counter well-documented housing shortage. The City's housing target for the eight-year planning period (January 31, 2023 to January 31, 2031) is defined by its RHNA allocation which assigns an additional 6,086 total units into four income categories. The financial implications of this housing growth would increase costs for land acquisition, planning and design, and construction, with offset by new revenues such as sales tax and other economic benefits derived from more affordable housing. The Housing Element[2] and the associated Environmental Impact Report (EIR)[3] provide more detail; however, such financial impacts, especially to the General Fund, have yet to be determined and incorporated into the LRFF.

Geng Road Safe Parking Program: The Geng Road program began in early 2021 as a place for households dwelling in their vehicles to park their vehicles in a designated off-street parking lot. The City launched the program in partnership with Santa Clara County to offer recreational vehicle (RV) dwellers a safe place to park, case management, and assistance with finding permanent homes. On August 19, 2024, City Council approved the site expansion at 2000 Geng

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[1] City of Palo Alto FY 2023-31 Housing Element, https://paloaltohousingelement.com/wp-content/uploads/2024/08/Palo-Alto-Housing-Element.pdf
[2] City of Palo Alto FY 2023-31 Housing Element, https://paloaltohousingelement.com/wp-content/uploads/2024/08/Palo-Alto-Housing-Element.pdf
[3] Addendum to the 2030 Comprehensive Plan Environmental Impact Report, https://files.ceqanet.opr.ca.gov/80033-5/attachment/XqcKmj04NCYoJsEb-_sTj8ondOwUj0KbDwiMk56gQ1DCexjgecgNZzQ5LYmJyKBi2EBHmZ65ks5lb4s00

Road to increase the number of safe parking spaces by 10 (CMR 2407-3274[4]). Staff is working to secure funding for this expansion through the California Department of Housing and Community Development's (HCD) Permanent Local Housing Allocation Program (PLHA). Even if granted, PLHA funding is not expected to fully fund the expansion, and any balance of the costs may be funded by business tax revenue for affordable housing and homeless services that has not yet been fully allocated, or other sources as may be identified during the budget process.

Sustainability and Climate Action Plan (S/CAP): In early 2020, the City launched an update of the Sustainability and Climate Action Plan (S/CAP) Framework to determine the goals and key actions needed to meet its sustainability goals, including the goal of reducing greenhouse gas (GHG) emissions to 80 percent below 1990 levels by 2030 (the "80x30" goal). Investments have been made across various City funds related to S/CAP including: a new Grid Modernization for Electrification capital project (EL-24000), realignment of staff to manage infrastructure improvement projects; scaling existing successful energy efficiency programs; performing and analyzing research in alternative energy sources, sustainable water supplies, carbon sequestration options; and increasing incentives for voluntary electrification programs. The S/CAP Three-Year Work Plan for 2023–2025, approved by Council in Spring 2023, provided a roadmap for these efforts, and the City has accounted for known capital projects and programmatic needs in its forecasts. However, there are uncertainties related to external factors that could impact the scope and scale of work needed to achieve the City's long-term sustainability goals. These unknowns are not fully reflected in this forecast.

Significant Code and Ordinance Updates: Updates to several significant programs, codes and ordinances are expected to be necessary in the near future. Some of these updates include: Seismic Inventory Ordinance and Program Development, Historic Building Survey and Ordinance Development, Zoning Code Updates, and the development of the 2040 Comprehensive Plan, the successor plan to the 2030 Comprehensive Plan. While some costs associated with zoning code updates and the preparation of the 2040 Comprehensive Plan were included in the forecast, additional resources may be required depending on future Council direction and the extent and pace of implementation efforts.

Fee and Organizational Studies: The Planning and Development Services (PDS) Department is in the process of finalizing a fee study which is tentatively scheduled for Finance Committee in February 2025. At the same time, the City is conducting a Citywide Municipal Fee Study and Cost Allocation Plan, with plans to implement its recommendations in FY 2026. Periodically completing fee studies with an outside consultant is a best practice to ensure the City's fees align with its cost recovery policies. Recently the Park, Community Center, and Library Development Impact Fees for residential development were converted from a per dwelling unit basis to a per square foot basis, aligning with AB 602 requirements for a more equitable distribution of fees based on

[4] City Council, August 19, 2024; Agenda Item #10; Staff Report #2407-3274, https://portal.laserfiche.com/Portal/DocView.aspx?id=88920&repo=r-704298fc&searchid=1196faea-adb3-49fd-9006-dfb863754685

development size. Additional impact fee modifications are anticipated, with a staff report providing further details expected in Spring.

Labor Negotiations: As of the timing of this report, all labor agreements for full-time employees are scheduled to expire by June 2025 except for the Service Employees International Union (SEIU) agreement, which expires January 2025. Consistent with Council direction in previous LRFF's, a general 2% assumption is included for all employees starting in either January or July 2025 for all years of the forecast since no MOA's would be in effect at that time; this is not as a commitment to future negotiations and is for forecasting purposes. Additionally, this forecast includes a level of reserve for potential changes in employee compensation in future agreements for competitive wages and other terms of employment. Actual funding needs may differ, depending on outcomes of future labor negotiations. Additional information on salary and benefit assumptions and reserves for future agreements is included in Attachment D.

Grade Separation: The grade separation project consists of four at-grade crossings along the Caltrain corridor in the City of Palo Alto located at Palo Alto Avenue, Churchill Avenue, Meadow Drive, and Charleston Road. As part of the FY 2024 Capital budget, the Council approved two capital projects to separate them, specifying the funding sources and costs associated with Churchill Avenue (PL-24001) and Meadow Drive and Charleston Road (PL-24000) which are being designed together. The Palo Alto Avenue project is currently on hold. In June 2024, City Council authorized staff to advance the project into Preliminary Engineering and Environmental Documentation (PE&ED) Phase (CMR 2404-2861[5]) for the three crossings at Churchill Avenue Meadow drive, and Charleston Road. The phase will lead to the development of 35% plans, renderings, and cost estimates as well as completion of CEQA and NEPA documentation to obtain necessary environmental clearances.

Currently, staff is working on developing a three-party cooperative agreement between the City, Valley Transportation Authority (VTA) and the Peninsula Corridor Joints Power Board (PCJPB) or also known as Caltrain to allocate $14.0 million from Santa Clara County 2016 Measure B Caltrain Grade Separation funding toward PE&ED phase. The 2016 Measure B program tax revenue amounts to a total of $700 million in 2017 dollars for all at-grade crossings in Santa Clara County, and the City anticipates an allocation of 50% of this funding. The VTA is currently programming these funds in two-year increments. As 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 2025-FY 2033). Additional resources will need to be explored to plan and fund these grade separations, including City staff pursuing additional funding through grant opportunities as they become available and other financing mechanisms.

[5] City Council, June 17, 2024; Staff Report #2404-2861, https://portal.laserfiche.com/Portal/DocView.aspx?id=73967&repo=r-704298fc&searchid=948efea6-f77f-4463-a371-dabd04cd097d

Parks Master Plan: The Parks, Trails, Natural Open Space and Recreation Master Plan[6] was adopted in 2017; and presents a long-term vision for the system. Potential funding mechanisms have been identified for several high-priority projects and programs, however, a strategy to fund implementation of the entire plan has not been completed. As such, this forecast does not yet contemplate the necessary investments to fully execute this plan.

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 Childcare 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. The Roth Building Rehabilitation Phase 1 capital project (PF-23001) is proceeding under a funding strategy outlined in the Tenant Work Letter and included in the LRFF; however, if costs for rehabilitating the facility further increase, additional sources of funding would need to be identified. Additionally, the City's newly approved community center at 445 Bryant Street will operate with part-time use by La Comida for a senior nutrition program, alongside potential programming and shared uses coordinated by the Community Services Department. While La Comida's rental terms are being defined, future revenue opportunities from shared programming or facility rentals remain uncertain.

Cubberley Community Center Redevelopment: On October 7, 2024, the City Council (CMR 2409-3500[7]) approved the MOU with PAUSD for Cubberley Site purchase and lease. The LRFF includes the revised lease financial terms and maintains the Real Estate Investment Reserve of $1 million annually which will fund the critical professional service contracts (i.e. master plan, community outreach, polling, etc.) in the next 24 months, and also serve as a placeholder for future real estate investment appropriations. However, the LRFF does not reflect any General Obligation bond cashflow as that is yet to be determined and hopefully will have an insignificant net impact on the General Fund. The LRFF does not factor in other costs such as future Cubberley operating costs and/or repairs, as these fiscal impacts will be informed in the upcoming 24 months with the development of the proposed operational and financial models.

Loans for Special Projects: From time to time the City's General Fund will assist other City operations with modest cash flow loans to bridge fiscal years. For example, the City provided over $3 million in loans to the Airport Fund as it worked to secure significant grant funding from the Federal Aviation Administration (FAA) for capital improvement costs. As of FY 2020, the Airport Fund began paying back the loan to the General Fund. Additions and other initiatives funded in other funds may need financial support from the General Fund to ensure they are fully implemented. In FY 2023 the Residential Preferential Parking (RPP) Fund received a $0.4 million General Fund loan to remain solvent while continuing operations, given the sustained drop in parking demand during the pandemic. A similar loan for $50,000 to the Residential Preferential

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[6] The Parks, Trails, Natural Open Space and Recreation Master Plan, 2017; https://www.cityofpaloalto.org/files/assets/public/public-works/palo-alto-parks-master-plan.pdf

[7] City Council, October 7, 2024; Agenda Item #AA1; Staff Report #2409-3500, https://portal.laserfiche.com/Portal/DocView.aspx?id=98620&repo=r-704298fc&searchid=d8e93928-24cc-47b6-b45b-978951b272c4

Parking (RPP) Fund and $450,000 to the California Avenue Parking Fund were approved as part of the FY 2024 budget. As parking continues to be impacted by effects from the Covid-19 pandemic and remote/hybrid work, additional loans from the General Fund of $2.0 million annually to the parking funds are assumed in this forecast. This LRFF also assumes repayment revenue to the General Fund from previous parking loans including $0.4 million (RPP) in FY 2033, $500,000 (RPP and California Avenue Parking Fund) in FY 2034, and $2.0 million (RPP, California Avenue Parking Fund, and University Avenue Parking Fund) in FY 2035. Staff will continue to review costs in the parking funds and revise funding needs and evaluate support as a loan or subsidy from the General Fund as part of the development of the FY 2026 budget.

Legislative Updates: Various actions at the state and federal level that could impact the City of Palo Alto have not been incorporated into this forecast due to the changing context and uncertainty of the quantitative impacts of potential legislative changes. As the potential impacts of various legislative initiatives are clarified, appropriate adjustments will be identified and brought forward as part of future budget development cycles.

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

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

Fire and Ambulance Service Expansion: On November 19, 2024, the Finance Committee reviewed and discussed fire and ambulance service expansion options (CMR 2406-3310). Staff continues to analyze these services, and any funding, appropriation and labor negotiation will be guided by future City Council direction, and as such not incorporated into the LRFF at this time.

Fire Training Center: As part of the FY 2023 Adopted Capital Budget the City Council approved the Fire Training Facility Replacement capital project (FD-24000) to identify an appropriate site and construct a new fire training facility in Palo Alto. Funding was only appropriated for the feasibility study portion of the project in FY 2024, and additional resources will need to be appropriated in future budget cycles based on the results of the study. In addition, the Fire

Department is also evaluating opportunities to partner with other local jurisdictions for training needs, instead of building a permanent facility in Palo Alto. Staff from Public Works and Fire Departments are working on a scope of work to study the facility needs and potential locations for the center and plan on engaging a consultant in early 2025.

Limited Term Programs: There are several programs currently in progress that are funded on a limited term basis per Council approval. If these programs are recommended to continue through the ten-year forecast period additional resources would be needed.

- The Psychiatric Emergency Response Team (PERT) program in the Police Department pairs a police officer in plain clothes and a mental health clinician to respond to calls for mental health emergencies. In FY 2024, PERT funds were unspent due to the inability to source and supply a clinician. The funds were returned to the Stanford University Medical Center (SUMC) Fund and recommended to be used in the future to support the PERT program when the County can provide a clinician. The PERT program is recommended to be supported with SUMC funding through FY 2028.

- PA Link, the on-demand transit service, is continuing its pilot program with grant funding from the Transportation Fund for Clean Air (TFCA) and contributions from the Stanford Research Project (SRP) in conjunction with CIty funding in FY 2025. Staff is looking for new funding sources including grant funding and potential strategic partnerships with companies. With the continuation of the SRP cost sharing agreement and current fare structure in FY 2026, it is estimated that an additional $0.4 million in funding is required to fully fund the program in FY 2026.

Vehicle Fleet Electrification: Currently the City's policy is to consider electric vehicles and then other alternative fuel vehicles when replacing existing vehicles. Transitioning the vehicle fleet to full Electric Vehicles (EVs) is part of the City's sustainability goals. It has been estimated that at least $6.0 million across all funds will be needed annually ($2.4 million above the FY 2025 budget) in order to replace all City vehicles with EVs.

Green Storm Infrastructure (GSI) Maintenance: The City is subject to the requirements of the Municipal Regional Stormwater National Pollutant Discharge Elimination System Permit in the San Francisco Bay Area (Order R2-2015-0049,) also known as the Municipal Regional Permit (MRP). The MRP applies to 79 municipalities and flood control agencies that discharge stormwater into the San Francisco Bay. MRP Provision C.3 requires "Regulated Projects," defined as new development and redevelopment projects that exceed certain impervious surface size thresholds, to mitigate stormwater quality impacts by incorporating site design, pollution control measures, and stormwater treatment measures--typically known as green stormwater infrastructure (GSI). Section C.3.j.ii.(2) also requires that the City, by June 30, 2027, construct GSI that treats 3.92 acres of impervious surface (based on a required ratio of 3 acres/50,000 residents). Moreover, the City is required to integrate GSI into Capital Improvement Program projects when possible. Consequently, the City expects to have significantly more GSI and associated maintenance in the coming years, the cost of which is still being quantified.

Attachment I

FINANCE MEETING
12/03/2024
☑Received Before Meeting

2

CITY OF
PALO ALTO

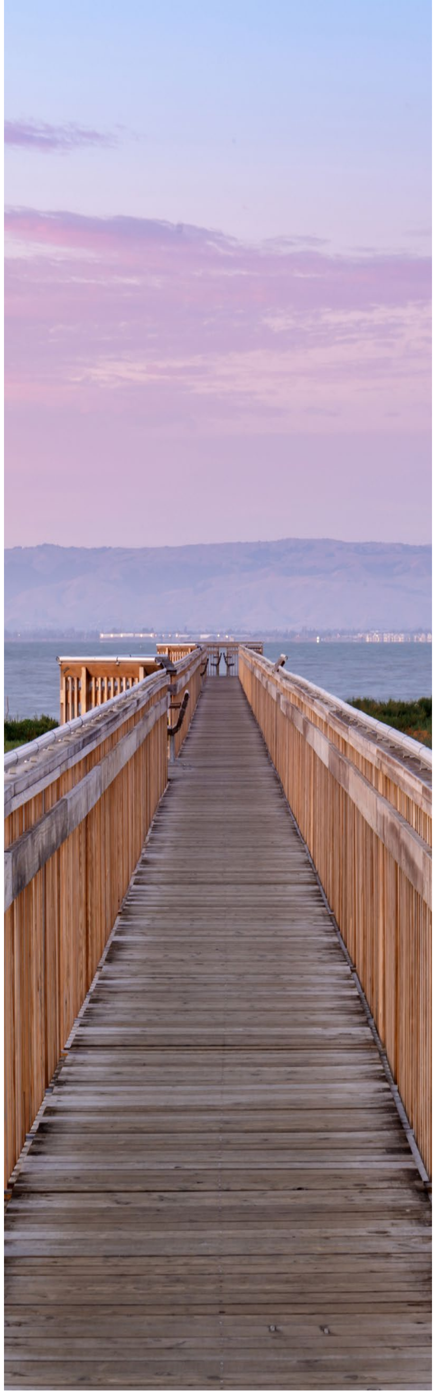
FY 2026 – FY 2035 LONG RANGE FINANCIAL FORECAST

Finance Committee Item #2

DECEMBER 3, 2024

www.cityofpaloalto.org

OVERVIEW



- Forecast the economy remains weak in 2025, returning to growth trend in 2026
    - Stagnation, uncertainty and potential volatility at Federal level
- Expense projections based on current approved service levels
    - Maintain funding for long-term liabilities and 18.5% BSR
- LRFF is fairly consistent with FY 2025 Adopted Budget
    - Multi-year budget balancing strategy
    - One-time funding continues to be used for near-term fiscal stability
    - Continued strategic planning and fiscal discipline

Fiscal Year 2026 - 2035 Base Case Forecast

CITY OF PALO ALTO

Attachment I

BASE CASE

	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Total Revenue	$254,799	$278,231	$287,554	$287,554	298,600	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
BSR Contribution (One-Time)	-	-	$3,247	$3,247	-	-	-	-	-	-	-	-	-	-
Reappropriated Funds (One-Time)	-	-	$16,093	$16,093	9,200	-	-	-	-	-	-	-	-	-
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$307,800	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
Year over Year increase (revenue only)					*3.8%*	*4.9%*	*4.1%*	*4.1%*	*4.6%*	*4.1%*	*3.8%*	*3.8%*	*3.9%*	*3.8%*
Total Expenditures	243,695	281,062	306,893	306,893	319,788	321,171	332,558	344,995	352,870	360,763	368,429	377,258	386,903	403,667
Total Use of Funds	$243,695	$281,062	$306,893	$306,893	$319,788	$321,171	$332,558	$344,995	$352,870	$360,763	$368,429	$377,258	$386,903	$403,667
Year over Year increase					*4.2%*	*0.4%*	*3.5%*	*3.7%*	*2.3%*	*2.2%*	*2.1%*	*2.4%*	*2.6%*	*4.3%*
Net One-Time Surplus/(Gap)	$11,104	($2,831)	$0	$0	($11,988)	($7,857)	($6,519)	($5,646)	$1,964	$8,589	$14,824	$20,612	$26,495	$25,401
Cumulative Net Operating Margin (One-Time)														$65,874
Net Operating Margin					($11,988)	$4,131	$1,339	$872	$7,610	$6,625	$6,235	$5,789	$5,883	($1,095)
Cumulative Net Operating Margin														$25,401

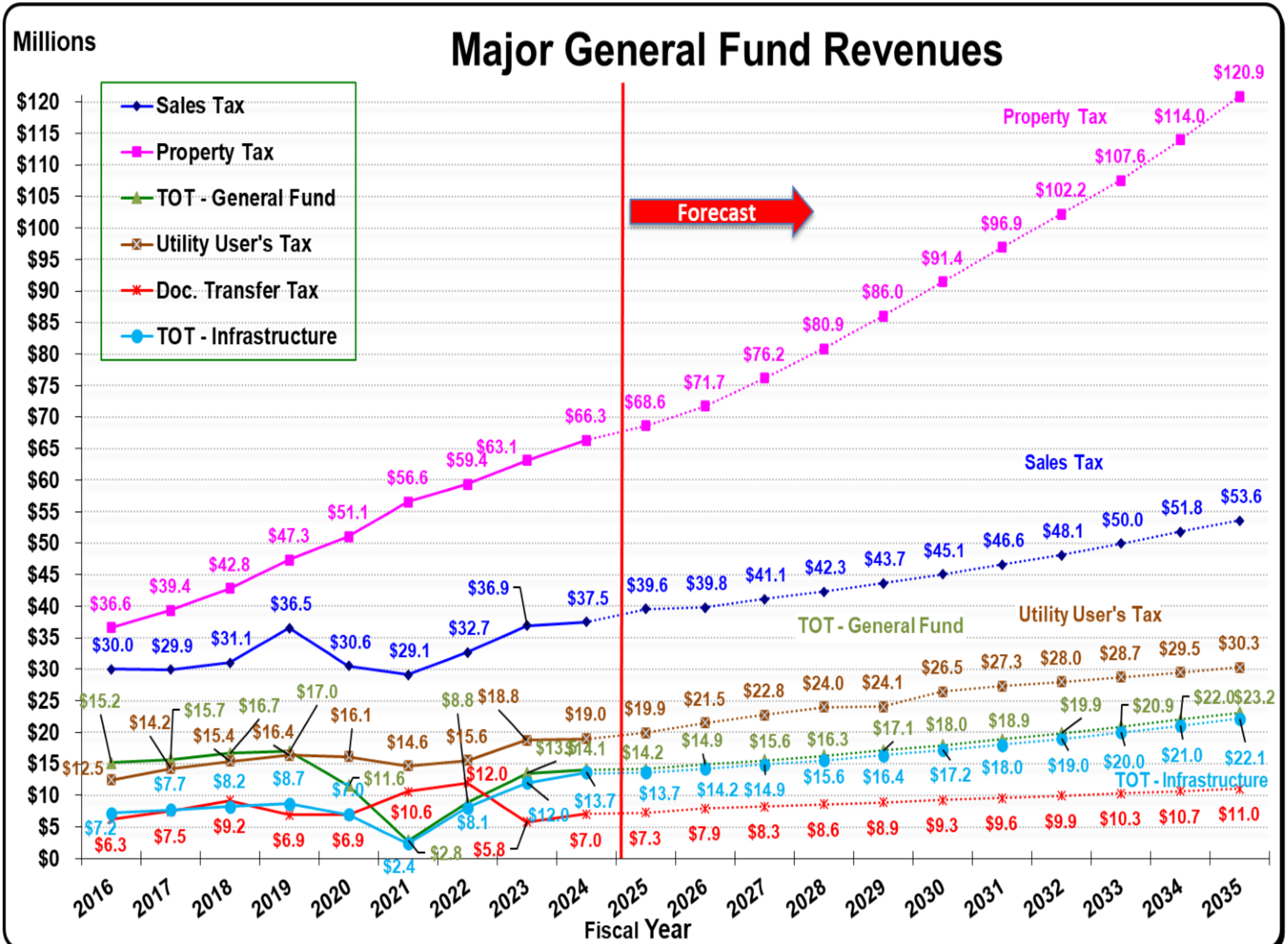
Net Operating Margin assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures

- **FY 2026 projected shortfall of $12.0 million, previously anticipated at $11.0 million**
  - Uncertainty Reserve of a recommended $12M offsets projected FY 2026 shortfall
- **Annual Shortfall in FY 2027-2029 range from $7.9M to 5.6M**
- Budgeted revenues projected to support expenditures starting in FY 2030

MAJOR TAX REVENUE PROJECTIONS

CITY OF PALO ALTO

Attachment I



BSR and Recommended FY24 Surplus Allocation

CITY OF PALO ALTO

Budget Stabilization Reserve (BSR) Summary	
BSR Balance June 30, 2024*	$63.3 Million
Transfer to Infrastructure Reserve	-$3.0 Million
Transfer to Budget Uncertainty Reserve	-$5.9 Million
Total Transfer to Reserves	-$8.9 million

Projected FY 2025 BSR Level June 30, 2025 (18.5% Target Level)	$54.4 Million

Recommended Budget Uncertainty Reserve	$12.0 Million

* After FY 2025 approved adjustments to balance FY 2025 ($2.6 million).

POLICY & STRATEGY:

- Maintaining FY 2025 BSR at 18.5% target level
- Multi-year strategy to balance anticipated shortfalls

RECOMMENDATION:

- $3.0M to Infrastructure Reserve and $5.9M to Budget Uncertainty Reserve

APPROPRIATION ACTION:

- FY 2025 Mid-Year Review (February 2025)

Attachment I

ALT SCENARIO A: ECONOMICALLY SENSITIVE REVENUE IN FY26

CITY OF PALO ALTO

ALTERNATIVE SCENARIO: RECESSION (1% Loss of Economically Sensitive Revenue in FY 2026)

	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Total Revenue	$254,799	$278,231	$287,554	$287,554	296,297	310,914	323,534	336,745	352,109	366,516	380,316	394,823	410,228	425,785
BSR Contribution (One-Time)	-	-	$3,247	$3,247	-	-	-	-	-	-	-	-	-	-
Reappropriated Funds (One-Time	-	-	$16,093	$16,093	9,200	-	-	-	-	-	-	-	-	-
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$305,497	$310,914	$323,534	$336,745	$352,109	$366,516	$380,316	$394,823	$410,228	$425,785
Year over Year increase (revenue only)					*3.0%*	*4.9%*	*4.1%*	*4.1%*	*4.6%*	*4.1%*	*3.8%*	*3.8%*	*3.9%*	*3.8%*
Total Expenditures	243,695	281,062	306,893	306,893	319,788	321,169	332,555	344,992	352,868	360,760	368,426	377,255	386,900	403,664
Total Use of Funds	$243,695	$281,062	$306,893	$306,893	$319,788	$321,169	$332,555	$344,992	$352,868	$360,760	$368,426	$377,255	$386,900	$403,664
Year over Year increase					*4.2%*	*0.4%*	*3.5%*	*3.7%*	*2.3%*	*2.2%*	*2.1%*	*2.4%*	*2.6%*	*4.3%*
Net One-Time Surplus/(Gap)	$11,104	($2,831)	$0	$0	($14,292)	($10,255)	($9,021)	($8,247)	($759)	$5,757	$11,890	$17,567	$23,328	$22,121
Cumulative Net Operating Margin (One-Time)														$38,088
Net Operating Margin					($14,292)	$4,036	$1,234	$774	$7,488	$6,516	$6,133	$5,678	$5,761	($1,207)
Cumulative Net Operating Margin														$22,121

Net Operating Margin assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures

- Models the impact of a 1% loss in economically sensitive revenue categories starting in FY 2026
  - Major Taxes, Charges for Services, and Permits and Licenses
- **Revenues decrease by $2.3M in FY 2026** and increase projected shortfalls
  - Gap of $14.3M in FY 2026
  - Gaps of $10.2M to $0.8M in FY 2027 – FY 2030

ALT SCENARIO B: COMPENSATION ADJUSTMENT IN FY26

CITY OF PALO ALTO

Attachment I

ALTERNATIVE SCENARIO: ONE-TIME COMPENSATION ADJUSTMENT (ADDITIONAL 1%) in FY 2026

	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Total Revenue	$254,799	$278,231	$287,554	$287,554	298,600	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
BSR Contribution (One-Time)	-	-	$3,247	$3,247	-	-	-	-	-	-	-	-	-	-
Reappropriated Funds (One-Time	-	-	$16,093	$16,093	9,200	-	-	-	-	-	-	-	-	-
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$307,800	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
Year over Year increase (revenue only)					*3.8%*	*4.9%*	*4.1%*	*4.1%*	*4.6%*	*4.1%*	*3.8%*	*3.8%*	*3.9%*	*3.8%*
Total Expenditures	243,695	281,062	306,893	306,893	320,878	322,305	333,725	346,198	354,097	362,014	369,705	378,560	388,231	405,021
Total Use of Funds	$243,695	$281,062	$306,893	$306,893	$320,878	$322,305	$333,725	$346,198	$354,097	$362,014	$369,705	$378,560	$388,231	$405,021
Year over Year increase					*4.6%*	*0.4%*	*3.5%*	*3.7%*	*2.3%*	*2.2%*	*2.1%*	*2.4%*	*2.6%*	*4.3%*
Net One-Time Surplus/(Gap)	$11,104	($2,831)	$0	$0	($13,078)	($8,991)	($7,686)	($6,849)	$737	$7,338	$13,547	$19,311	$25,168	$24,046
Cumulative Net Operating Margin (One-Time)														$53,542
Net Operating Margin					($13,078)	$4,087	$1,305	$837	$7,586	$6,601	$6,210	$5,763	$5,857	($1,121)
Cumulative Net Operating Margin														$24,046

Net Operating Margin assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures

- Models the impact of a 1% compensation adjustment once negotiated agreements sunset
  - Maintains 5% Vacancy Factor
  - Increases reserve for potential changes to future labor costs and benefit rate variability
- **Expenses increase by $1.1M in FY 2026** and increase projected shortfalls
  - Gap of $13.1M in FY 2026
  - Gaps of $9.0M to $6.8M in FY 2027 – FY 2029

FY 2026 BUDGET DEVELOPMENT GUIDELINES (Attachment A)

- Develop a structurally balanced budget to maintain fiscal sustainability
- Examine appropriate use of surpluses
- Review resource allocation for City Council's identified priorities
- Focus on business process redesign and explore alternative service delivery models
- Explore expansion of existing revenue sources or the addition of new revenue sources
- Continue to prioritize proactively funding long term liabilities

ASSUMPTIONS NOT INCLUDED IN FORECAST (Attachment E)

List is not comprehensive nor in any priority order

- Labor Negotiations (contracts expire in Jan/Jun 2025);
  LRFF includes an estimated reserve for changes in vacancy rates, labor and benefit variability, and inflation
- Housing Growth Impacts
- Cubberley Community Center Redevelopment
- Fire and Ambulance Service Expansion
- Parks Master Plan
- Railroad Grade Separation
- Vehicle Fleet Electrification

CONCLUSION AND NEXT STEPS

- 2026-2035 LRFF is fairly consistent with FY 2025 Adopted Budget
  - Economic stagnation and potential volatility
  - Focus on investing in key areas of priority or urgent needs
  - Uncertainty Reserve and one-time surpluses are critical to manage the near-term fiscal stability and investments in priority initiatives
  - Strategic planning and fiscal discipline needed to solve estimated shortfalls in subsequent years of the forecast
  - Policy planning tool that informs the budget process.

Next Steps Annual Budget Process

- *Jan 2025:* Council review LRFF
- *Feb 2025:* FY 2025 Mid-Year Budget
- *May 2025:* FY 2026 Proposed Budget

RECOMMENDED ACTION

Staff recommends that the Finance Committee:

Review and recommend that the City Council accept the Fiscal Year 2026 – 2035 Long Range Financial Forecast Base Case and the FY 2026 Budget Development Guidelines (Attachment A).

Direct staff to use this forecast as a starting point for the FY 2026 budget process.

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COUNCIL MEETING
1/13/2025
☑Received Before Meeting

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CITY OF
PALO ALTO

FY 2026 – FY 2035 LONG RANGE FINANCIAL FORECAST

City Council Item #12

JANUARY 13, 2025

www.cityofpaloalto.org

OVERVIEW

- 2026-2035 LRFF is fairly consistent with FY 2025 Adopted Budget
  - Economic stagnation and potential volatility
  - Focus on investing in key areas of priority or urgent needs
  - Uncertainty Reserve and one-time surpluses are critical to manage the near-term fiscal stability and investments in priority initiatives
  - Strategic planning and fiscal discipline needed to solve estimated shortfalls in subsequent years of the forecast
  - Planning tool that informs the budget process

Next Steps Annual Budget Process

- *Feb 2025:* FY 2025 Mid-Year Budget
- *May 2025:* FY 2026 Proposed Budget
- *June 2025:* FY 2026 Budget Adoption

Fiscal Year 2026 - 2035 Base Case Forecast

BASE CASE

	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Total Revenue	$254,799	$278,231	$287,554	$287,554	298,600	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
BSR Contribution (One-Time)	-	-	$3,247	$3,247	-	-	-	-	-	-	-	-	-	-
Reappropriated Funds (One-Time)	-	-	$16,093	$16,093	9,200	-	-	-	-	-	-	-	-	-
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$307,800	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
Year over Year increase (revenue only)					*3.8%*	*4.9%*	*4.1%*	*4.1%*	*4.6%*	*4.1%*	*3.8%*	*3.8%*	*3.9%*	*3.8%*
Total Expenditures	243,695	281,062	306,893	306,893	319,788	321,171	332,558	344,995	352,870	360,763	368,429	377,258	386,903	403,667
Total Use of Funds	$243,695	$281,062	$306,893	$306,893	$319,788	$321,171	$332,558	$344,995	$352,870	$360,763	$368,429	$377,258	$386,903	$403,667
Year over Year increase					*4.2%*	*0.4%*	*3.5%*	*3.7%*	*2.3%*	*2.2%*	*2.1%*	*2.4%*	*2.6%*	*4.3%*
Net One-Time Surplus/(Gap)	$11,104	($2,831)	$0	$0	($11,988)	($7,857)	($6,519)	($5,646)	$1,964	$8,589	$14,824	$20,612	$26,495	$25,401
Cumulative Net Operating Margin (One-Time)														$65,874
Net Operating Margin					($11,988)	$4,131	$1,339	$872	$7,610	$6,625	$6,235	$5,789	$5,883	($1,095)
Cumulative Net Operating Margin														$25,401

Net Operating Margin assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures

- **FY 2026 projected shortfall of $12.0 million, previously anticipated at $11.0 million**
  - Uncertainty Reserve of a recommended $12M offsets projected FY 2026 shortfall
- **Annual Shortfall in FY 2027-2029 ranges from $7.9M to 5.6M**
- Budgeted revenues projected to support expenditures starting in FY 2030

BSR and Recommended FY24 Surplus Allocation

Budget Stabilization Reserve (BSR) Summary	
BSR Balance June 30, 2024*	$63.3 Million
Transfer to Infrastructure Reserve	-$3.0 Million
Transfer to Budget Uncertainty Reserve	-$5.9 Million
Total Transfer to Reserves	-$8.9 million

Projected FY 2025 BSR Level June 30, 2025 (18.5% Target Level)	$54.4 Million

Recommended Budget Uncertainty Reserve	$12.0 Million

* After FY 2025 approved adjustments to balance FY 2025 ($2.6 million).

POLICY & STRATEGY:

- Maintaining FY 2025 BSR at 18.5% target level
- Multi-year strategy to balance anticipated shortfalls

RECOMMENDATION:

- $3.0M to Infrastructure Reserve and $5.9M to Budget Uncertainty Reserve

APPROPRIATION ACTION:

- FY 2025 Mid-Year Review (February 2025)

ALT SCENARIO A: ECONOMICALLY SENSITIVE REVENUE IN FY26

CITY OF PALO ALTO

ALTERNATIVE SCENARIO: RECESSION (1% Loss of Economically Sensitive Revenue in FY 2026)

	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Total Revenue	$254,799	$278,231	$287,554	$287,554	296,297	310,914	323,534	336,745	352,109	366,516	380,316	394,823	410,228	425,785
BSR Contribution (One-Time)	-	-	$3,247	$3,247	-	-	-	-	-	-	-	-	-	-
Reappropriated Funds (One-Time	-	-	$16,093	$16,093	9,200	-	-	-	-	-	-	-	-	-
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$305,497	$310,914	$323,534	$336,745	$352,109	$366,516	$380,316	$394,823	$410,228	$425,785
Year over Year increase (revenue only)					*3.0%*	*4.9%*	*4.1%*	*4.1%*	*4.6%*	*4.1%*	*3.8%*	*3.8%*	*3.9%*	*3.8%*
Total Expenditures	243,695	281,062	306,893	306,893	319,788	321,169	332,555	344,992	352,868	360,760	368,426	377,255	386,900	403,664
Total Use of Funds	$243,695	$281,062	$306,893	$306,893	$319,788	$321,169	$332,555	$344,992	$352,868	$360,760	$368,426	$377,255	$386,900	$403,664
Year over Year increase					*4.2%*	*0.4%*	*3.5%*	*3.7%*	*2.3%*	*2.2%*	*2.1%*	*2.4%*	*2.6%*	*4.3%*
Net One-Time Surplus/(Gap)	$11,104	($2,831)	$0	$0	($14,292)	($10,255)	($9,021)	($8,247)	($759)	$5,757	$11,890	$17,567	$23,328	$22,121
Cumulative Net Operating Margin (One-Time)														$38,088
Net Operating Margin					($14,292)	$4,036	$1,234	$774	$7,488	$6,516	$6,133	$5,678	$5,761	($1,207)
Cumulative Net Operating Margin														$22,121

Net Operating Margin assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures

- Models the impact of a 1% loss in economically sensitive revenue categories starting in FY 2026
  - Major Taxes, Charges for Services, and Permits and Licenses
- **Revenues decrease by $2.3M in FY 2026** and increase projected shortfalls
  - Gap of $14.3M in FY 2026
  - Gaps of $10.2M to $0.8M in FY 2027 – FY 2030

ALT SCENARIO B: COMPENSATION ADJUSTMENT IN FY26

CITY OF PALO ALTO

ALTERNATIVE SCENARIO: ONE-TIME COMPENSATION ADJUSTMENT (ADDITIONAL 1%) in FY 2026

	Actual 2023	Actual 2024	Adopted 2025	Projected 2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Total Revenue	$254,799	$278,231	$287,554	$287,554	298,600	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
BSR Contribution (One-Time)	-	-	$3,247	$3,247	-	-	-	-	-	-	-	-	-	-
Reappropriated Funds (One-Time	-	-	$16,093	$16,093	9,200	-	-	-	-	-	-	-	-	-
Total Source of Funds	$254,799	$278,231	$306,893	$306,893	$307,800	$313,314	$326,039	$339,349	$354,834	$369,351	$383,252	$397,871	$413,399	$429,068
Year over Year increase (revenue only)					*3.8%*	*4.9%*	*4.1%*	*4.1%*	*4.6%*	*4.1%*	*3.8%*	*3.8%*	*3.9%*	*3.8%*
Total Expenditures	243,695	281,062	306,893	306,893	320,878	322,305	333,725	346,198	354,097	362,014	369,705	378,560	388,231	405,021
Total Use of Funds	$243,695	$281,062	$306,893	$306,893	$320,878	$322,305	$333,725	$346,198	$354,097	$362,014	$369,705	$378,560	$388,231	$405,021
Year over Year increase					*4.6%*	*0.4%*	*3.5%*	*3.7%*	*2.3%*	*2.2%*	*2.1%*	*2.4%*	*2.6%*	*4.3%*
Net One-Time Surplus/(Gap)	$11,104	($2,831)	$0	$0	($13,078)	($8,991)	($7,686)	($6,849)	$737	$7,338	$13,547	$19,311	$25,168	$24,046
Cumulative Net Operating Margin (One-Time)														$53,542
Net Operating Margin					($13,078)	$4,087	$1,305	$837	$7,586	$6,601	$6,210	$5,763	$5,857	($1,121)
Cumulative Net Operating Margin														$24,046

Net Operating Margin assumes that the annual shortfalls are solved with ongoing solutions and annual surpluses are spent for ongoing expenditures

- Models the impact of a 1% compensation adjustment once negotiated agreements sunset
  - Maintains 5% Vacancy Factor
  - Increases reserve for potential changes to future labor costs and benefit rate variability

- **Expenses increase by $1.1M in FY 2026** and increase projected shortfalls
  - Gap of $13.1M in FY 2026
  - Gaps of $9.0M to $6.8M in FY 2027 – FY 2029

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- Continue to prioritize proactively funding long term liabilities

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- Fire and Ambulance Service Expansion
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FINANCE COMMITTEE DISCUSSIONS

- Revenue Volatility in the Past
  - Great Recession initial 4% decline moderated to 1% over time
- Vacancies
  - Currently 10% vacancies citywide, down from 12% pre-covid
- Uncertainty Reserve
- Risk Mitigation Tools
  - Updates to existing revenue sources or new revenues
  - Review policies for reserves & long-term liability funding
  - Financing strategies for capital infrastructure
- Fiscal Discipline

RECOMMENDED ACTION

Finance Committee and Staff recommend that the City Council:

Accept the Fiscal Year 2026 – 2035 Long Range Financial Forecast Base Case and the FY 2026 Budget Development Guidelines (Attachment A).

Direct staff to use this forecast as a starting point for the FY 2026 budget process.

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