CITY OF PALO ALTO

FINANCE COMMITTEE
Tuesday, December 6, 2022
Special Meeting
Community Meeting Room & Virtual
5:30 PM
Amended Agenda
Amended agenda items appear below in Red

Pursuant to AB 361 Palo Alto City Council and Committee meetings will be held as "hybrid" meetings with the option to attend by teleconference/video conference or in person. To maximize public safety while still maintaining transparency and public access, members of the public can choose to participate from home or attend in person. Information on how the public may observe and participate in the meeting is located at the end of the agenda.

HOW TO PARTICIPATE

VIRTUAL PARTICIPATION

CLICK HERE TO JOIN (https://cityofpaloalto.zoom.us/j/99227307235)
Meeting ID: 992 2730 7235 Phone:1(669)900-6833

The meeting will be broadcast on Cable TV Channel 26, live on YouTube at https://www.youtube.com/c/cityofpaloalto, and streamed to Midpen Media Center at https://midpenmedia.org.

PUBLIC COMMENTS

Public Comments will be accepted both in person and via Zoom meeting. All requests to speak will be taken until 5 minutes after the staff's presentation. Written public comments can be submitted in advance to city.council@cityofpaloalto.org and will be provided to the Committee and available for inspection on the City's website. Please clearly indicate which agenda item you are referencing in your email subject line.

CALL TO ORDER

ORAL COMMUNICATIONS

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

ACTION ITEMS

1. FY 2023 Finance Committee Referrals Update

2. Pension Policy and Retiree Healthcare Review and Update
Late Packet Report added
Staff Presentation
Consultant Presentation

3. First Quarter Fiscal Year 2023 Financial Report
Presentation

4. Review and Forward the FY 2024 - 2033 Long Range Financial Forecast
Presentation

Materials related to an item on this agenda submitted to the Finance Committee after distribution of the agenda packet are available for public inspection in the city's website at www.cityofpaloalto.org

FUTURE MEETINGS AND AGENDAS

ADJOURNMENT

PUBLIC COMMENT INSTRUCTIONS

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

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

2. **In person public comments** please complete a speaker request card located on the table at the entrance to the Council Chambers, and deliver it to the City Clerk prior to discussion of the item.

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

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

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

AMERICANS WITH DISABILITY ACT (ADA)

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

City of Palo Alto
Finance Committee Staff Report

(ID # 14906)

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

Title: FY 2023 Finance Committee Referrals Update

From: City Manager

Lead Department: Administrative Services

Recommendation

This report provides a status update of Council referrals requested and approved, during the City Council Retreat and annual Budget Process. Staff recommends the Committee review and accept this report.

Background and Discussion

This report provides an update of the outstanding Council referrals to the Finance Committee as requested during the February 2022 City Council Retreat, during the May 2022 Budget Process, and throughout the year. The City Council requested information on various items that are discussed in this report and is provided in coordination with assigned departments. A summary table of the current referrals and their status follows.

Referral	Assigned Department	Status
FY 2020: Evaluation of Printing & Mailing Services levels and service delivery. Referred May 2019.	Administrative Services	**Nov 2022 Status: In Progress** The Administrative Services Department is in the process of evaluating responses to a Request for Proposal (RFP). Interviews with responders are expected to occur before the end of the calendar year. A return to the Finance Committee is expected in calendar year 2023. This project has been delayed due to staff capacity and significant vacancies.
FY 2021: A report or item on the JMZ six months after it opens and what it would look like to eliminate the	Community Services Department	**Nov 2022 Status: Complete** On September 2022, staff presented to the Finance Committee (CMR 14584) preliminary revenue and expenditures for the FY ending in 2022. The report reflected results from 7

General Fund Subsidy through a fully cost recoverable program. Referred June 2020		months of operations, and based on current data, projected what potential increases to memberships and ticket prices would have on cost recovery levels. The Committee recommended to Council that the current cost recovery levels be maintained. Additionally, the Committee also directed staff to return on a future date with updated attendance data and more detailed recommendations on membership and ticket prices.
FY 2022: Dialogue with PAUSD regarding cost-sharing for mutual activities (i.e Crossing Guards, Children's Theater Outreach)	Police Department	**Nov 2022 Status: In Progress** The City maintains a productive working relationship with the PAUSD and is actively engaged in partnering in mutually beneficial activities for the community. Currently, the CAO is in the process of reviewing a draft for a cost-sharing agreement for crossing guards. It is anticipated to have this contract approved and executed in the latter half of FY 2023.
FY 2023: JMZ ticket pricing analysis to understand interactions between changes to $18 ticket, attendance, and cost recovery	Community Services Department	**Nov 2022 Status: Pending** On September 2022, the staff presented to the Finance Committee (CMR 14584) the preliminary results of the JMZ with projections on how pricing could affect cost recovery levels. Staff is also in the process of evaluating the potential use of a consultant to conduct an organizational and operational study for the JMZ, which would consider how pricing changes could affect demand and cost recovery as a requirement of the study.
FY 2023: Planning and Development Services Fee Study	Planning and Development Services	**Nov 2022 Status: Pending** In FY 2022 the Planning and Development Services Department embarked on a fee study to right-size fees to achieve cost neutrality based on the newly combined department structure. Due to competing priorities the study is on hold while the Fire Prevention Program organizational study is completed. Study results and potential

		corresponding revenue and expense adjustments will be brought forward for consideration upon conclusion of the study.

Stakeholder Engagement
This is an informational report to follow up on Council referral items and has been coordinated internally among departmental parties.

Environmental Review
This is not a project under Section 21065 for purposes of the California Environmental Quality Act (CEQA).

City of Palo Alto

(ID # 15007)

Finance Committee Staff Report

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

Title: Pension Policy and Retiree Healthcare Review and Update

From: City Manager

Lead Department: Administrative Services

This report will be a special late packet release on Thursday, December 1st, 2022.

City of Palo Alto
Finance Committee Staff Report

(ID # 14630)

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

Title: First Quarter Fiscal Year 2023 Financial Report

From: City Manager

Lead Department: Administrative Services

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

EXECUTIVE SUMMARY
The purpose of this report is to provide the Finance Committee with information on the financial status of the City's General Fund and Enterprise Funds as of the end of the First (1st) Quarter of Fiscal Year (FY) 2023 (July 1, 2022 through September, 2022). The figures presented here are unaudited.

For the 1st quarter, the General Fund revenues totaled $30.9 million which is 1.5% higher than the same period of the prior year while expenditures totaled $47.5 million which is 13.68% higher that than prior year and are tracking at 20.4% of Adjusted Budget which is comparable to the prior year trend.

All Enterprise Funds, except Airport Fund, resulted to a positive change in net position. The total change in position decreased by $5.9 million, or 51.0%, lower than the same period of the prior year.

BACKGROUND
This report summarizes the financial information of the General and Enterprise Funds for First(1st) quarter ending September 30, 2022 of Fiscal Year (FY) 2023 and compares those amounts to the same period of the prior year and to the FY 2023 Adjusted Budget.

Attachment A provides a breakdown of revenues by source and expenses by function, with separate columns for Adopted Budget and Adjusted Budget. The Adjusted Budget column includes prior year commitments that were carried forward into this fiscal year and amendments to the FY 2023 Adopted Budget through September 30. Encumbrances and actual expenses for the three-month period are also reported.

DISCUSSION & ANALYSIS

General Fund revenues (excluding operating transfers) for the 1st quarter of FY 2023 are $30.9 million which is 14.4% of the current year Adjusted Budget. The actual revenues totaled $30.9 million, 1.5% higher than the same period of the prior year (increase of $0.4 million). All of the major taxes except documentary transfer taxes were higher compared to the same period of the prior year. This indicates the economy is showing positive signs of recovery; however, mixed economic data increases difficulty in determining if this trend will continue. The first quarter General Fund cash receipts are not indicative of the annual expected receipts in FY 2023 due to timing of major revenues received over the fiscal year.

For the 1st quarter, General Fund expenses totaled $47.5 million which is $5.7 million, 13.68% higher than the prior year and tracking at 20.4% of Adjusted Budget which is comparable to the prior year trend.

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

Revenue Highlights for 1st Quarter FY 2023

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

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

	1st Quarter Actuals			Adjusted Budget			
	FY 2023	FY 2022	% change	FY 2023	%	FY 2022	%
Property Tax	$174	$55	216.4%	$59,770	0.3%	$51,228	0.1%
Sales Tax	2,551	1,976	29.1%	32,580	7.8%	28,184	7.0%
Charges for Services	6,427	5,327	20.6%	30,786	20.9%	24,515	21.7%
Transient Occupancy Tax	2,663	1,469	81.3%	18,199	14.6%	8,428	17.4%
Utility User Tax	3,495	3,473	0.6%	15,579	22.4%	14,370	24.2%
Permits and Licenses	1,781	1,872	-4.9%	9,499	18.7%	7,761	24.1%
Documentary Transfer Tax	1,207	2,062	-41.5%	7,217	16.7%	7,137	28.9%
All Other Revenue Sources	12,644	14,261	-11.3%	41,851	30.2%	41,650	34.2%
Total Revenue	**$30,942**	**$30,495**	**1.5%**	**$215,481**	**14.4%**	**$183,273**	**16.6%**

Property tax revenue in the 1st quarter of the fiscal year is only a nominal amount as property tax receipts are paid by the County over three months beginning in the month of November and then again beginning in March. The FY 2022 actual property tax revenue was $59.4 million, $6.1 million (11.5%) higher than the FY 2022 adjusted budget and $2.8 million (4.9%) over the prior year. Robust property sales in FY2022 resulted in higher than anticipated assessed value growth and an additional $1.1 million in excess Educational Revenue Augmentation Fund (ERAF) distributions contributed to these increased receipts.

The excess ERAF distributions from the County of Santa Clara in fiscal years 2018, 2019, 2020, 2021, and 2022 receipts are $1.4 million, $2.7 million, $3.9 million, and $5.6 million, and $6.6 million, respectively. Of this $6.6 million receipt, $1.7 million has been set aside for the at-risk amount due to the lawsuit filed in November 2021 by the California School Boards of Association and its Education Legal Alliance against the Controller of the State of California for over the calculation methodology of the Excess ERAF.

The FY 2023 budget amount is $59.8 million, 0.7% higher than the prior year's actual revenue. This budget amount has been reduced by $1.5 million for the on-going FY 2023 Excess ERAF lawsuit at-risk amount; without this reduction the budget increase would have been $1.9 million or 3.2% higher.

Sales tax revenue cash receipts for the 1st quarter have increased by $0.6 million, or 29.1%, from the same period of last year. This represents one month's sales tax activity due to the two-month delay between sales tax collection by the State and remittance to the City. The FY 2022 actual sales tax revenue was $32.7 million, $3.6 million or 12.3% higher than FY 2021. While the outlook of the local activity appears positive and sales tax continue to perform well, the FY2023 estimate remain below pre-pandemic actuals of $36.5 million in FY 2019. Due to the economic uncertainties, the FY 2023 adopted budget anticipates the sales tax recovery will soften.

Charges for services revenue is up $1.1 million or 20.6%, compared to the same quarter of last year. The decrease is due to combination of the following items:

- Program and class revenues increased by $0.7 million due to increase of enrollees and additional programs such as modern dance and metal jewelry classes.
- Plan check fees increased by $0.3 million due to large projects at 1036 E Meadow Circle, 2225 E Bayshore Road and 525 Charleston Road.

Transient occupancy tax (TOT) revenue of $2.7 million represents about one and half month of collections which is an increase of $1.2 million or 81.3%, compared to the same period of last year. This same period last year, marked a starting point for recovery from the pandemic with most travel restrictions being removed during this time in 2021. When compared to the pre-pandemic actuals of $3.2 million on Q1 in FY 2020 the receipts in FY 2023 Q1 are $0.5 million or 15.6% below pre-pandemic levels. This indicates that TOT revenue remains low and still affected by pandemic. The FY 2023 adopted budget of $18.2 million is still significantly below the FY 2019 actuals of $25.6 million. In addition, two major hotels have opened in the last year and a half adding almost 300 rooms.

During the first two months of the first quarter, hotels average daily room and occupancy rates were $251.04 per day an increase of 74.9%; a 61.2% increase in average daily room and 24.4% in occupancy rates over the same period of the prior year. As of writing of this report, the occupancy percentage of individual hotels ranged from around 30% to over 95%.

Documentary transfer tax cash receipts for two and half months total $1.2 million, or 16.7% of the FY 2022 adjusted budget and is $0.9 million, or 41.5%, lower than prior year receipts for the same period. The number of transactions are 30.3% lower compared to prior first quarter. This revenue source is volatile, it is highly dependent on sales volume and the mix of commercial and residential sales. The prior year had a record receipt due to nine large commercial sales which is not expected to occur in FY 2023. Staff continues to monitor these receipts closely due to significant fluctuations that can occur anytime depending on the real estate sales activity.

All other revenue sources cash receipts for the 1st quarter have decreased $1.6 million or 11.3%, from the same period of last year primarily due to lower revenue from ARPA allocation.

Expense Highlights for 1st Quarter FY 2022

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

Table 2
General Fund Expenses
FY 2023 1st Quarter
(000's)

	1st Quarter Actuals			Adjusted Budget			
Expenditures	**FY 2023**	**FY 2022**	**% change**	**FY 2023**	**%**	**FY 2022**	**%**
Police	$ 12,333	$ 10,507	17.4%	$ 47,723	25.8%	$ 43,319	24.3%
Fire	10,502	9,137	14.9%	41,379	25.4%	35,951	25.4%
Community Services	6,713	6,816	-1.5%	34,429	19.5%	32,098	21.2%
Public Works	4,504	3,935	14.5%	22,667	19.9%	19,980	19.7%
Planning and Development Servic	4,223	3,507	20.4%	26,131	16.2%	19,855	17.7%
Library	2,133	2,055	3.8%	10,524	20.3%	8,976	22.9%
Administrative Services	2,301	1,934	19.0%	10,107	22.8%	9,201	21.0%
All Other Departments	4,743	3,851	23.2%	39,827	11.9%	31,359	12.3%
Total Expenses	**$ 47,452**	**$ 41,742**	**13.7%**	**$ 232,787**	**20.4%**	**$ 200,739**	**20.8%**

For the 1st quarter of the fiscal year, total expenses increased $5.7 million, or 13.7%, compared to the same quarter prior year and are trending in line with total budget at 20.4%. The 13.7% increase is due to increased salary and benefit expense, including overtime, primarily due to the 4.0% cost of living adjustment wage increase for all labor groups, effective April 2022. Staff continues to work on filling vacant positions though maintains a high vacancy level which is expected to generate savings in FY 2023.

Attachment A shows total expenses, including encumbrances for the 1st quarter are 29% of the adjusted budget. This is higher than 25% due to some purchase orders that cover the entire year (i.e., golf course management, consultant fees and others). It is the City's practice in many instances to encumber budget funds for the fiscal year so that invoices are drawdown, or paid against, the encumbrances.

Police and Fire comprise 48.1% of the total General Fund expenditures for the 1st quarter, which is 16.2% higher compared to the prior year. The following highlights Police and Fire salaries and overtime for the 1st quarter.

Table 3
Police and Fire
Salaries and Overtime Expense
FY 2023 1st Quarter YTD
(000's)

	1st Quarter YTD Actuals			Adjusted Budget			
	FY 2023	FY 2022	% change	FY 2023	%	FY 2022	%
Police - Salaries	$4,476	$4,241	5.5%	$20,026	22.4%	$17,499	24.2%
Police - Overtime	740	379	95.3%	973	76.1%	944	40.1%
Total Police	**5,216**	**4,620**	**12.9%**	**20,999**	**24.8%**	**18,443**	**25.1%**
Fire - Salaries	3,553	3,219	10.4%	15,997	22.2%	13,676	23.5%
Fire - Overtime	1,070	1,202	-11.0%	2,124	50.4%	1,931	62.2%
Total Fire	**4,623**	**4,421**	**4.6%**	**18,121**	**25.5%**	**15,607**	**28.3%**
Total Public Safety Salaries & Overtime	**$9,839**	**$9,041**	**8.8%**	**$39,120**	**25.2%**	**$34,050**	**26.6%**

Police overtime is 95.3% higher than the prior year and 76.1% of adjusted budget due to the following:

- Backfilling 14 vacancies: 7 police officers, 2 dispatchers, 5 other records and support staff. The vacancy rate is still high despite vigorous hiring.
- 7 employees on various levels are on extended leave.
- Catching-up on a hiring and training freeze which results in positions being allocated from patrol to training (academy/Field Training Officer).
- Backfill to meet patrol and dispatch minimum staffing requirements.

The Department is anticipating overtime to continue this fiscal year, but it should improve when the staff clearing training requirements are completed. On a combined basis, salaries and overtime are 24.8% of the budget through the 1st quarter of the fiscal year.

The Fire overtime is 11.0% lower than the same period in prior year and 50.4% of adjusted budget. Overtime is generated when there are firefighters on leave and the position is backfilled with overtime. In FY 2023 1st quarter overtime was primarily generated from the firefighter positions that were vacant, however, there were positions that have been filled in current year, which reduces overtime spending. The department is actively recruiting entry level firefighters to keep up with staff turnover, there are currently 3 new firefighters in a Joint Fire Academy. Despite of the decreased overtime in the FY 2023 1st quarter, the department expect the overtime to rise as there is more staff turnover. Overtime was also generated to staff Fire Station 8 during high fire danger days. This is reimbursed by Santa Clara County Fire, which will show in the midyear budget as an adjustment to the revenue and overtime.

On a combined basis, salaries and overtime are 25.5% of the budget through the 1st quarter of the fiscal year. The Department's overtime analysis is included in Attachment B.

General Fund Budget Stabilization Reserve (BSR) Balance

Based on information reported in the FY 2022 Annual Comprehensive Financial Report (ACFR) CMR 14632[1], the City's current BSR balance is $59.8 million, approximately $14.2 million above the 18.5% target of $45.6 million for FY 2023. There are recommended adjustments in line with the City Manager's authority for transfer of excess BSR, adjusted for a recommendation to reserve funds to safeguard the financial stability by re-establishing an economic uncertainty reserve. Staff do recommend a transfer to the Infrastructure Reserve as inflationary costs are impacting capital project needs including anticipated significant price increases in the Automated Parking Guidance Project, as well as a need to provide safety improvements to critical assets such as the artificial turf playing fields. These actions will leave the BSR at $45.8 million or $0.2 million above the 18.5% Council recommended level. Staff anticipates returning to Council in February 2023 with the FY 2023 Mid-Year Review and recommendations in alignment with the allocation below for the appropriation of BSR funds above the 18.5% level.

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

Enterprise Funds

Following is a summary of changes in net position for each of the Enterprise Funds for the three months ended September 30, 2022, including a comparison of results from the same period last year.

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

	1st Qtr FY 2023	1st Qtr FY 2022	Increase (Decrease)	% Change
Water	$3,701	$5,321	($1,620)	-30%
Electric	2,245	1,943	302	16%
Fiber Optic	202	170	32	19%
Gas	364	(631)	995	158%
Wastewater collection	116	(32)	148	463%
Wastewater treatment	7,054	660	6,394	969%
Refuse	3,419	3,316	103	3%
Storm Drainage	502	788	(286)	-36%
Airport	(11)	120	(131)	-109%
Total Change in Net Position	**$17,592**	**$11,655**	**$5,937**	**51%**

Water Fund decreased $1.6 million, or 30.0%, from prior year due to overall decrease in revenues and increase in operation costs. Revenue decreased despite a 4% rate increase effective July 1, 2022 due to voluntary water conservation efforts. The increase in operation costs is driven by commodity purchases and cost. The San Francisco Public Utilities Commission (SFPUC) commodity rate increased from $4.10 to $4.75, a 15% increase due to drought conditions.

Electric Fund increased $0.3 million, or 16.0%, from prior year due to a 5% rate increase effective July 1, 2022, partially offset by increase in operating expenses. The majority of the costs are related to energy purchases, mainly due to rising transmission cost and low levels of water supply that lead to lower-than-normal generation from hydroelectric plants.

Gas Fund increased $0.9 million, or 158.0%, from prior year due to a $2.1 million increase in revenue from customer sales partially offset by higher commodity purchases. A 4% rate increase effective July 1, 2022 resulted in an average overall rate increase of $0.55 compared to FY 2022. In additional, overall average consumption in FY 2023 increased compared to FY 2022.

Wastewater Treatment Fund increased $6.4 million, or 969.0%, from prior year as a result of an earlier receipt of $4.8 million in partner payments, compared to FY 2022 and a $1.7 million reimbursement from the California State Water Resources Control Board for the Primary Sedimentation Tank project.

Storm Drainage Fund decreased by $0.29 million, or 36.0%, from prior year due to higher operating expenses related to salary and benefits costs, contract services, and indirect charges.

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

Resource Impact
At this time, this report does not recommend an action amending the City's financials, however, depending on trends and further input from Council, actions may be necessary later in the year to better align revenues with expected collections. The City continues to monitor activities closely.

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

Attachments:
- Attachment A FY2023 First Quarter General Fund Financial Report
- Attachment B FY2023 First Quarter Public Safety Overtime Analysis

ATTACHMENT A
CITY OF PALO ALTO
GENERAL FUND FIRST QUARTER FINANCIAL REPORT
FISCAL YEAR ENDING JUNE 30, 2023
(in thousands)

	BUDGET		ACTUALS (as of 9/30/2022)			
Categories	Adopted Budget	Adjusted Budget	Pre Encumbr	Encumbr	Actual	% of Adj Budget*
Revenues & Other Sources						
Sales Tax	32,580	32,580	-	-	2,551	8%
Property Tax	59,770	59,770	-	-	174	0%
Transient Occupancy Tax	18,199	18,199	-	-	2,663	15%
Documentary Transfer Tax	7,217	7,217	-	-	1,207	17%
Utility Users Tax	15,579	15,579	-	-	3,495	22%
Motor Vehicle Tax, Penalties & Fines	1,784	1,784	-	-	(127)	-7%
Charges for Services	30,786	30,786	-	-	6,427	21%
Permits & Licenses	9,249	9,499	-	-	1,781	19%
Return on Investment	1,066	1,066	-	-	204	19%
Rental Income	15,499	15,499	-	-	3,429	22%
From Other Agencies	9,179	9,179	-	-	5,631	61%
Charges To Other Funds	13,690	13,690	-	-	3,426	25%
Other Revenues	548	633	-	-	81	13%
Total Revenues	**215,146**	**215,481**	**-**	**-**	**30,942**	**14%**
Operating Transfers-In	22,532	22,532	-	-	5,633	25%
Encumbrances and Reappropriation	159	10,457	-	-	-	-
Contribution from Development Services Reserves	399	399	-	-	-	-
Total Sources of Funds	**238,236**	**248,869**	**-**	**-**	**36,575**	**15%**
Expenditures & Other Uses						
City Attorney	4,234	4,622	-	468	1,046	33%
City Auditor	979	1,174	0	714	9	62%
City Clerk	1,429	1,502	80	144	287	34%
City Council	436	485	-	75	82	32%
City Manager	4,094	4,446	176	188	784	26%
Administrative Services	9,745	10,107	31	323	2,301	26%
Community Services	32,866	34,429	1,550	6,228	6,713	42%
Fire	40,981	41,379	59	737	10,502	27%
Human Resources	4,742	4,982	50	236	850	23%
Library	10,211	10,524	219	536	2,133	27%
Office of Emergency Services	1,342	1,500	60	323	167	37%
Office of Transporation	1,718	1,737	0	19	390	24%
Planning and Development Services	22,615	26,131	91	3,560	4,223	30%
Police	47,401	47,723	38	900	12,333	28%
Public Works	20,104	22,667	109	3,721	4,504	37%
Non-Departmental	19,088	19,377	25	294	1,129	7%
Total Expenditures	**221,986**	**232,787**	**2,486**	**18,467**	**47,452**	**29%**
Operating Transfers-Out	4,962	4,962	-	-	1,241	25%
Transfer to Infrastructure	20,400	20,400	-	-	5,100	25%
Total Use of Funds	247,348	258,149	2,486	18,467	53,793	29%
Net Change to BSR	**(9,112)**	**(9,279)**			**(17,218)**	

Budget Amendments in the General Fund Authorized by Council thru 9/30/2022		
Action to support Downtown Streets Team (06/20/2022)	CMR#14526	(167)
Total Budget Amendments Authorized by Council	-	(167)
BSR Balance as of 9/30/2022	**45,538**	**45,371**
BSR % of Adopted Total Use of Funds	**18.4%**	**18.3%**

Public Safety Departments
Overtime Analysis for Fiscal Years 2021 through 2023

	2021	2022	*Q1* 2023
POLICE DEPARTMENT			
Overtime Expense			
Adopted Budget **(A)**	$944,186	$944,186	$972,512
Modified Budget **(B)**	944,186	1,244,186	972,512
Net Overtime Cost - see below	366,045	781,344	345,785
Variance to Budget	578,141	462,842	626,727
Overtime Net Cost			
Actual Expense	$1,431,959	$2,319,043	$740,075
Less Reimbursements			
California OES/FEMA (Strike Teams)	-	-	-
Stanford Communications	64,906	107,684	34,431
Utilities Communications Reimbursement	33,191	56,004	18,047
Local Agencies **(C)**	2,412	5,456	1,362
Police Service Fees	467,167	120,411	5,863
Total Reimbursements	567,676	289,556	59,704
Less Department Vacancies **(A)**	498,238	1,248,143	334,586
Net Overtime Cost	$366,045	$781,344	$345,785
Department Vacancies (number of days)	1,494	3,903	1,143
Workers' Compensation Cases	14	11	3
Department Disabilities (number of days)	1,007	1,221	318
FIRE DEPARTMENT			
Overtime Expense			
Adopted Budget **(D)**	$1,931,121	$1,931,121	$2,124,054
Modified Budget **(E)**	2,971,460	2,703,621	2,124,054
Net Overtime Cost - see below	1,792,228	4,073,011	747,593
Variance to Budget	1,026,424	(1,369,390)	1,376,461
Overtime Net Cost			
Actual Expense	$2,840,968	$4,684,796	$1,070,143
Less Reimbursements			
California OES/FEMA (Strike Teams)	887,531	-	-
Total Reimbursements	887,531	-	-
Less Department Vacancies **(D)**	161,208	611,784	322,549
Net Overtime Cost	$1,792,228	$4,073,011	$747,593
Department Vacancies (number of days)	1,942	1,717	938
Workers' Compensation Cases	14	35	10
Department Disabilities (number of days)	387	947	200

NOTES:

(A) The FY 2022/23 Police Department budget was increased by 4.0 Police Officers, 1.0 Business Analyst, and 2.0 Public Safety Dispatcher.

(B) Police Department adopted budget not modified during FY 2023, Q1

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

(D) The FY 2022/23 Fire Department budget was increased by 1.0 Deputy Chief, 0.20 40-Hour Captain, 3.0 Fire Fighter Trainee, and 0.05 Fire Marshal.

(E) Fire Department adopted budget not modified during FY 2023, Q1

City of Palo Alto (ID # 14629)

Finance Committee Staff Report

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

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

From: City Manager

Lead Department: Administrative Services

Recommendation

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

Executive Summary

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

The **Base Case Long Range General Fund forecast** projects a surplus of $0.4 million in FY 2024, followed by a $3.4 million gap in FY 2025 and a $2.6 million gap in FY 2026, with small but increasing surpluses in FY 2027 through FY 2033. This forecast maintains current service levels approved in FY 2023 and should be used for planning purposes to assist in gauging effects of major policy interventions against a likely "status quo" version of the future.

Staff modeled an **alternate forecast scenario that reflects a more severe recession**. Compared to the Base Case, this scenario increases the General Fund gap over the next ten years. FY 2024 changes from a surplus to a gap of $3.5 million, and revenues are not anticipated to be able to fund the annual expenditures until FY 2029.

Staff modeled an **alternate forecast that reflects estimated funding from Measure K** and the impacts on the General Fund over the next ten years reflects a surplus in FY 2024 of $1.1 million, a gap in FY 2025 of $1.9 million, and surpluses in FY 2026 through FY 2033. These alternate forecasts were done separately to show the impacts of each

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

As the COVID-19 pandemic is waning, new economic challenges are emerging such as monetary policy tightening actions by the US Federal Reserve to tame persistently high inflation and increasing geopolitical risks which may lead the United States into a recessionary period. This economic uncertainty has heightened the intensity of financial forecasting and budget development process. New analyses and data generation demands require deep dives into complex problem-solving within an engaged public process across a wide range of issues. These forecast figures present staff with the challenge of prioritizing the growing needs of the City with the fiscal sustainability of these needs.

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

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

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

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

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

Background

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

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

The Economy

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

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

Discussion

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

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

Base Case

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

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

The incremental forecast assumes that each shortfall is addressed completely with ongoing solutions in the year it appears and that each surplus is completely expended with ongoing expenditures. It is the City's goal to remain in balance on an ongoing basis, so the incremental figure is useful to illustrate the additional surplus and/or shortfall attributed to a particular fiscal year. To the extent a shortfall is not resolved, or a surplus is not expended on an ongoing basis, it is important to understand that the remaining budget gap or surplus will remain and be pushed to the following year.

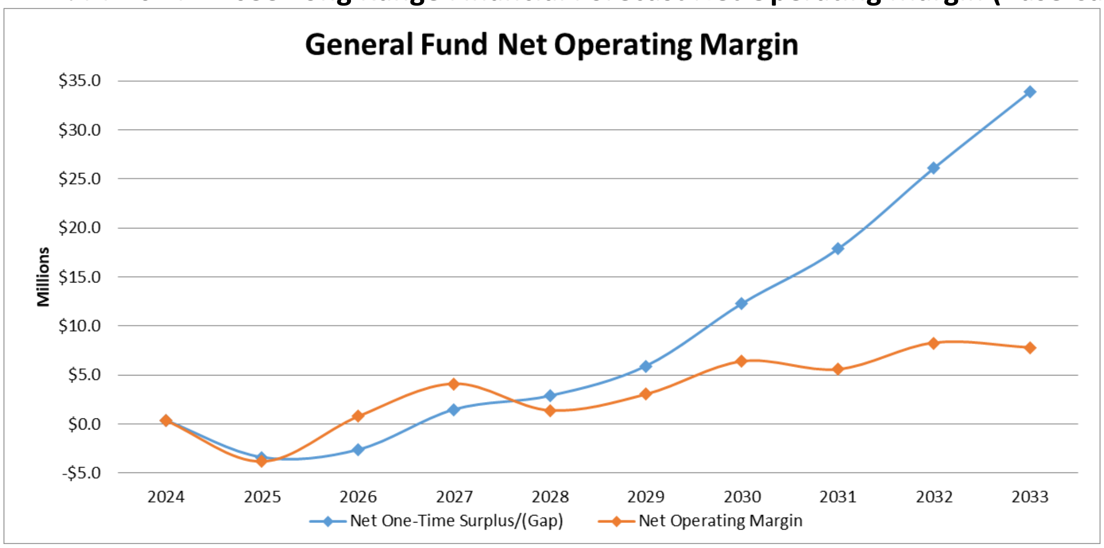
The Base Case financial forecast projects a surplus of $0.4 million in FY 2024, followed by a $3.4 million shortfall in FY 2025, a $2.6 million shortfall in FY 2026, and increasing surpluses thereafter. Based on these assumptions, the cumulative net operating margin, or ongoing surplus, during the forecast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

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

BASE CASE

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

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



Revenue Assumptions

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

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

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

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

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

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

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

testing programs; and

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

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

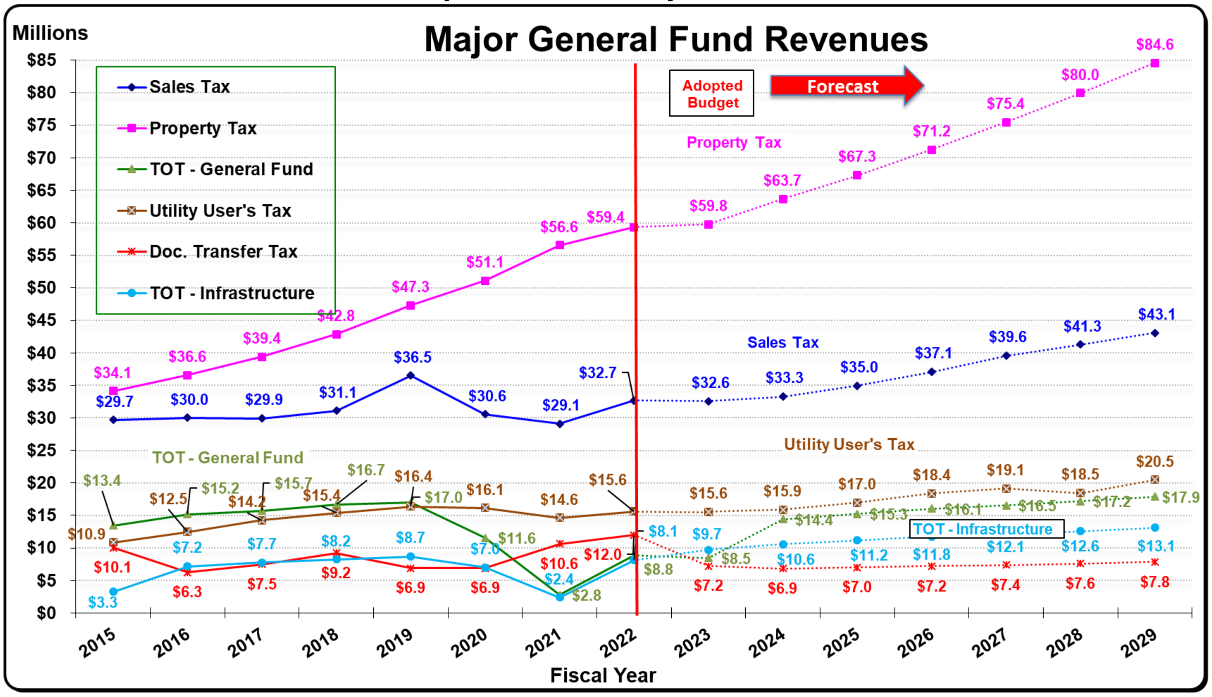
TABLE 3: General Fund Revenue Forecast

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

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

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

TABLE 5: City of Palo Alto Major General Fund Revenues



Expense Assumptions

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

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

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

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

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

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

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

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

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

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

Budget Stabilization Reserve

The City's Budget Stabilization Reserve (BSR) serves as the primary General Fund reserve. By policy, the BSR is maintained in the range of 15 to 20% of General Fund operating expenditures, with a target of 18.5%. Any reduction to the reserve below 15% requires City Council approval. At the discretion of the City Manager, any BSR balance above 18.5% may be transferred to the Infrastructure Reserve (IR) in the Capital Improvement Fund, and/or the City's Section 115 Pension Trust Fund, as outlined in the Pension Funding Policy. The BSR is used to fund unanticipated one-time costs as opposed to ongoing or recurring operating expenditures; ongoing revenue or expense trends are updated as part of the annual budget process to adjust ongoing needs. The City's intent is to fund ongoing programs and services with ongoing dollars. Maintaining the BSR at 18.5% also provides flexibility for the City to deal with unforeseen issues that may arise. Furthermore, establishing, and following, sound fiscal reserve policies has been a strong factor in the City being rated AAA by rating agencies.

Based on information reported in the FY 2022 Annual Comprehensive Financial Report (ACFR) CMR 14632[2], the City's current BSR balance is $59.8 million, approximately $14.2 million above the 18.5% target of $45.6 million for FY 2023. Micro and macro-economic conditions are adjusting daily, with rising inflation, changes in jobs, and recessionary trends creating significant uncertainty. As the State of California Legislative Analyst Office (LAO) wrote in their annual Fiscal Outlooks for California "Economic Conditions Weigh on Revenues, [the] booming

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

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

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

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

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

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

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

Assumptions NOT Included in Forecast

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

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

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

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

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

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

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

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

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

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

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

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

Capital Infrastructure Plan: As referenced earlier, the June 2014 Council approved Infrastructure Plan of $125.8 million in projects was based on construction and design costs with data from 2012. As construction costs have increased and the City is required to pay prevailing wages, the Infrastructure Plan's funding status has shifted. The FY 2023 Adopted Capital Budget anticipated that these projects would cost $261.8 million. Staff is working to maintain these projects within the current budget; however, project costs can fluctuate based on market conditions at the time of construction award.

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

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

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

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

Parks Master Plan: The Parks Master Plan[14] was finalized in 2017; however, when approved it identified a need to develop a funding strategy and this is still in process. As such, this forecast does not yet contemplate the necessary investments to fully execute this plan.

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

[12] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20220523/20220523pccsm-revised.pdf
[13] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/at-places-memo/20220810apmccsm.pdf
[14] https://www.cityofpaloalto.org/files/assets/public/public-works/palo-alto-parks-master-plan.pdf
[15] http://cityofpaloalto.org/civicax/filebank/documents/77273

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

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

City owned assets operated by non-profit organizations: This Forecast does not include any additional capital or operating investments for the Avenidas Senior Center, the Ventura Child Care Center, nor the Sea Scout Building. As costs around potential capital or operating investments for these assets solidify, staff will return to City Council to address them as appropriate. As part of the FY 2023 Adopted Capital Budget[17] the City Council established the Roth Building Rehabilitation Phase 1 capital project (PF-23001) directed a funding strategy for the Roth Building Rehabilitation Project, which consists of utilizing $5.4 million from a variety of funding sources including the Stanford University Medical Center (SUMC) Fund; library, parks, and community center impact fees; grants from Santa Clara County; and donations from the Palo Alto Museum. This funding strategy is included in the LRFF; however, if costs for rehabilitating the Roth building increase, additional sources of funding would need to be identified.

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

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

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

Loans for special projects: From time to time the City's General Fund will assist other City operations with modest cash flow loans to bridge fiscal years. For example, the City provided over $3 million in loans to the Airport Fund as it worked to secure significant grant funding from the Federal Aviation Administration (FAA) for capital improvement costs. As of FY 2020, the Airport Fund began paying back the loan to the General Fund. Additions and other initiatives funded in other funds may need financial support from the General Fund to ensure they are fully implemented. In FY 2023 the Residential Preferential Parking (RPP) Fund received a one-time $0.4 million General Fund loan to remain solvent while continuing operations given the sustained drop in parking demand during the pandemic. Additional loans from the General Fund are not assumed in this forecast.

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

Tax revenue alignment with updated Comprehensive Plan: The 2030 Comprehensive Plan was adopted in FY 2018, including the potential fiscal impact of various land use scenarios. The fiscal impact of this plan and various land use scenarios are not factored into this forecast.

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

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

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

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

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

FY 2023 Budget Development Guidelines

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

[18] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2020/id-11439.pdf
[19] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2021/id-12041.pdf
[20] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20221024/20221024pccsm-amended.pdf
[21] https://www.cityofpaloalto.org/files/assets/public/administrative-services/city-budgets/fy2023-city-budget/adopted-fy23/capital-budget_final-4-online-version.pdf
[22] https://www.cityofpaloalto.org/civicax/filebank/documents/70506

or potential activities proposed to be completed”. The inclusion of Budget Development Guidelines in with this forecast represents staff’s recommended method of addressing this referral. Pairing Budget Development Guidelines with the forecast at the beginning of the budget process links the anticipated fiscal condition of the organization with the necessary context regarding service delivery prioritization and resource allocation that will be further explored through the process. This also ensures that the City is able to proactively address anticipated changes in its fiscal condition through the budget process.

As discussed earlier in this document, this preliminary forecast represents the initial steps of the FY 2024 budget development process. Due to the clear overlap of projecting the City’s fiscal condition and the need to shape service level expectations, staff recommends that the inclusion of Budget Development Guidelines be incorporated into the discussions at the beginning of an annual budget process. The FY 2024 Budget Development Guidelines, which are detailed in Attachment A, are meant to reflect the anticipated fiscal condition of the City and to provide high-level budgetary direction to the organization. These guidelines will shape and inform the annual financial planning and the allocation of resources across the organization, especially in the General Fund.

Conclusion

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

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

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

Alternative Scenarios for Consideration

Alternative Forecast Scenario A: Moderate Recession

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

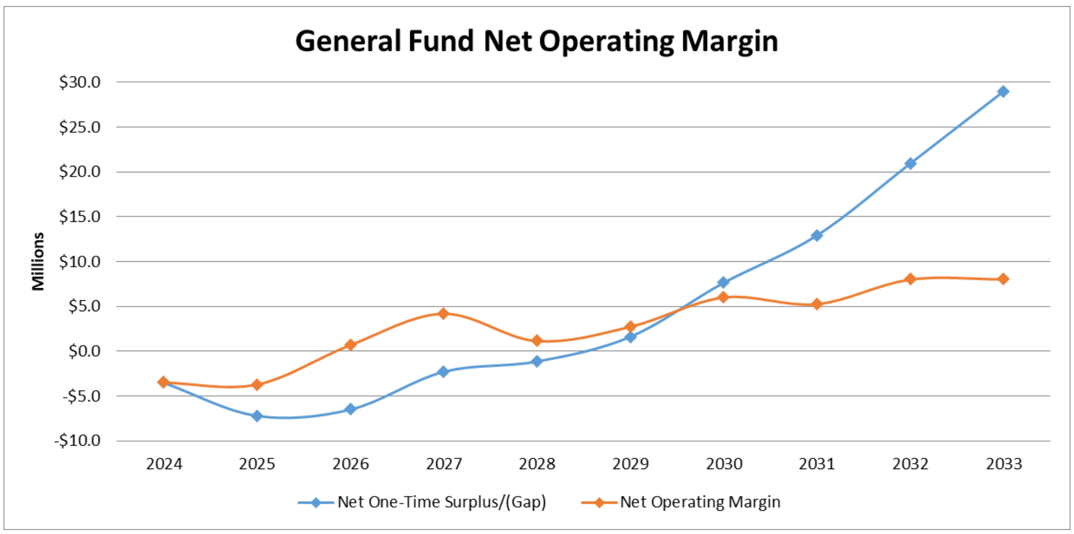
TABLE 8: FY 2024 – FY 2033 Long Range Financial Forecast
Alternative Forecast A

ALTERNATIVE SCENARIO: MODERATE RECESSION

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

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

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



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

Alternative Forecast B: Measure K Funding

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

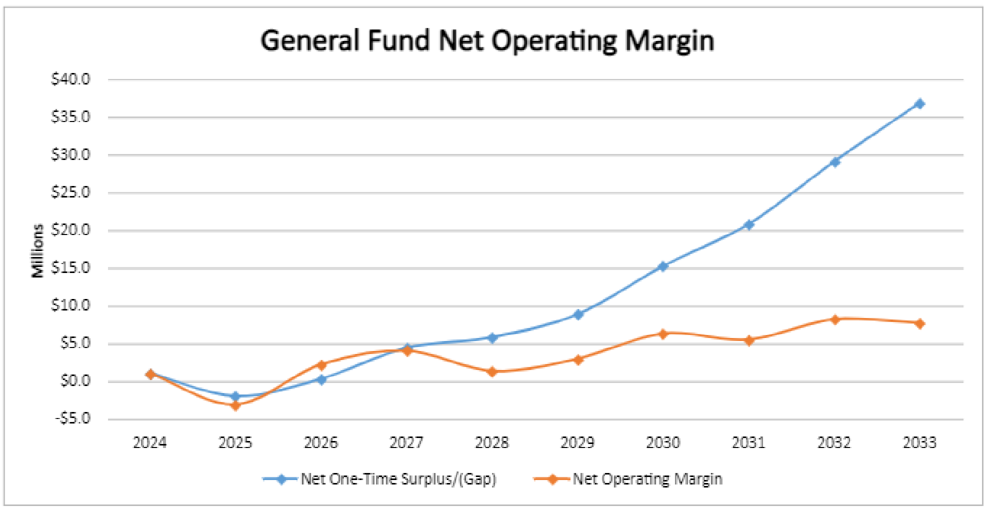
TABLE 10: FY 2024 – FY 2033 Long Range Financial Forecast
Alternative Forecast B

ALTERNATIVE SCENARIO: MEASURE K FUNDING

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

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

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



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

STAKEHOLDER ENGAGEMENT

The preliminary forecast for FY 2024 represents the beginning of the fiscal year 2024 budget development process. Information provided in this report will be discussed with the City Council after Finance Committee and those conversations will provide direction to staff in the budget development process. It is anticipated that conversations with City Council and the community will occur through public budget hearings in Spring 2023, according to the standard budget adoption process.

RESOURCE IMPACT

Financial implications from this report and input from the Finance Committee will be considered in the City Manager's development of the Fiscal Year 2024 budget.

ENVIRONMENTAL IMPACT

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

Attachments:

- Attachment A - FY 2024 Budget Policy Guidelines
- Attachment B - The Economy
- Attachment C - General Fund Base Case Revenue Assumptions
- Attachment D - General Fund Base Case Expense Assumptions

FY 2024 Budget Development Guidelines

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

2) Allocate one-time resources for one-time needs rather than committing one-time resources to ongoing services. Examine appropriate uses of revenue surpluses that exceed forecasted levels such as planning for recession needs, restoration needs, and strategic investments.

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

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

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

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

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

8) Continue to analyze and prioritize resource augmentations, seeking to offset augmentations with reductions elsewhere for net-zero impacts to the budget whenever possible; however, ensuring when resource augmentations are added, it is in alignment with one-time and ongoing forecasted sources.

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

ATTACHMENT B

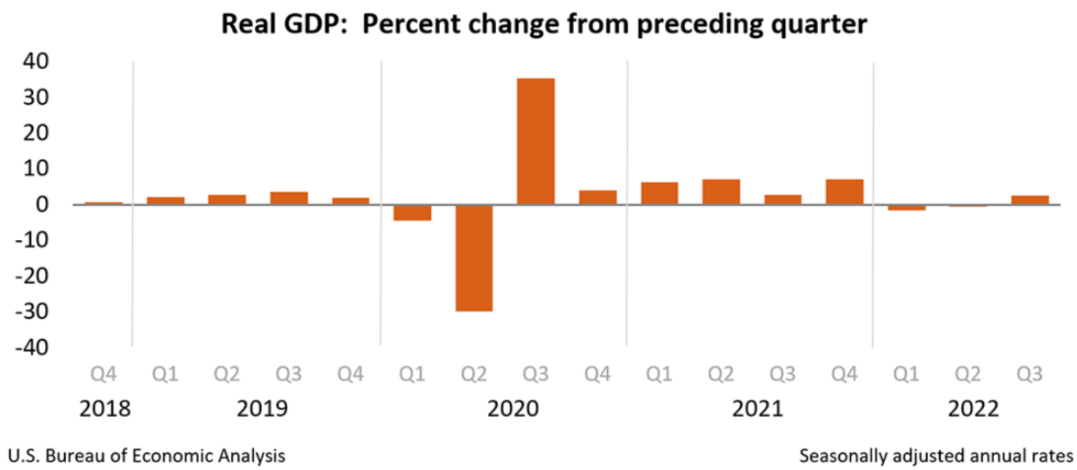
The Economy

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

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

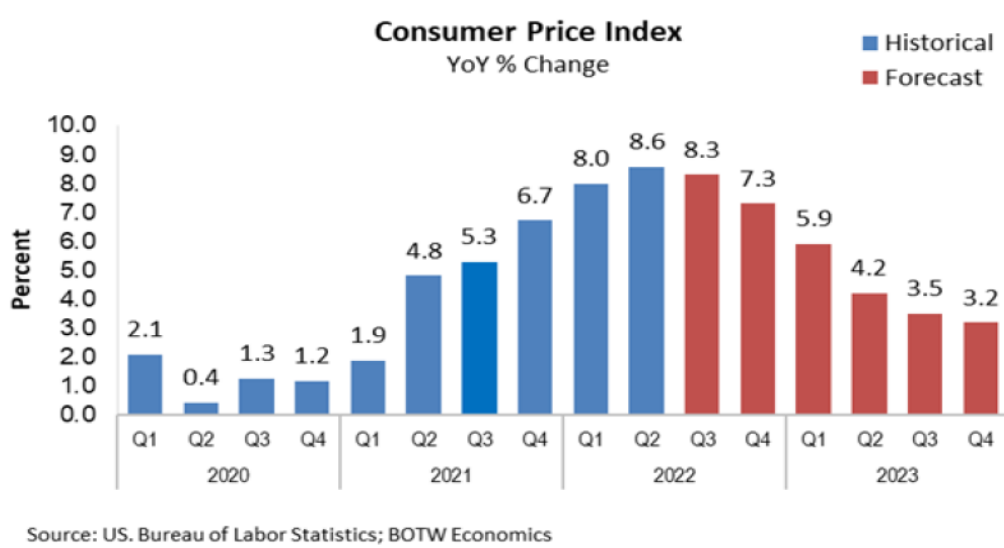
According to the US Bureau of Economic Analysis (BEA), the “advance” estimate of the U.S. economy’s real gross domestic product (GDP) percentage change, from the preceding quarter, changed in the second and third (calendar) quarters of 2022 by a decline of .06% and an increase of 2.6%, respectively.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

Table 1: National Gross Domestic Product (GDP)



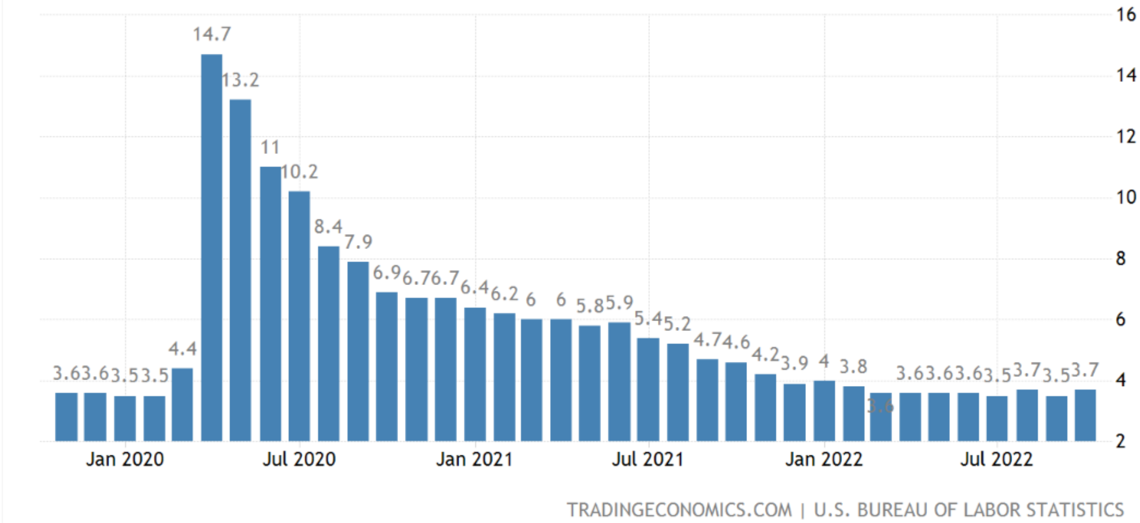
The national Consumer Price Index (CPI), as of the second calendar quarter peaked at 8.6% and is expected to steadily decline in the coming quarters. In the third quarter, actuals in July, September and October 2022 were 8.2%, 8.2% and 7.7%. This is slightly better than shown in the Table 2 third quarter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

Table 2: National Consumer Price Index



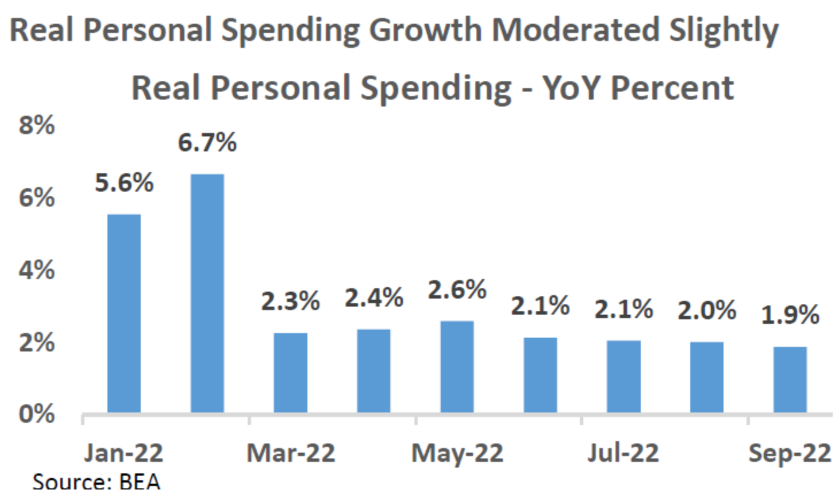
The nation's unemployment rate is 3.7% as of October 2022, compared to a record high of 14.7% at the height of the pandemic in April 2020. It is expected, by the U.S. Bureau of Labor Statistics, that the unemployment rate will rise due to the Federal Open Market Committee (FOMC or aka federal reserve)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

Table 3: U.S. Unemployment Rate



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

Table 4: Real Personal Spending Growth



ATTACHMENT C

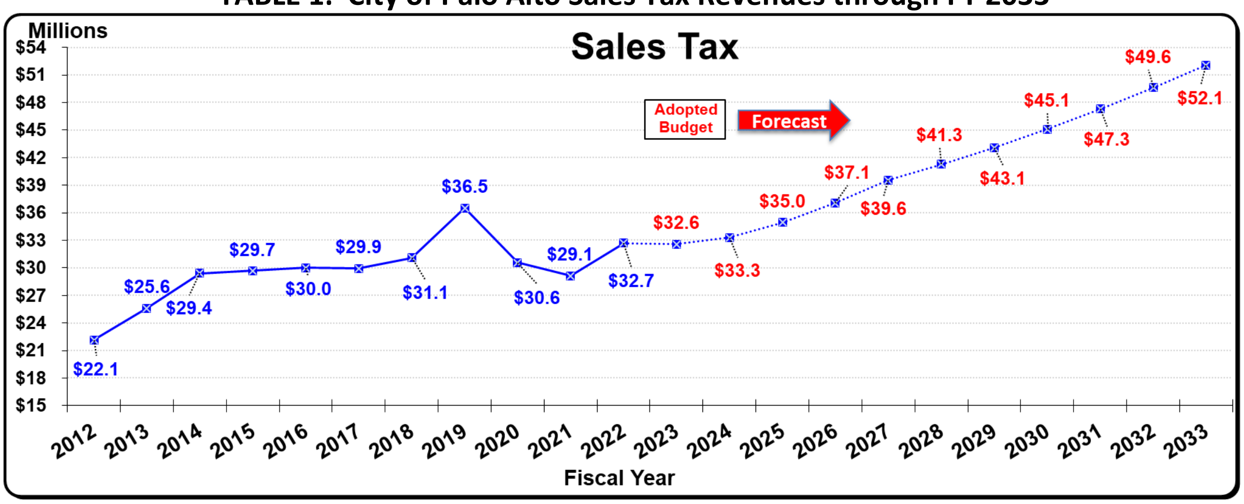
General Fund Base Case Revenue Assumptions

Sales Tax

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

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

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



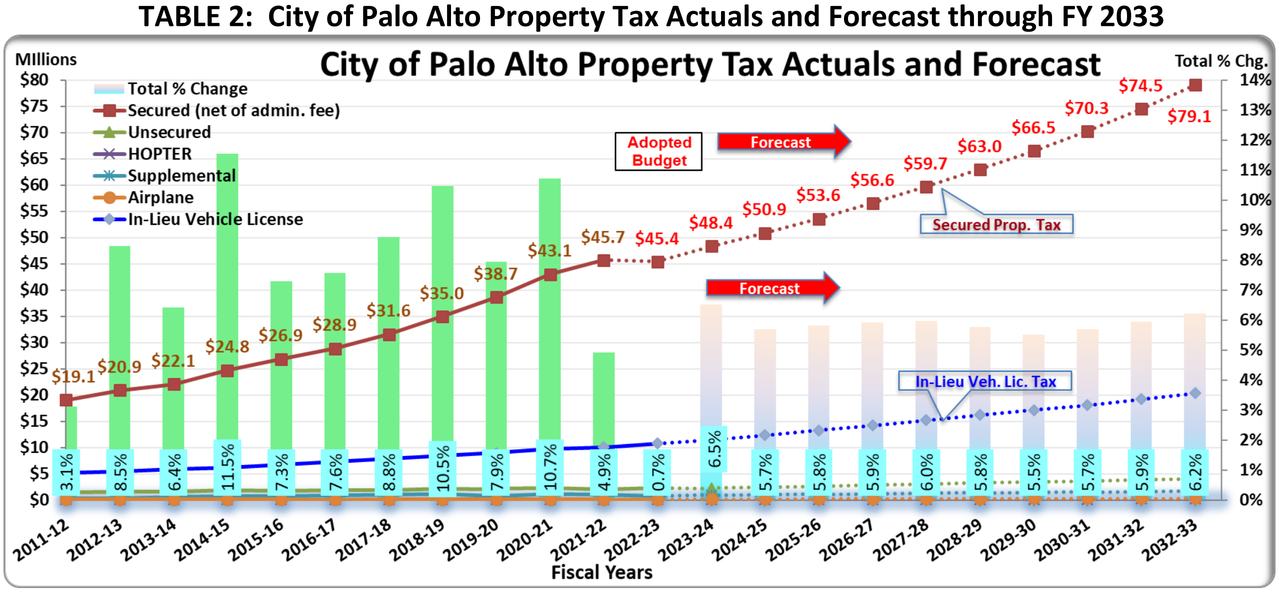
Property Tax

Property tax revenue is the General Fund's largest revenue source and represents approximately 25% of the total revenues. Historically, the 10-year compound annual growth rate (CAGR) was 8.4% with a low of 3.1% in FY 2012 and a high of 11.5% in FY 2015. During economic downturns, impacts to property tax occur a year later, however, due to robust residential and commercial property sales and significant Educational Revenue Augmentation Fund (ERAF) growth, the FY 2022 actual growth was 4.9%. In addition, fiscal years 2019, 2020, 2021, and 2022 included receipts of $2.7 million, $3.9 million, $5.5 million, and $6.6 million, respectively, for excess ERAF distributions from the County of Santa Clara. The FY 2022 budget included $4.9 million for excess ERAF, however, actual receipts were $6.6 million, or $1.7 million higher which is explained further below. ERAF is the fund used to collect and disburse property taxes that are shifted to/from cities, the County, and special districts prior to their reallocation to K-14 school agencies. When the state shifts more local property tax than required to support schools, these funds are returned and known as excess ERAF. As a result of the volatility of ERAF, it is not considered a permanent local revenue source.

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

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

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



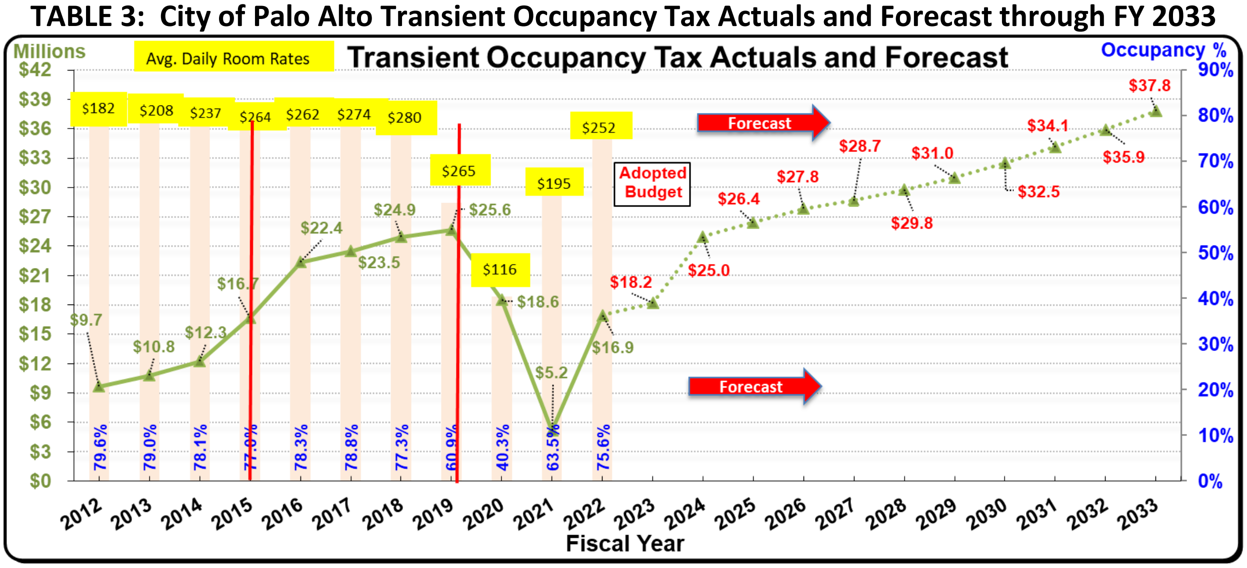
The FY 2023 Adopted Budget for Property Tax is $59.8 million, a $0.4 million or 0.7% increase over the FY 2022 actuals of $59.4 million. In FY 2024, this revenue is anticipated to increase to $63.7 million, a $3.9 million or 6.5% increase over FY 2023 Adopted Budget level.

Transient Occupancy Tax (TOT)

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

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

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



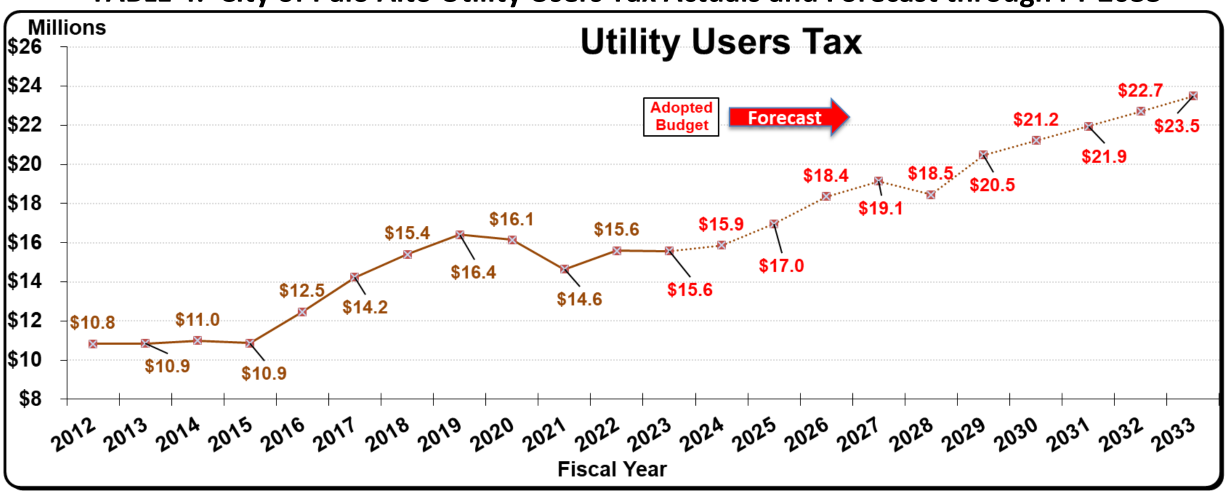
Note: January 2015, TOT Rate went from 12% to 14%

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

Utility User's Tax (UUT)

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

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

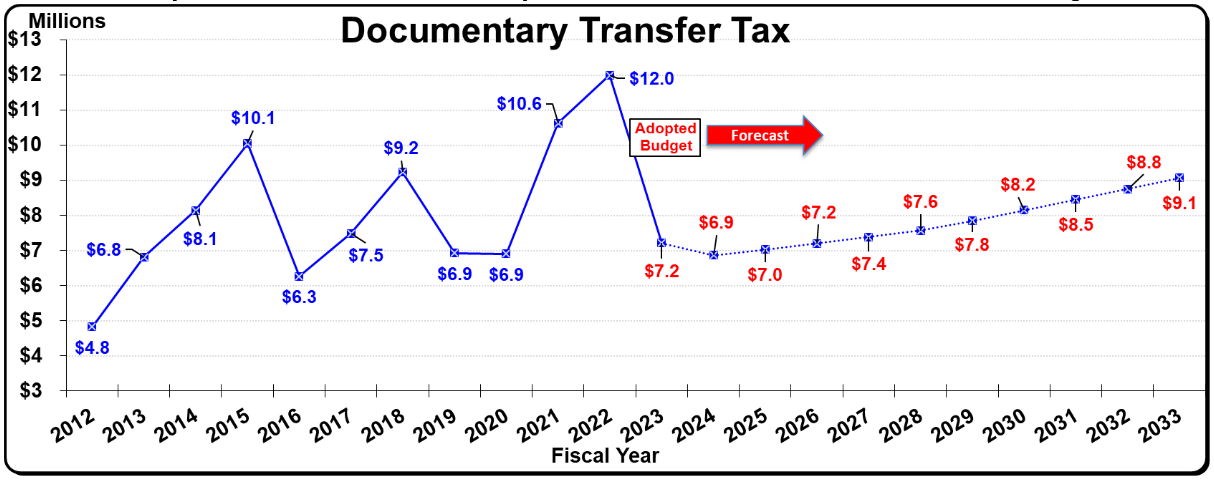


Documentary Transfer Tax (DTT)

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

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

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



Rental Income

Rental Income of $16.4 million in FY 2024 primarily reflects rent paid to the General Fund from the City's Enterprise Funds and the Cubberley Community Center. There is a slight increase in rental income of $0.8 million compared to the FY 2023 Adopted Budget. The increase can be attributed to a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period, and it is expected that revenues will be reviewed and revised subsequent to this forecast based on updated information, typically the December-to-December change in the CCPI.

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

Charges for Services and Permits and Licenses

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

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

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

The revenue estimates in these categories are based on current activity levels. These revenue sources are primarily driven by the cost of staff to provide services to the community. Therefore, as part of the FY 2024 Municipal Fee process, staff will evaluate and bring forward recommendations to align fees with target cost recovery levels, and general salary and benefits and CPI trends. One exception to this is for Development Services activities and related revenue. Development Services fees are fully cost-recoverable, and the department has been modeled as cost-neutral in this forecast. staff will analyze municipal fee revenue activity as part of the FY 2024 Budget development process and bring forward adjustments as appropriate.

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

Charges to Other Funds

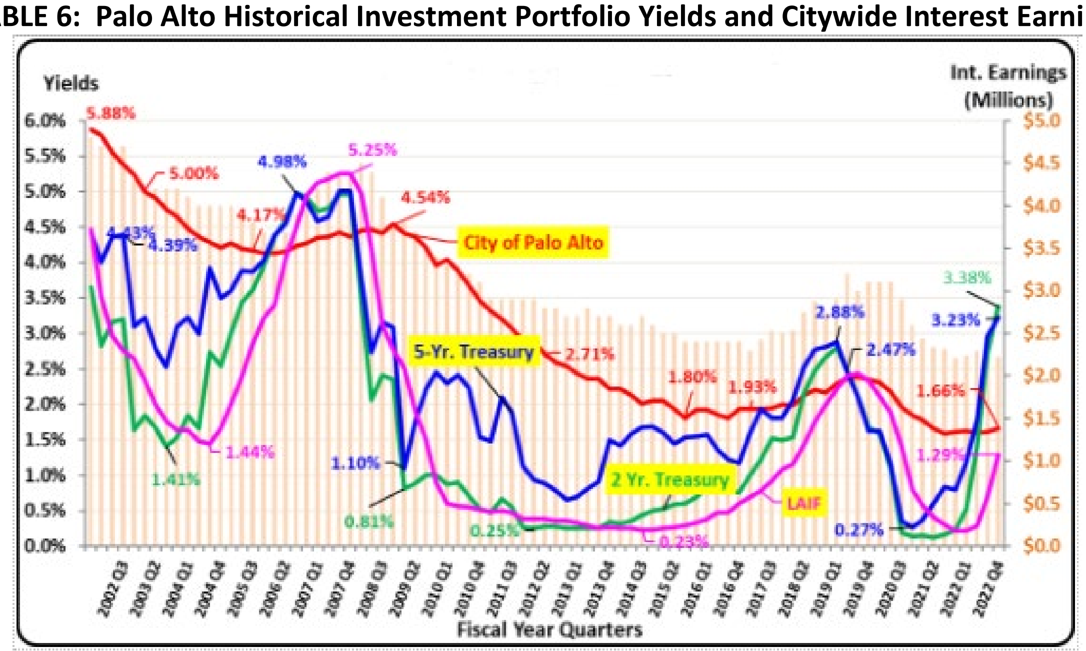
The main source of revenues in this category is General Fund administrative cost allocation plan charges to the Enterprise and Internal Service Funds. Internal support departments such as Administrative Services, Human Resources, and Council Appointed Offices provide services to Enterprise and Internal Service Funds. The costs for these services are recovered through the administrative cost allocation plan charges. The FY 2024 estimate for Charges to Other Funds of $14.5 million reflects a slight increase of 5.6% from the FY 2023 Adopted amount of $13.7 million; this is primarily attributed to fully adjusting the costs associated with the allocated charges in the Internal Support Departments to the adjustments made as part of the FY 2023 Budget as well as a technical adjustment to better align the cost plan methodology with the system calculations.

Return on Investment

The return-on-investment category reflects the interest earnings on the City's investment portfolio. This category is a combination of past investments, new investments at current market rates, and available investable cash which fluctuates seasonally and annually. As of the timing of this LRFF, the Federal Open Market Committee (FOMC) has raised the federal funds rate six times totaling 3.75% and may increase this rate further to bring down the inflation rate between 2 to 3%. As a result, an increase in interest earnings is forecasted; earnings on new portfolio investments have increased from 0.5 to 2% to 4.5 to 6%.

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

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



Operating Transfers-in

Operating Transfers-in materialize as expenses in other funds throughout the City and as a revenue in the General Fund. This budget category includes repayment of a previous loan from the General Fund to the Airport Fund, funding for police patrol in the downtown area, and the equity transfer from the Electric and Gas funds. Overall, the Operating Transfers-in are estimated to be $23.6 million, a $1.1 million increase from the FY 2023 level of $22.5 million due to a $0.5 million increase from the Electric Fund and a $0.6 million increase from the Gas Fund.

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

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

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

ATTACHMENT D

General Fund Base Case Expense Assumptions

Salary and Benefits

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

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

Salary

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

Benefits

Pension: Pensions are budgeted based on CalPERS determined rates as of the June 30, 2021 valuation (CMR 14628[1]) for the City's Miscellaneous and Safety plans. CalPERS determines the City's total contributions for a given Fiscal Year as the sum of two factors: Normal Cost (NC) and Unfunded Accrued Liability (UAL). Together the NC and the UAL expressed as a percentage of payroll is the 'blended rate' and is used to represent total costs in the discussion below.

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

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

necessary funding for the City to pay for employees presuming that CalPERS meets the current set of assumptions.

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

In the miscellaneous plan, total costs are projected to increase from the current 42.9 percent in FY 2023 to the 44.8% in FY 2024. In the safety plan, total costs are projected to increase from the current 71.1% in FY 2023 to 74.0% in FY 2024. These rates do not consider the employee pick-up of the employer share; that pick-up materializes as savings in the City's pension costs. Consistent with applicable MOAs, the FY 2023 forecast presumes that the miscellaneous plan will pick up 1 to 2% of the employer pension cost and that safety plan members will pick up 3 to 4%.

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

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

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

(percentage of payroll)

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

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

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

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

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

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[2] http://cityofpaloalto.org/civicax/filebank/documents/55487
[3] http://cityofpaloalto.org/civicax/filebank/documents/79256
[4] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20220920/20220920pfcs.pdf
[5] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/finance-committee/2022/20221018/20221018pfcs.pdf

Healthcare: Consistent with the most recent labor agreements between the City and its bargaining units in the General Fund, the City's contribution amounts towards medical costs for employees are based on a flat rate contribution from the City, with the employee contributing towards the remaining medical plan premium. Like salaries, healthcare costs are updated in accordance with applicable Memorandum of Agreements (MOA) between the City and its labor groups and the Management and Professional Personnel and Council Appointees Compensation Plan(s).

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

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

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

TABLE 2: Retiree Medical General Fund Contributions

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

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

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

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

Contract Services

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

Contract Services - Committed Additions

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

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

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

Supplies and Materials
The FY 2023 Adopted Budget for the General Fund included $3.2 million for Supplies and Materials, which is anticipated to increase by a 5.0% CPI cost increase in FY 2024 to $3.3 million based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for supplies and materials as part of the FY 2024 budget process.

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

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

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

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

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

Rents and Leases

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

Facilities and Equipment

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

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

purchases in FY 2023 such as electric leaf blowers and medical gurneys. Along with funding for various equipment across departments, this budget category includes subscription payments for equipment like public safety radios. The reduction is partially offset by a CPI cost increase based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for equipment needs as part of the FY 2024 budget process.

Allocated Charges

Allocated Charges represent expense allocations by the City's Enterprise and Internal Service Funds for services and products they provide to General Fund departments. The FY 2023 Adopted Budget for the General Fund included $22.7 million for these expenses, including utilities usage, general liability insurance, technology costs, vehicle equipment maintenance and replacement costs, and other charges for services provided by other City departments and funds. The FY 2024 allocated charges in the Forecast update the revenues and expenses for these various allocations based on the information available at the time of the Forecast development. FY 2024 is anticipated to experience an increase of 8.9% to a total of $24.7 million. This increase is primarily due to anticipated higher costs associated with technology services and utilities for City facilities such as water, electricity, and gas.

Operating Transfers Out

Operating Transfers Out include transfers from the General Fund to Debt Service Funds, the Technology Fund, and various other funds but excludes transfers to the Capital Improvement Fund, which are detailed in the following Transfer to Infrastructure section. The FY 2023 Adopted Budget included Operating Transfers Out of $5.0 million. In FY 2024, Operating Transfers Out are anticipated to decrease to $4.6 million due to the elimination of funding for a one-time loan of $0.4 million to the residential parking permit fund in FY 2023. At this time no loans to the parking permit funds are anticipated as part of the LRFF; however, staff will be evaluating these funds as part of the FY 2024 budget development and will bring forward recommendations for additional loans if needed to keep the parking permit funds solvent.

Transfer to Infrastructure

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

City of Palo Alto (ID # 14748)

Finance Committee Staff Report

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

Title: Pension Policy and Retiree Healthcare Review and Update

From: City Manager

Lead Department: Administrative Services

Recommendation

Staff recommends that the Finance Committee review and accept the revised actuarial pension analysis using alternative assumptions and recommend City Council adoption of modifications to the Pension Funding Policy used to guide financial planning of these benefits.

Executive Summary

In alignment with the Pension Funding Policy and Council direction, periodic reviews are conducted to assess and respond to changes impacting the City's pensions and Other Post-Employment Benefits (OPEB) plans and the funding available to meet those benefit costs. This report focuses on actuarial analysis using alternative assumptions to CalPERS. These results will be used to inform the status of pension plans, progress towards meeting funded status goals, and other risk mitigation strategies.

As part of this review, staff recommends memorializing any practices adjusted since adoption of the policy and discussing further policy modifications or budgetary practices used to inform long term financial planning of these benefits. Potential policy revisions recommended include:

- Adding proactive planning for Other Post-Employment Benefits (OPEB)/retiree healthcare to policy, consistent with City Council actions
- Assuming a more conservative discount rate for supplemental contributions from 6.2 percent to 5.3 percent (Pension) and from 6.25 percent to 5.75 percent (OPEB), as approved by the City Council
- Adding language for investment strategy of Pension and OPEB Trusts, including more conservative investment allocations once 75-80% funded, or when the City's actuary recommends disbursements
- Identifying areas of focus for accumulated savings, such as rate stabilization and Additional Discretionary Payments (ADPs) to CalPERS, such as
  - ADPs in excess of one-year employer contribution (current policy)
  - No ADPs, accumulate savings in Pension Trust

  - ADPs for excess BSR contributions and/or supplemental contributions only
- Modifying actuary reporting from 3 to 4 years to align with CalPERS Asset Liability Management (ALM) process and Experience Study

Background

The City has taken several proactive steps to address rising pension costs and long-term liabilities, including cost-sharing in labor agreements, establishing an irrevocable Section 115 Pension Trust ("Pension Trust") (CMR 7553[1]), and adopting a Pension Funding Policy (CMR 11722[2]). The Pension Policy is an evergreen policy that automatically renews until goals are complete, subject to modification at the City Council's direction. The policy identifies a path forward for the City to address its pension obligations on an ongoing basis, ensure prudent and proactive financial planning, and avoid significant impacts to service delivery.

The current Pension Funding Policy sets the following goals and principles:

Funding Goal and Timeframe:

- Target of reaching a 90 percent funded status of the CalPERS determined liability within fifteen years (FY 2036).

Funding Components:

- 'pay go' costs also known as Normal Cost (NC) of annual pension costs to be funded with a discount rate of 6.2%, more conservative than CalPERS rate of 7.0%.
- Discretion to the City Manager to make additional contributions from excess Budget Stabilization Reserve (BSR) above the City Council approved target BSR level.

Use of Funds:

- City Manager must identify the impacts on the funding goal and timeframe to modify the transmission of contributions to the PARS Trust Fund.
- Any transmission of funds from PARS to CalPERS will require City Council approval.

Reporting:

- Every three years, staff will consult with an actuary to inform the City Council on the progress the City has made towards its goal
- Staff will report to the City Council through the annual budget process on the status of the PARS section 115 pension trust fund, recommended contributions to the PARS fund, and potential transmission of any funds from PARS to CalPERS for the coming fiscal year

In alignment with the policy and Council direction, periodic reviews are conducted to assess and respond to changes impacting the City's pensions and Other Post-Employment Benefits (OPEB) plans and the funding available to meet those benefit costs. Staff expects as part of this process

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[1] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2017/7553.pdf

[2] https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2020-2/id-11722.pdf

to memorialize any practices adjusted since the adoption of the policy, review progress towards policy goals, and discuss and review any modifications to the Pension Policy or budgetary practices used to inform financial planning of these benefits.

To facilitate this review, staff planned three meetings with the Finance Committee beginning in September 2022 including: 1) Review of the most current actuarial analysis as distributed by CalPERS (CMR 14628[3]), 2) Review of the current status of both the Pension and Other Post-Employment Benefits (OPEB)/retiree healthcare liabilities including the proactive contributions and discussion with plan providers (CMR 14829[4]), and 3) Review of actuarial analysis based on alternative assumptions as defined in the Pension Funding Policy and recommended revisions to the Pension Funding Policy for City Council consideration and adoption (December 6, 2022).

Discussion

This report includes a comprehensive analysis of the City's pension plans completed by an outside actuarial consultant, Foster & Foster **(Attachment A)** formerly Bartel & Associates**.** This actuarial analysis provides an updated status of the City's pension plans, including alternative calculations as compared to CalPERS for economic and demographic assumptions, funding policy, and other risk mitigation strategies. Additionally, this analysis considers other factors not assumed in CalPERS reporting, such as cost-sharing with employees, preliminary investment losses earned by CalPERS in the most recent reporting period, and accumulated savings in the City's Pension Trust. These factors, and the resulting impact on projected employer contributions and funded status, are to inform discussions on long-term pension obligations and the progress of meeting policy goals.

Overview of Actuarial Analysis Results

Representatives from Foster & Foster will provide an overview of the detailed presentation of the attached report that provides an updated status of pension plans, progress towards meeting funded status goals, and other risk mitigation strategies (Attachment A). As noted above, this analysis considers alternative assumptions to CalPERS, including:

- Preliminary 6.1 percent investment loss for the period ending June 30, 2022[5]; this loss will be included in the CalPERS valuation analysis issued in August 2023
- Reduction to discount rate (6.8 percent assumed by CalPERS); ultimately reaching 6.0 percent over 20+ years
- Consideration for employee contributions towards the employer share of costs[6]

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

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

[5] This has since been revised from an estimate of 6.1 percent to an estimate of 7.4 percent, as reported in the November 15, 2022 CalPERS Finance and Administration Committee: https://www.calpers.ca.gov/docs/board-agendas/202211/financeadmin/item-6a-01_a.pdf

- Supplemental contributions to the Pension Trust calculated at the equivalent of a 5.3 percent discount rate for normal cost
- Additional Discretionary Payments (ADPs) from the Pension Trust to the CalPERS plans for amounts in excess of a one-year employer contribution

Ultimately, the City is expected to reach a 90 percent funded status in the Miscellaneous plan by FY 2038, and the Safety plan by FY 2040, without consideration for the City's Pension Trust. Once the accumulation of funds in the Pension Trust (no payments to CalPERS) and payments to CalPERS are considered, the Miscellaneous plan is expected to meet funding targets by FY 2034, whereas the Safety plan is expected to meet funding targets by FY 2036-37. Of note, this does not consider future contributions to the Pension Trust using excess BSR, since these amounts are one-time and tend to vary from year to year; balances already in the trust have been considered in this analysis. Additional contributions would help the City to reach to target funded status levels sooner.

Pension Policy Revisions for Consideration

This report concludes the series of meetings initiated with the Finance Committee to review the status of pension and retiree healthcare plans. Staff recommends memorializing any practices adjusted since the adoption of the policy and discussing further modifications to the Pension Policy or budgetary practices used to inform long term financial planning of these benefits. A summary of the current Pension Policy and potential revisions is included in **Attachment B** and discussed in more detail in this report.

Add proactive planning for Other Post-Employment Benefits (OPEB)/retiree healthcare to policy, consistent with City Council actions

The Pension Policy does not explicitly include language for Other Post-Employment Benefit (OPEB)/retiree healthcare plans. As directed by the City Council, staff have worked to align the City's policy goals for pension and retiree healthcare liabilities since the adoption of the Pension Policy. A revision is included for Finance Committee consideration to change the title to be inclusive of both plans, from 'Pension Funding Policy' to 'Retiree Benefit Funding Policy'.

Assume a move conservative discount rate for supplemental contributions from 6.2 percent to 5.3 percent (Pension) and from 6.25 percent to 5.75 percent (OPEB), as approved by the City Council

Beginning in FY 2023, the City Council approved reducing the discount rate to calculate supplemental pension contributions from the previously approved rate of 6.2 percent to 5.3 percent over two years; FY 2023 is a transitional year equivalent to a rate of approximately 5.8 percent. These actions more closely align the discount rate with the CalPERS Asset Liability Management (ALM) study completed in November 2021, which includes a survey of external

[6] The City has negotiated Memoranda of Agreements (MOAs) with labor groups to include provisions for employees to accept a greater share of pension costs; Miscellaneous groups pick-up 1-2 percent and Safety groups pick up 3-4 percent of the employer share of pension cost

asset managers and consultants to gain expert projections on expected market returns. In the most recent ALM study, the median expected returns of survey participants were 5.3 percent (10-year) and 6.2 percent (20-year). Additionally, the City Council approved the use of a lower discount rate for supplemental OPEB contributions from 6.25 percent to 5.75 percent, and alternative assumptions to align with known variables such as investment returns (CMR 14112 as amended by CMR 14502[7]).

A goal of this funding element is to identify a discount rate for the calculation of the normal cost of pensions that best aligns with actual investment returns, mitigating the creation of new liability bases resulting from these discrepancies to the extent possible. Future adjustments are anticipated to align planned contributions with anticipated economic and demographic assumptions, including but not limited to expected investment returns, subject to City Council approval. Staff expects to use proactive measures to inform changes, such as the ALM study and other external expert projections. Additionally, staff will continue to monitor any major factors that contribute to the creation of new liabilities in future CalPERS reporting.

Add language for investment strategy of Pension and OPEB Trusts, including more conservative investment allocations once 75-80% funded, or when actuary recommend disbursements

In October 2022, staff facilitated a status update of the City's irrevocable 115 Pension Trust Fund and the City's California Employers' Retiree Benefit Trust (CERBT) Fund for the retiree healthcare plans with plan providers (CMR 14829[8]). Ultimately, the investments made in these funds are required to be used to pay retiree pension and healthcare costs respectively. However, the City has the discretion to select the investment risk tolerance and control the inflow and outflow of funds. Ultimately, the balance maintained, and investment strategy(s) should depend on the intended use of the funds.

As prefunding strategies move the City closer to meeting funded status goals, staff recommends revising the investment strategy for these funds. When actuary valuations recommend disbursements or when the balance-maintained approaches 75-80 percent funded status, the investment strategy should be diversified with an intention of ensuring both stability and growth of the assets versus an only growth focused goal. This strategy is intended to preserve assets and mitigate against volatility in the market when the funds are expected to be disbursed. Currently, the City's Pension Trust is invested in a Moderately Conservative portfolio, this is the second most conservative of five (5) portfolios. The City's CERBT Fund is invested in a Strategy 1 portfolio, which offers the highest expected return of three (3) portfolios. Changes to the investment portfolio selection(s) do not require additional budgetary action, as funds may be moved from one portfolio to another at the City's discretion.

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

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

Contributions to the OPEB Trust are intended to generate long-term asset growth through accumulated contributions until returns are sufficient to contribute to a portion of the annual "pay-go" costs. In consultation with CERBT representatives, staff recommends setting aside 2-3 years of estimated disbursements in a more conservative portfolio. The alternative assumptions approved by the City Council for development of the FY 2023 and FY 2024 budget do not recommend this type of disbursement over the next ten years. Staff expects to monitor the status of disbursements in future valuations; the next valuation will be completed as of June 30, 2023 for the development of the FY 2025 and FY 2026 budget.

Identify areas of focus for accumulated savings, such as rate stabilization and Additional Discretionary Payments (ADPs) to CalPERS

The City has discretion to control the inflow and outflow of funds contributed to the Section 115 Pension and OPEB Trusts; contributions to the Pension Trust are held separately from CalPERS and do not directly pay down pension liabilities, whereas contributions to the OPEB Trust directly pay down retiree healthcare liabilities. Therefore, the City may use the Pension Trust as a rate stabilization reserve, where funds may be used to smooth volatility in employer contributions in any given year, or a "rainy day" reserve in an emergency or in difficult economic times. Additionally, the City may use the Pension Trust to pay down liabilities through Additional Discretionary Payments (ADPs) to CalPERS. The City may elect to make additional contributions, above and beyond the required employer contribution, at any time and in any amount. However, payments made to CalPERS are permanent and cannot be returned.

The Pension policy outlines two funding components: 1) the difference in cost using a more conservative discount rate to CalPERS for normal cost ("supplemental contributions"); and 2) 50 percent of excess BSR above City Council target levels. Currently, both components are contributed directly to the Pension Trust. Consistent with the current Pension Policy, the actuary analysis in this report contemplates ADPs from the Pension Trust to CalPERS once funding levels exceed a single-year employer contribution. This level of funding is expected in the next couple of years. This analysis does not consider future contributions to the Pension Trust using excess BSR, since these amounts are one-time and tend to vary from year to year. Alternatively, the City may elect to keep contributions in the Pension Trust, with payments to CalPERS made at a later date. Or, the City may direct one or both components as an ADP to CalPERS. For example, the City may elect to direct one-time contributions using excess BSR as an ADP to CalPERS to directly pay down the liability, whereas supplemental contributions using a lower discount rate would continue to be made to the Pension Trust, or vice versa.

Modify actuary reporting from 3 to 4 years to align with CalPERS Asset Liability Management (ALM) process and Experience Study

Every four years, CalPERS completes a comprehensive Asset Liability Management (ALM) process to review the capital market assumptions and strategic asset allocation to ascertain whether a change in the discount rate, investment profile, and other economic assumptions is warranted. Additionally, the Actuarial Office completes an Experience Study to review pension demographics for potential modification. This most recent study was completed in November 2021 and resulted in notable changes to reduce the discount rate from 7.0 to 6.8 percent, reduce price inflation assumptions from 2.5 to 2.3 percent, and revise the asset allocation to target 1/3 investment in private assets, add 5 percent leverage, and reduce public equity exposure. Revising policy requirements for actuary reporting from 3 to 4 years will align the studies and ensure that the City's analysis includes the most up to date changes approved by the CalPERS board, including changes to economic and demographic assumptions that inform overall liability and employer cost.

Resource Impact
Revisions and updates to the City's Pension Funding Policy will inform the development of the annual budget, financial planning and analysis of operation, and other long term financial planning. The funding elements of this policy are intended to support the financial sustainability of the organization by limiting the risk of generating long-term liabilities due to actual pension and retiree healthcare plan experience that differs from assumptions, such as lower than anticipated investment returns.

Stakeholder Engagement
Staff continues to use external consultants for updates on the status and forecast of long-term liabilities associated with pension and retiree healthcare programs. As in prior years, these results are used to inform funding policy discussions with the Finance Committee and City Council. All communication is structured around public hearings to facilitate opportunities for community input and provide guidance to staff in the budget development process.

Environmental Review
This report is not a project for the purposes of the California Environmental Quality Act. Environmental Review is not required.
Attachments:
- Attachment A: Foster and Foster Actuarial Analysis_City of Palo Alto Pension Plans
- Attachment B: Pension Funding Policy Overview and Potential Revisions

CITY OF PALO ALTO

CITY OF PALO ALTO
MISCELLANEOUS & SAFETY PLANS

FOSTER & FOSTER
ACTUARIES AND CONSULTANTS

CalPERS Actuarial Analysis – 6/30/21 Valuation
Preliminary Results

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Bianca Lin, FSA, EA, MAAA, FCA
Matthew Childs
Foster & Foster, Inc.

October 21, 2022

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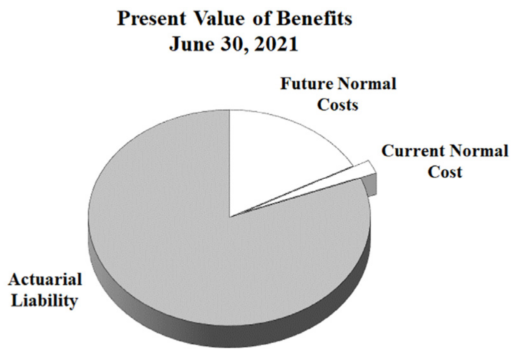
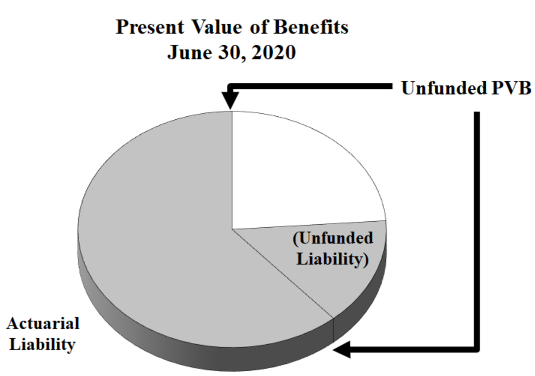
DEFINITIONS

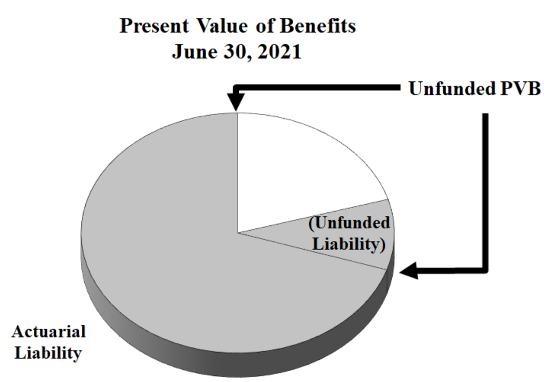


- **PVB - Present Value of all Projected Benefits:**
  - The value now of amounts due to be paid in the future
  - Discounted value (at valuation date - 6/30/21), of all future expected benefit payments based on various (actuarial) assumptions

- **Current Normal Cost (NC):**
  - Portion of PVB allocated to (or "earned" during) current year
  - Value of employee and employer current service benefit
- **Actuarial Liability (AAL):**
  - Discounted value (at valuation date) of benefits earned through valuation date [value of past service benefit]
  - Portion of PVB "earned" at measurement

DEFINITIONS



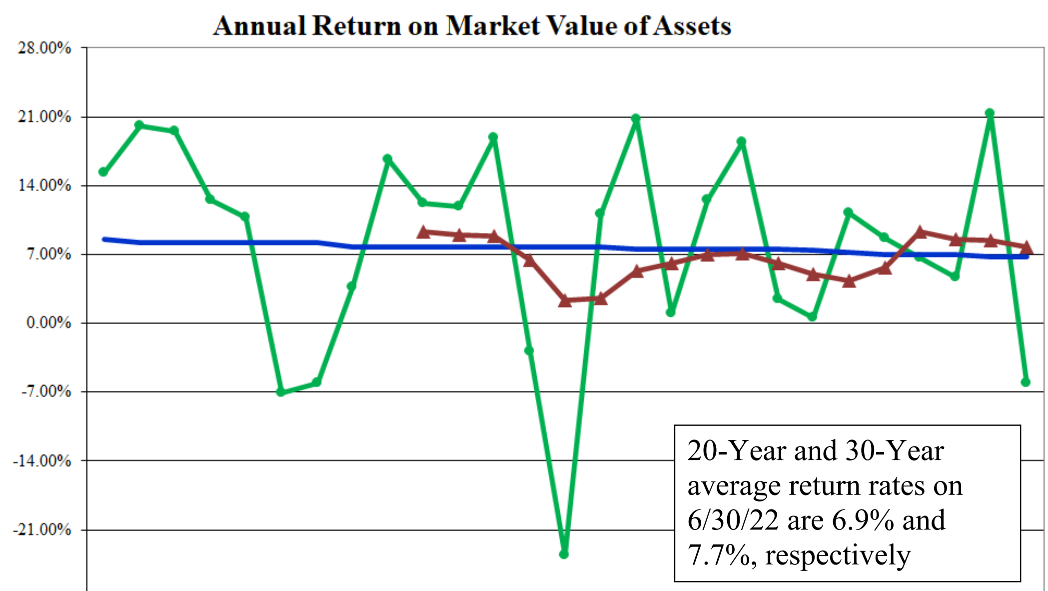


- **Target-** Have money in the bank to cover Actuarial Liability (past service)
- **Unfunded Liability (UAAL or UAL) -** Money short of target <u>at valuation date</u>
  - If all actuarial assumptions were always exactly met, then the plan assets would always equal AAL
  - Any difference is the unfunded (or overfunded) AAL
  - Every year, the actuary calculates the difference between the expected UAAL and Actual UAAL. This is a new layer or amortization base
  - Each new layer gets amortized (paid off) over a period of time as part of the contribution [rate]

How We Got Here

- Investment Losses
- CalPERS Contribution Policy
- Enhanced Benefits
- Demographics

How We Got Here – Investment Return



	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08
Rate of Return	15.3%	20.1%	19.5%	12.5%	10.7%	-7.1%	-6.1%	3.7%	16.6%	12.2%	11.9%	18.8%	-2.9%
Discount Rate	8.50%	8.25%	8.25%	8.25%	8.25%	8.25%	8.25%	7.75%	7.75%	7.75%	7.75%	7.75%	7.75%
10-Year Rolling Average										9.3%	9.0%	8.9%	6.4%

	'09	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22
Rate of Return	-23.6%	11.1%	20.7%	1.0%	12.5%	18.4%	2.4%	0.6%	11.2%	8.6%	6.70%	4.70%	21.30%	-6.10%
Discount Rate	7.75%	7.75%	7.50%	7.50%	7.50%	7.50%	7.50%	7.375%	7.25%	7.00%	7.00%	7.00%	6.80%	6.80%
10-Year Rolling Average	2.3%	2.6%	5.4%	6.1%	7.0%	7.1%	6.1%	5.0%	4.3%	5.7%	9.3%	8.5%	8.5%	7.7%

Returns (after 2001) shown are gross returns, unreduced for administrative expenses, from CalPERS valuation reports, when available. The discount rate is based on expected returns net of administrative expenses.

How We Got Here – Old Contribution Policy

- Effective with 2003 valuations:
  - Slow (15 year) recognition of investment losses into funded status
  - Rolling 30 year amortization of all (primarily investment) losses

- Designed to:
  - First smooth rates and
  - Second pay off UAL

- Mitigated contribution volatility

How We Got Here – Enhanced Benefits

- At CalPERS, Enhanced Benefits implemented using all (future & prior) service
- Typically not negotiated with cost sharing
- City of Palo Alto

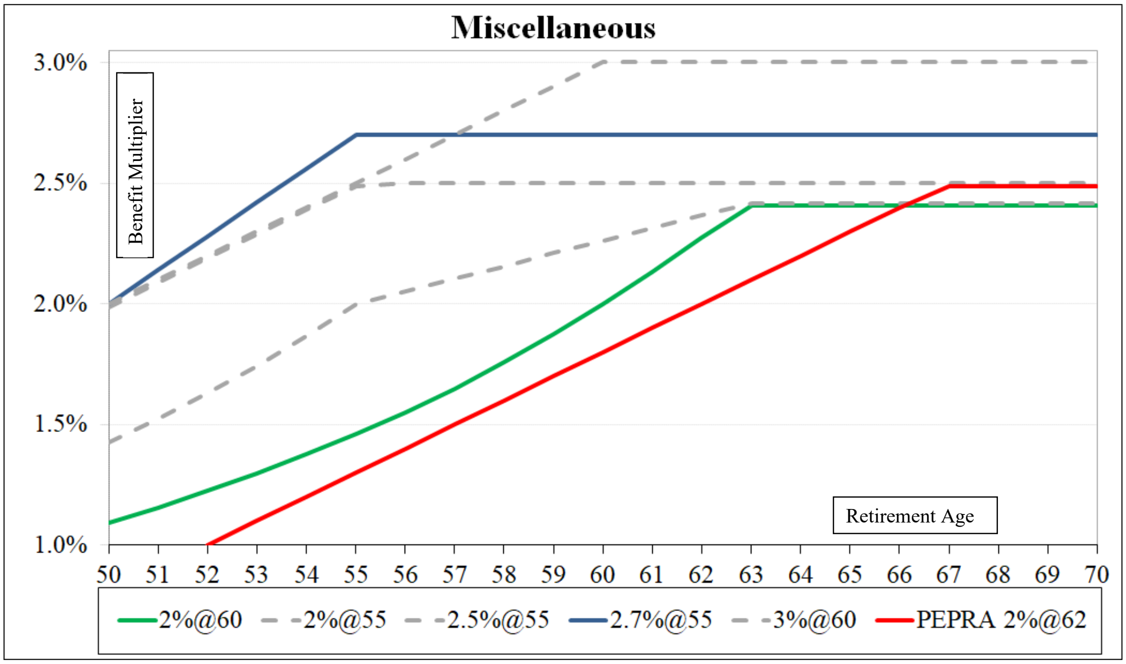
	Tier 1	Tier 2	PEPRA
● Miscellaneous	2.7%@55 FAE1	2%@60 FAE1	2%@62 FAE3
● Safety	3%@50 FAE1	3%@55 FAE3	2.7%@57 FAE3

  - Note:
    - ☐ FAE1 is highest one year (typically final) average earnings
    - ☐ FAE3 is highest three years (typically final three) average earnings

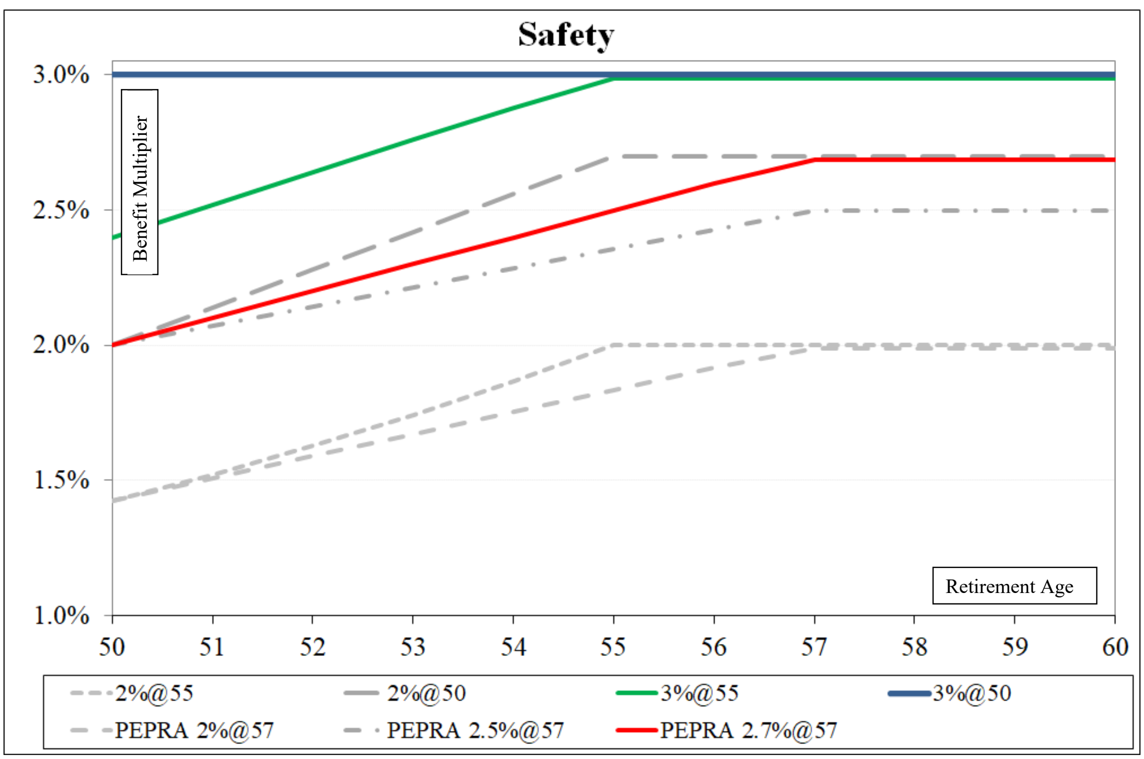
- PEPRA tier implemented for new employees hired after 1/1/13
  - Employee pays half of total normal cost
  - 2022 Compensation limit
    - ☐ Social Security participants: $134,974
    - ☐ Non-Social Security participants: $161,969

How We Got Here – Enhanced Benefits

- Available CalPERS Benefit formulas. City's formulas shown in red.
- For any retirement age, chart shows benefit multiplier (% FAE per year of service)



How We Got Here – Enhanced Benefits



How We Got Here – Demographic

- Around the State
  - Large retiree liability compared to actives
    - State average: 56% for Miscellaneous, 65% for Safety
  - Declining active population and increasing number of retirees
  - Higher percentage of retiree liability increases contribution volatility

- City of Palo Alto percentage of liability belonging to retirees:
  - Miscellaneous 62%
  - Safety 71%

CalPERS Changes

- April 2013: CalPERS adopted new contribution policy
  - No asset smoothing or rolling amortization
- February 2018: New amortization policy for 2021/22 contributions
  - Fixed dollar (level) 20-year amortization rather than % pay (escalating)
  - 5-year ramp up (not down) for investment gains and losses
- CalPERS Board changed the discount rate to 7%, still phasing in to rates:

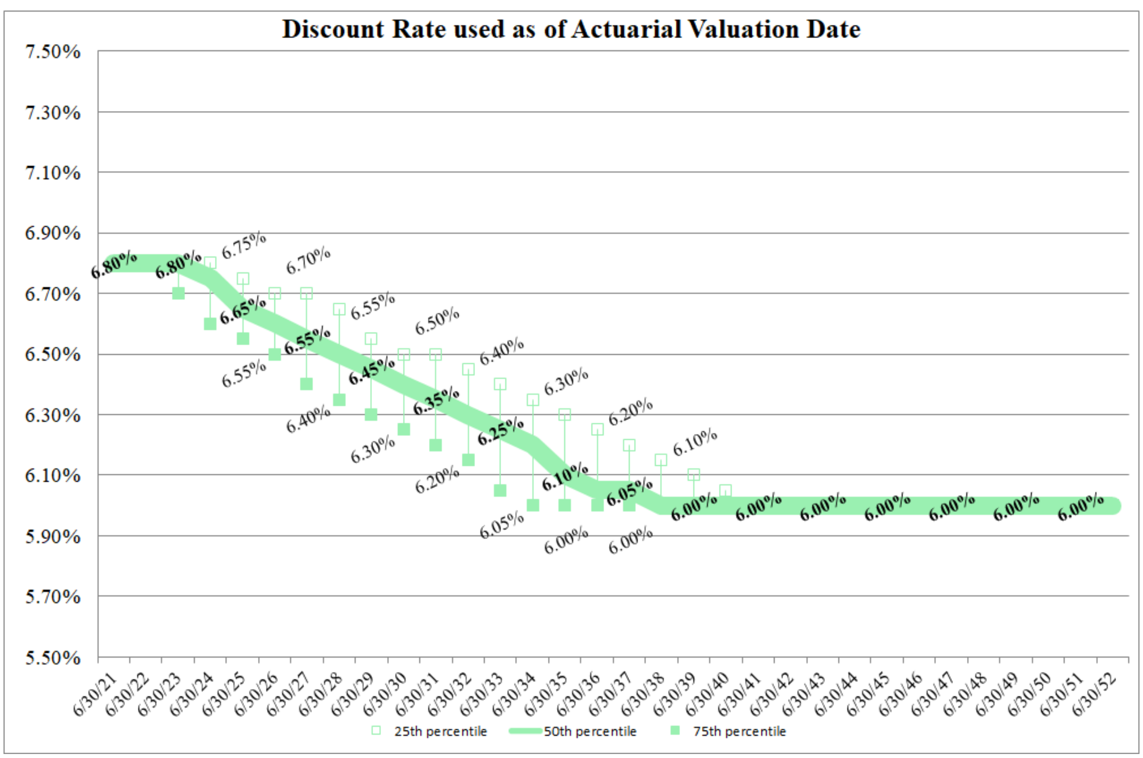
	Rate	Initial Impact	Full Impact
6/30/16 valuation	7.375%	18/19	22/23
6/30/17 valuation	7.25%	19/20	23/24
6/30/18 valuation	7.00%	20/21	24/25

- In the November 2021 meeting, CalPERS Board adopted new
  - Discount rate and investment allocation
    - Discount rate: 6.8% for 6/30/2021. UAL impact matches investment gain amortization (5-year ramp-up)
    - Asset allocation has higher investment risk than current portfolio
  - Experience study (Demographic assumptions)

CALPERS CHANGES

- Risk Mitigation Strategy
  - Move to more conservative investments over time to reduce volatility
    - Only when investment return is better than expected
    - Lower discount rate in concert
    - Essentially use ≈50% of investment gains to pay for cost increases
  - Likely get to 6.0% discount rate over 20+ years
    - Risk mitigation suspended from 6/30/16 to 6/30/18 valuation
    - Did not trigger for 6/30/19 or 6/30/20 valuations
  - First triggered for 6/30/21 valuation – 6.8% discount rate

CALPERS CHANGES



CalPERS Changes

Capital Market Assumptions

Asset Class	Asset Segment	Near-Term Return (5-year)	Long-Term Return (20-year)	Volatility (20-year)
Growth	Global Equity – Cap Weighted	6.8%	6.8%	17.0%
	Global Equity – Non-Cap Weighted	5.1%	6.1%	13.5%
	Private Equity	8.9%	9.6%	30.1%
Income	Long U.S. Treasuries	0.1%	2.6%	12.4%
	Mortgage-Backed Securities	1.2%	2.8%	3.1%
	Investment Grade Corporates	0.1%	3.9%	8.5%
	Spread Product – High Yield	2.2%	4.7%	9.2%
	Spread Product – Sovereigns	3.2%	4.5%	10.4%
	High Yield Segment	2.2%	4.6%	9.0%
Real Assets	Real Estate	5.3%	5.5%	12.2%
Liquidity	Liquidity	0.3%	1.7%	0.8%
Other	Private Debt	6.8%	5.9%	9.9%
	Emerging Market Debt	2.7%	4.8%	10.3%

CalPERS Changes

Portfolio Target Allocations

	Current Portfolio	New Portfolio
Liquidity	1%	-
Real Assets	13%	15%
Private Debt	-	5%
EM Sov Bonds	1%	5%
High Yield	4%	5%
Investment Grade Corp.	6%	10%
Mtge-backed Securities	7%	5%
Treasury	10%	5%
Private Equity	8%	13%
Global Equity[1]	50%	42%
Leverage	-	(5)%
Total	100%	100%

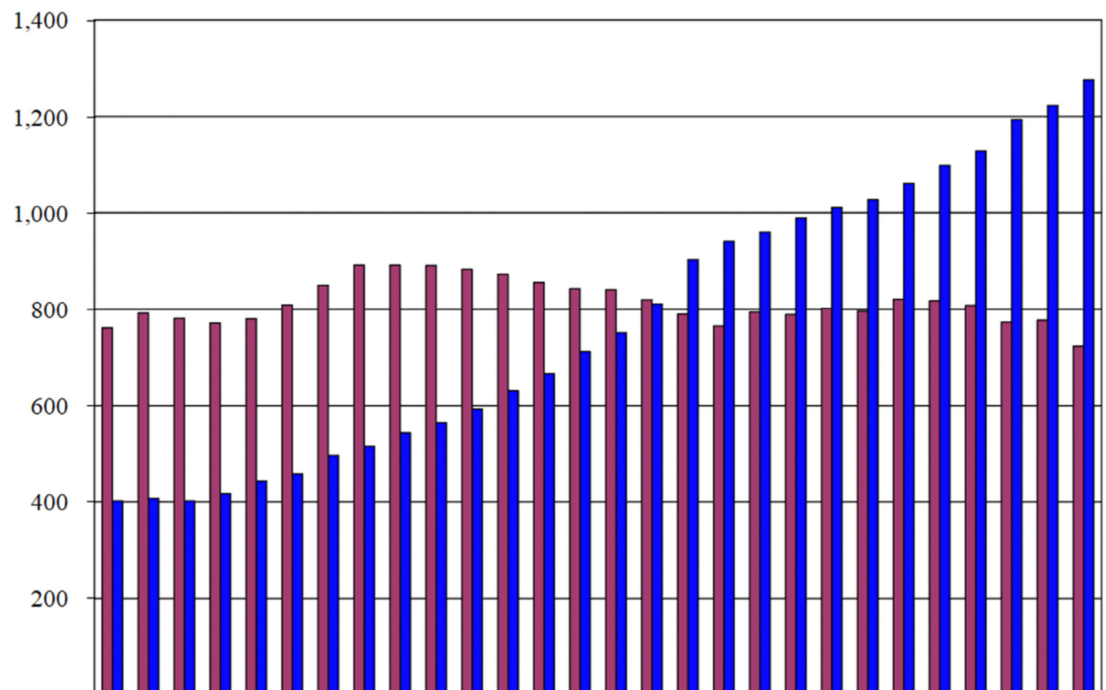
[1] Cap and non-cap weighted combined for this table; actual portfolios have specific allocations for each classification.

SUMMARY OF DEMOGRAPHIC INFORMATION - MISCELLANEOUS

	2001	2011	2020	2021
Actives				
■ Counts	892	765	777	723
■ Average				
• Age	45	45	46	46
• City Service	9	10	11	11
• PERSable Wages	$ 58,200	$ 78,800	$ 109,300	$ 110,300
■ Total PERSable Wages	51,900,000	60,300,000	84,900,000	79,700,000
Inactive Members				
■ Counts				
• Transferred	223	294	385	386
• Separated	242	305	450	463
• Retired				
☐ Service	389	778	1,028	1,073
☐ Disability	64	73	70	71
☐ Beneficiaries	61	90	125	132
☐ Total	516	941	1,223	1,276
■ Average Annual City Provided Benefit for Service Retirees[2]	$ 16,600	$ 32,300	$ 39,800	$ 41,000

[2] Average City-provided pensions are based on City service & City benefit formula, and are not representative of benefits for long-service employees.

SUMMARY OF DEMOGRAPHIC INFORMATION - MISCELLANEOUS



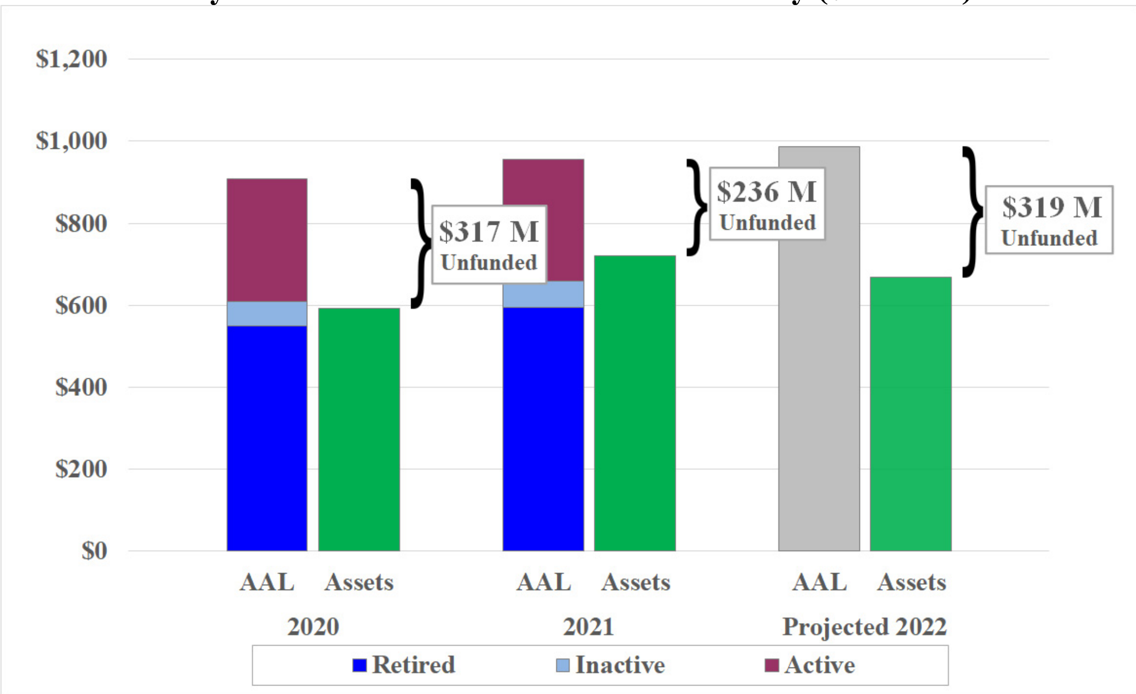
	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21
■ Active	761	792	781	771	780	809	850	892	892	891	883	873	856	843	841	820	790	765	794	789	802	796	821	818	808	773	777	723
■ Receiving Payments	402	407	402	417	443	458	497	516	544	565	593	631	666	712	751	811	903	941	960	989	1,011	1,027	1,061	1,098	1,129	1,194	1,223	1,276

PLAN FUNDED STATUS - MISCELLANEOUS

	June 30, 2020	June 30, 2021
■ **Actuarial Accrued Liability**		
● Active	$ 301,000,000	$ 298,300,000
● Retiree	549,900,000	594,800,000
● Inactive	58,500,000	63,100,000
● Total	909,400,000	956,200,000
■ **Assets**	592,300,000	720,100,000
■ **Unfunded Liability**	317,100,000	236,100,000
■ **Funded Ratio**	65.1%	75.3%
■ **Average funded ratio for CalPERS Public Agency Miscellaneous Plans**	72.3%	83.7%

PLAN FUNDED STATUS - MISCELLANEOUS

City CalPERS Assets and Actuarial Liability ($Millions)



PLAN FUNDED STATUS - MISCELLANEOUS

Discount Rate Sensitivity

June 30, 2021

	Discount Rate		
	6.80%	**6.30%[3]**	**5.80%**
AAL	$956,200,000	$1,018,100,000	$1,079,900,000
Assets	720,100,000	720,100,000	720,100,000
Unfunded Liability	236,100,000	298,000,000	359,800,000
Funded Ratio	75.3%	70.7%	66.7%

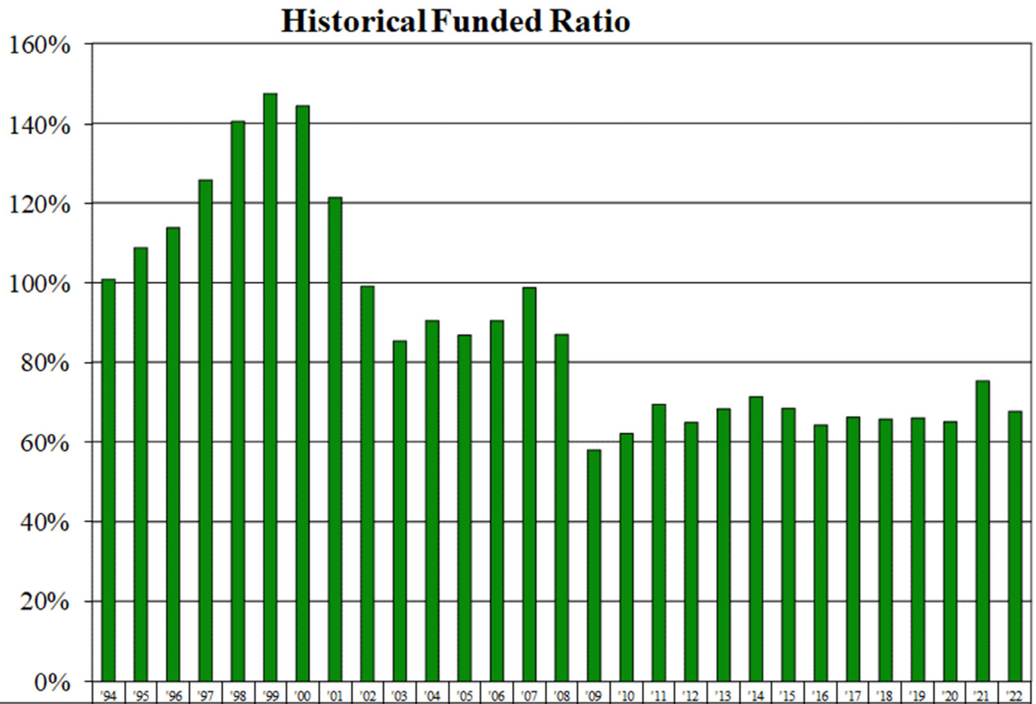
[3] Estimated by Foster & Foster.

PLAN FUNDED STATUS - MISCELLANEOUS

Unfunded Accrued Liability Changes

■ **Unfunded Accrued Liability on 6/30/20**		$317,100,000
■ **Expected 6/30/21 Unfunded Accrued Liability**		315,200,000
■ **Changes**		
• Assumption Change (demographics)	500,000	
• Discount Rate 7% to 6.8%	21,700,000	
• Asset Loss (Gain) (21.2% return for FY 2021)	(94,700,000)	
• Contribution & Experience Loss (Gain)	(6,600,000)	
• Total		(79,100,000)
■ **Unfunded Accrued Liability on 6/30/21**		236,100,000
■ **Projected Unfunded Accrued Liability on 6/30/22**		319,000,000

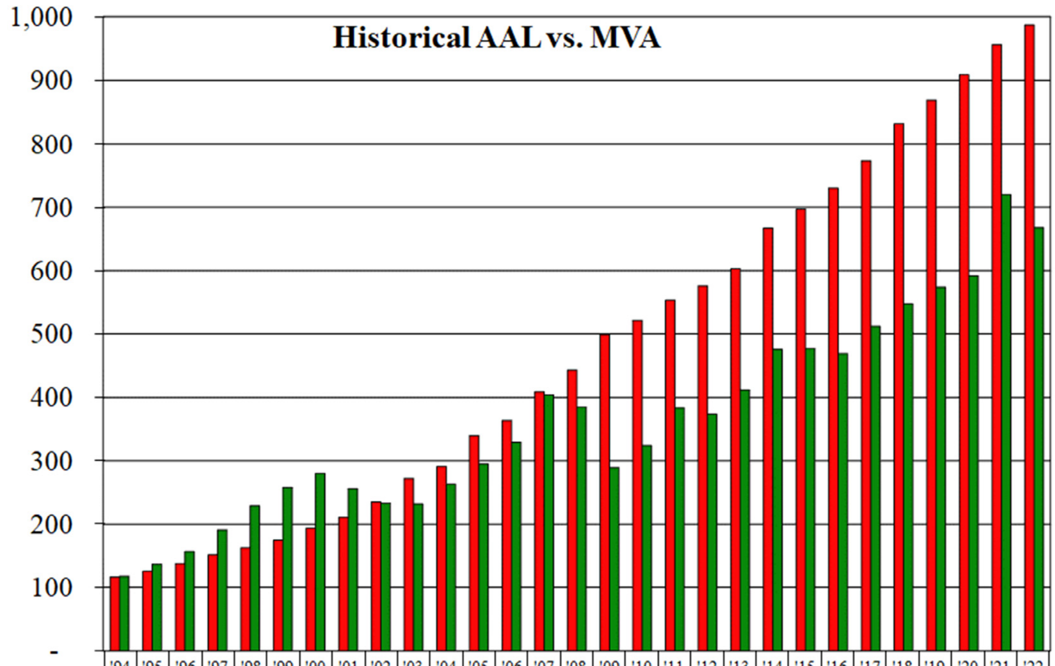
FUNDED RATIO - MISCELLANEOUS



	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22
Funded Ratio - MVA/AAL	101%	109%	114%	126%	140%	147%	144%	121%	99%	85%	90%	87%	90%	99%	87%	58%	62%	69%	65%	68%	71%	68%	64%	66%	66%	66%	65%	75%	68%

6/30/22 funded status estimated

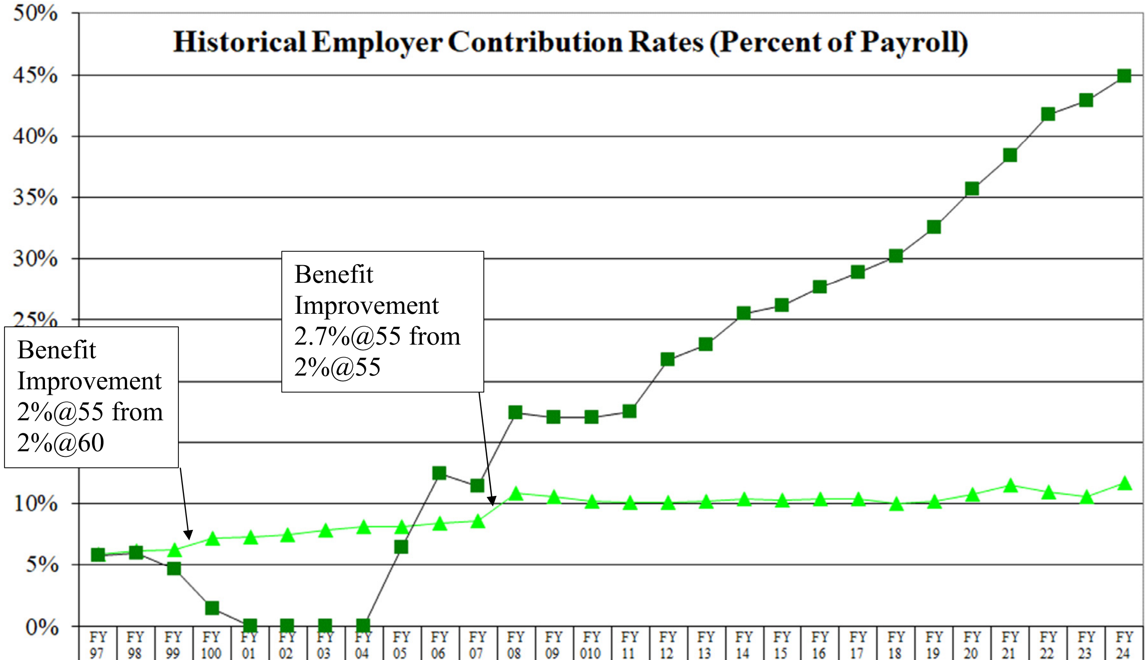
FUNDED STATUS (MILLIONS) - MISCELLANEOUS



	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22
AAL	117	126	138	152	163	175	194	211	235	272	291	340	364	409	443	499	521	553	576	603	667	697	730	773	832	869	909	956	987
Assets	118	137	157	191	229	258	280	256	233	232	263	295	329	404	385	289	324	384	374	412	476	477	469	512	547	574	592	720	668

6/30/22 funded status estimated

CONTRIBUTION RATES - MISCELLANEOUS



	FY 97	FY 98	FY 99	FY 100	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 010	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17	FY 18	FY 19	FY 20	FY 21	FY 22	FY 23	FY 24
Normal Cost	5.9%	6.2%	6.3%	7.1%	7.3%	7.5%	7.8%	8.1%	8.1%	8.4%	8.6%	10.9%	10.6%	10.1%	10.1%	10.1%	10.2%	10.4%	10.3%	10.4%	10.3%	10.0%	10.2%	10.7%	11.5%	11.0%	10.6%	11.7%
Total Rate	5.8%	6.0%	4.6%	1.5%	0.0%	0.0%	0.0%	0.0%	6.4%	12.4%	11.4%	17.4%	17.0%	17.1%	17.6%	21.7%	23.0%	25.5%	26.1%	27.7%	28.9%	30.2%	32.6%	35.6%	38.4%	41.8%	42.8%	44.8%

CONTRIBUTION RATES - MISCELLANEOUS

	6/30/20 2022/2023	6/30/21 2023/2024
■ Total Normal Cost	17.8%	19.3%
■ Employee Normal Cost	7.2%	7.6%
■ Employer Normal Cost	10.6%	11.7%
■ Amortization Payments	32.3%	33.1%[4]
■ Total Employer Contribution Rate	42.8%	44.8%

■ 2022/23 Employer Contribution Rate	42.8%
● Payroll less than Expected	2.7%
● 6/30/17 Discount Rate & Inflation (5th Year)	0.3%
● 6/30/18 Discount Rate change (4th Year)	0.7%
● 6/30/21 Demog. Assumption change (1st Year, no ramp)	1.1%
● 6/30/21 Risk Mitigation (Normal Cost change)	0.8%
● Other (Gains)/Losses mainly net investment gain	(3.6%)
■ 2023/24 Employer Contribution Rate	44.8%

[4] Equivalent to 13.5% of UAL. One year, 6.8% interest on the UAL is 16.7% of payroll. 2023/24 amortization payment exceeds interest on the UAL, so there is no "negative amortization."

CONTRIBUTION PROJECTION - MISCELLANEOUS

- Market Value Investment Return:
  - June 30, 2022 (6.1%)[5]
  - Future returns based on stochastic analysis using 1,000 trials

Single Year Returns at[6]	25th Percentile	50th Percentile	75th Percentile
Current investment mix – first 10 years, without risk mitigation	**-1.8%**	**6.0%**	**14.7%**
Current investment mix – after 10 years, without risk mitigation	**-0.7%**	**7.5%**	**16.4%**

  - Assumes investment returns will generally be lower over the next 10 years and higher beyond that.
- Discount Rate decreases due to Risk Mitigation policy – Ultimate rate 6.0%
- No Other: Gains/Losses, Method/Assumption Changes, Benefit Improvements
- Different from CalPERS projection
- Impact of Risk Mitigation Policy:
  - Net impact of investment gain and discount rate change amortized over 20 years with 5 year ramp up
  - Same amortization method for all future years

5 Gross return based on July 2022 CalPERS press release.
6 N^{th} percentile means N percentage of our trials result in returns lower than the indicated rates.

CONTRIBUTION PROJECTION - MISCELLANEOUS

- New hire assumptions:
  - All new hires assumed PEPRA members and none are Classic members

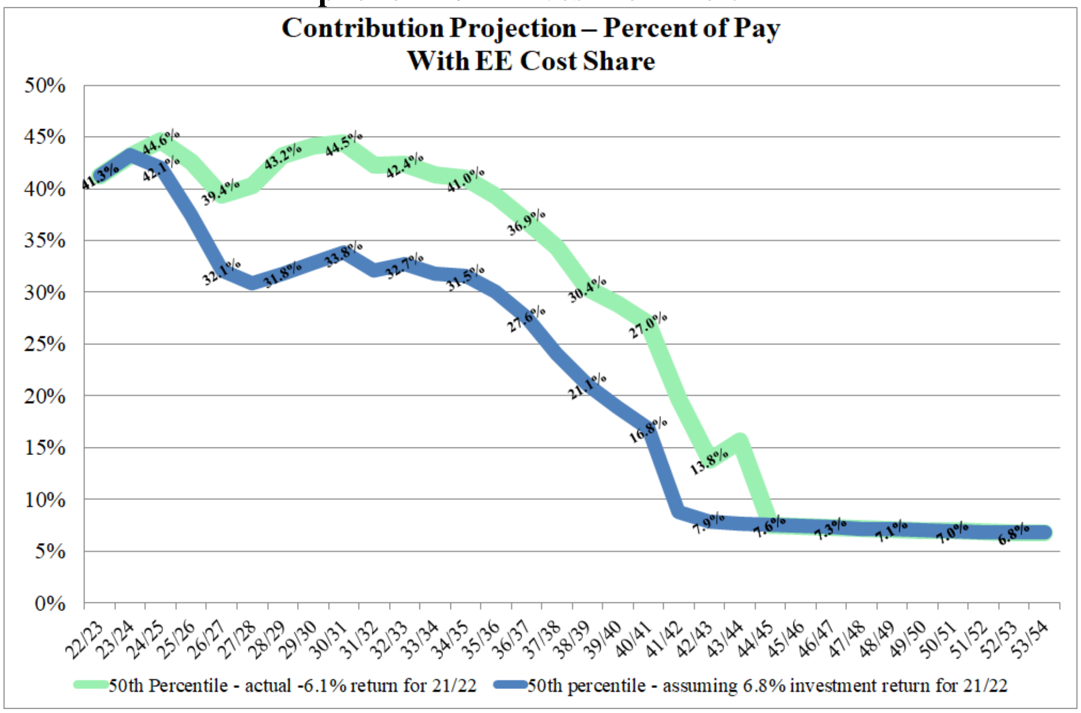
- 6/30/21 employee distribution:

Benefit Tier	Count	20/21 Payroll
• 2.7%@55 FAE1	306	$36,349,200
• 2%@60 FAE1	96	12,519,900
• 2%@62 FAE3 (PEPRA)	321	30,849,900

- Employee cost sharing by bargaining group (percentage of pay):
  - SEIU: 2% effective 12/1/2020
  - All other groups: 1%
  - Payroll split by bargaining group: 58% for SEIU and 42% for all other groups

CONTRIBUTION PROJECTION - MISCELLANEOUS

Impact of 21/22 Investment Return



CONTRIBUTION PROJECTION - MISCELLANEOUS

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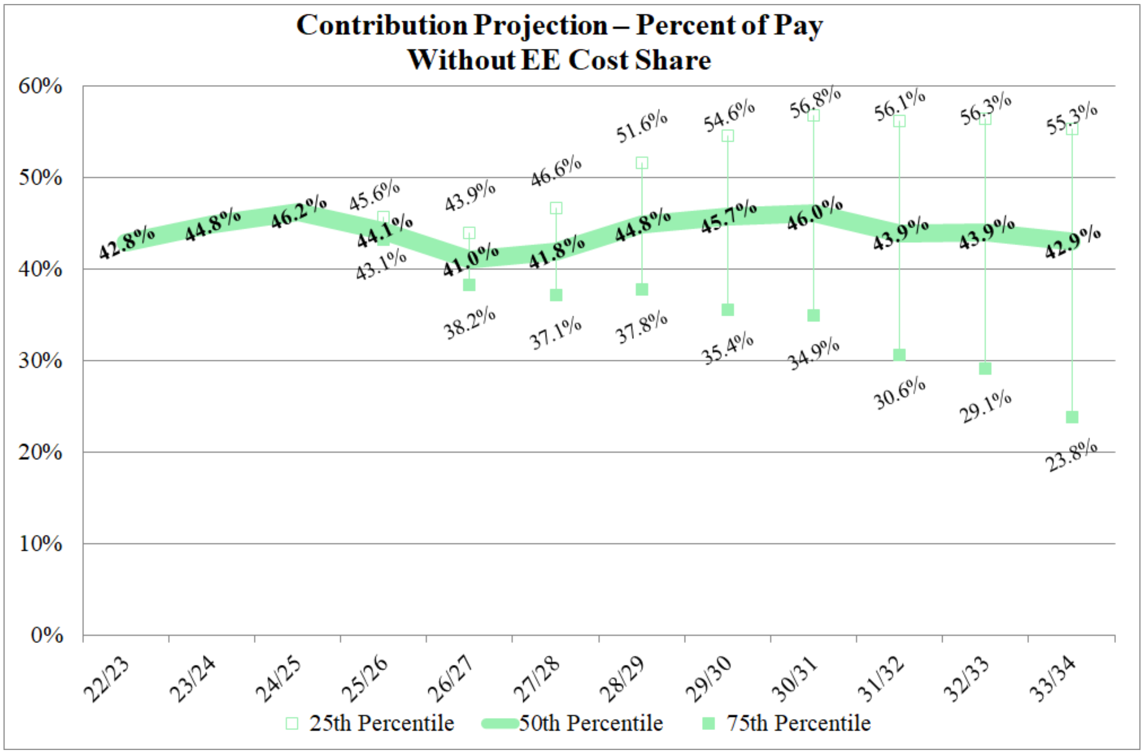
CONTRIBUTION PROJECTION - MISCELLANEOUS



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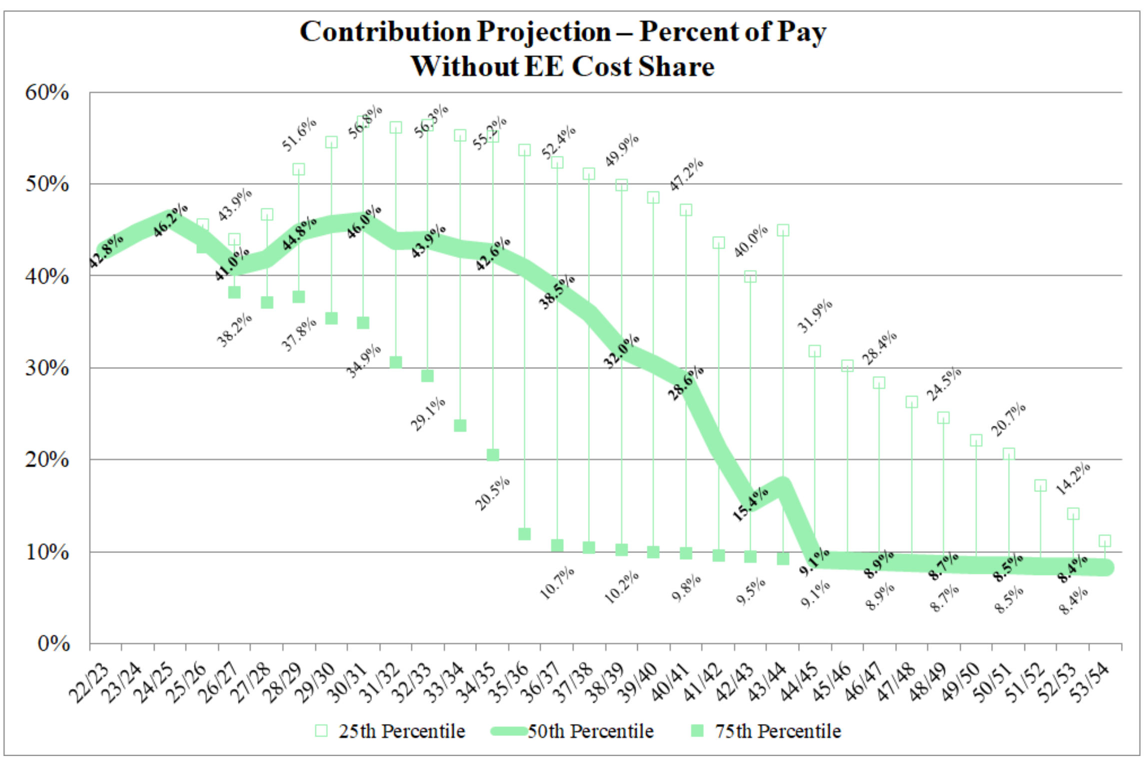
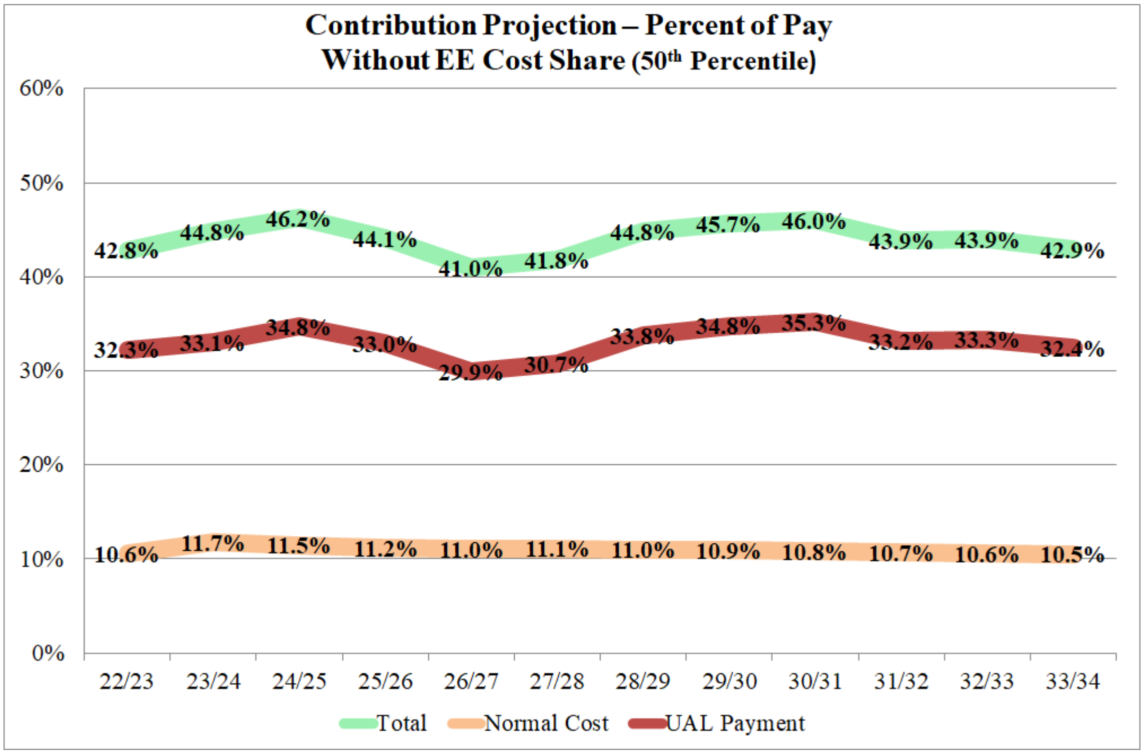
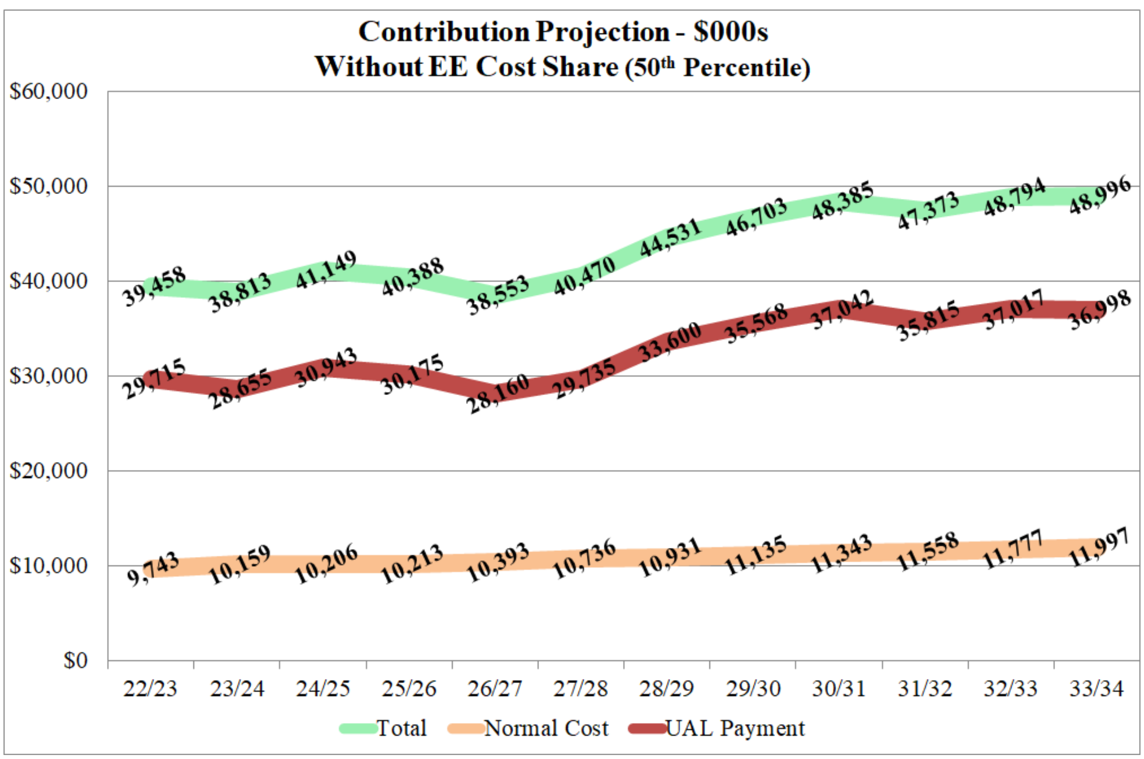


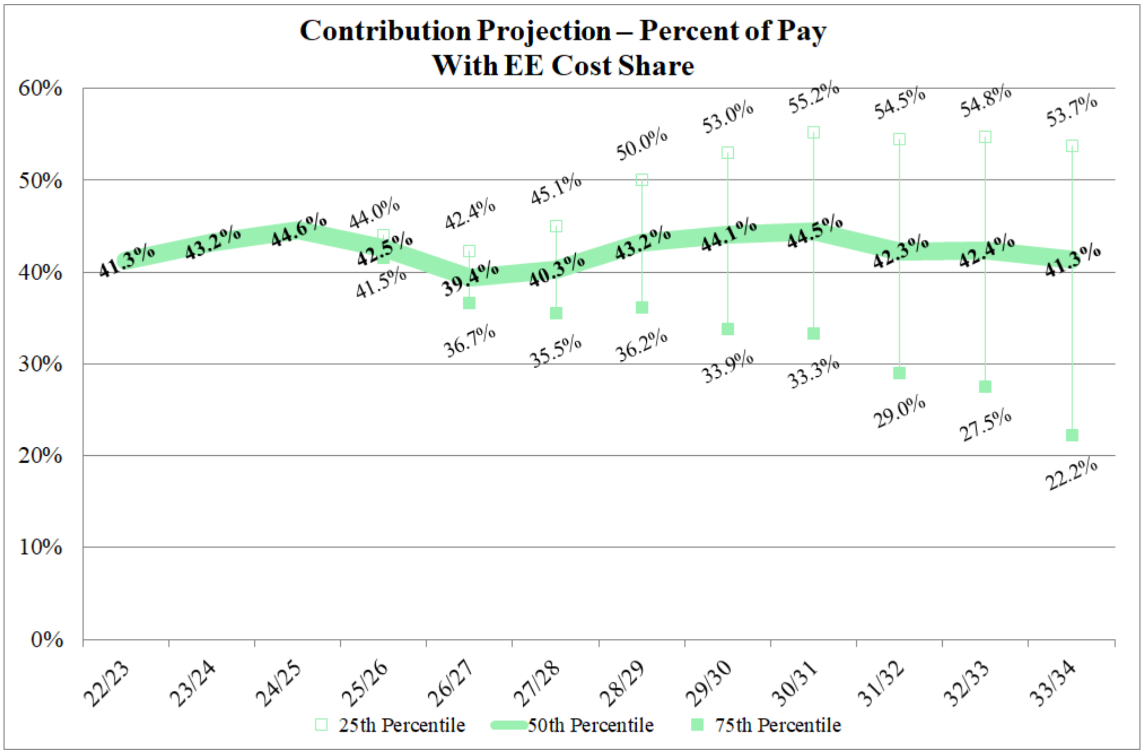
Contribution Projection - Miscellaneous



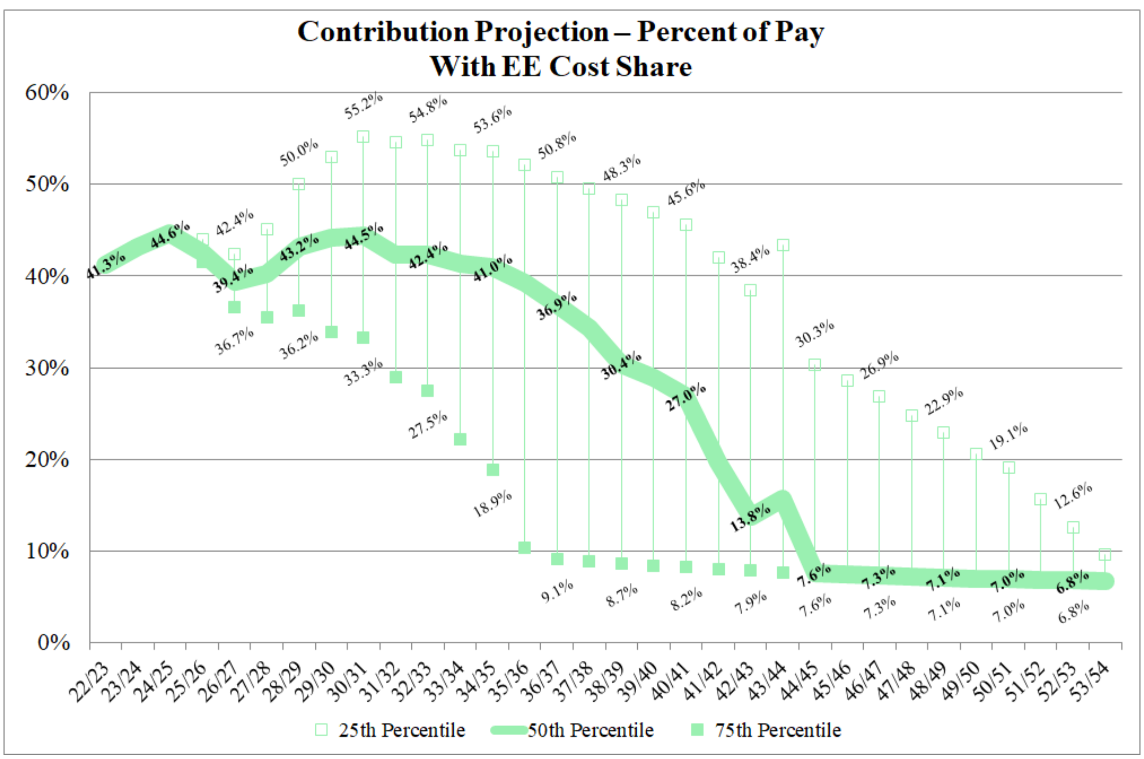
Contribution Projection - Miscellaneous



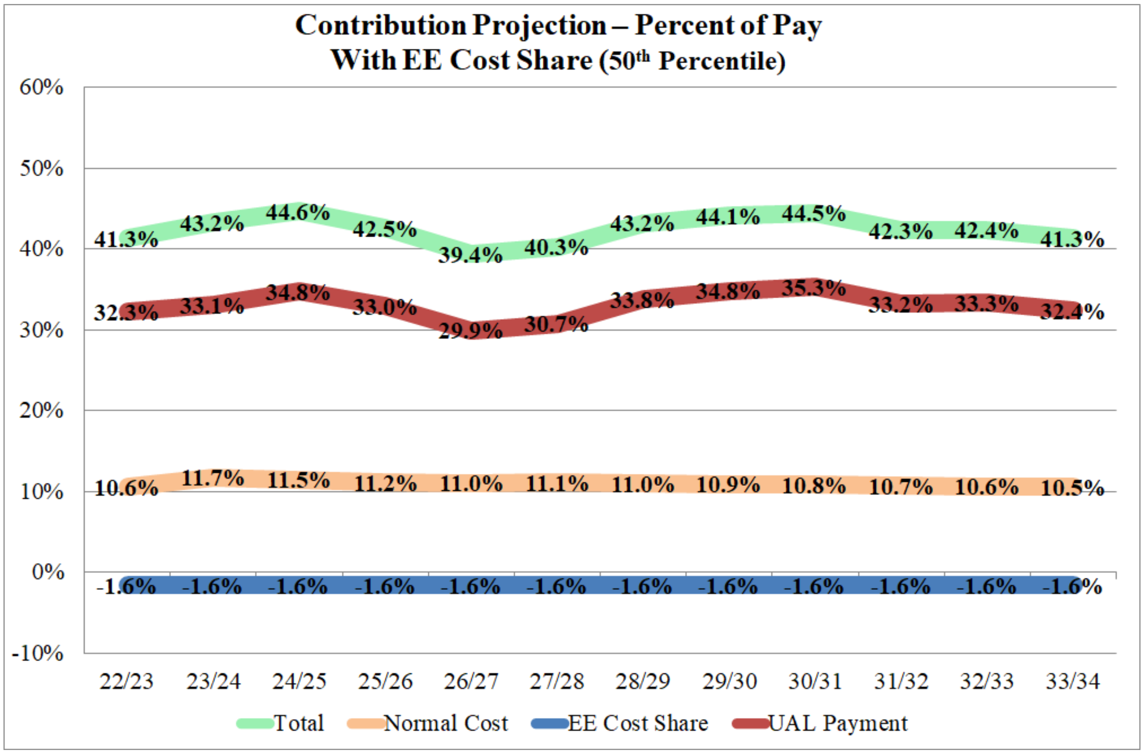
CONTRIBUTION PROJECTION - MISCELLANEOUS



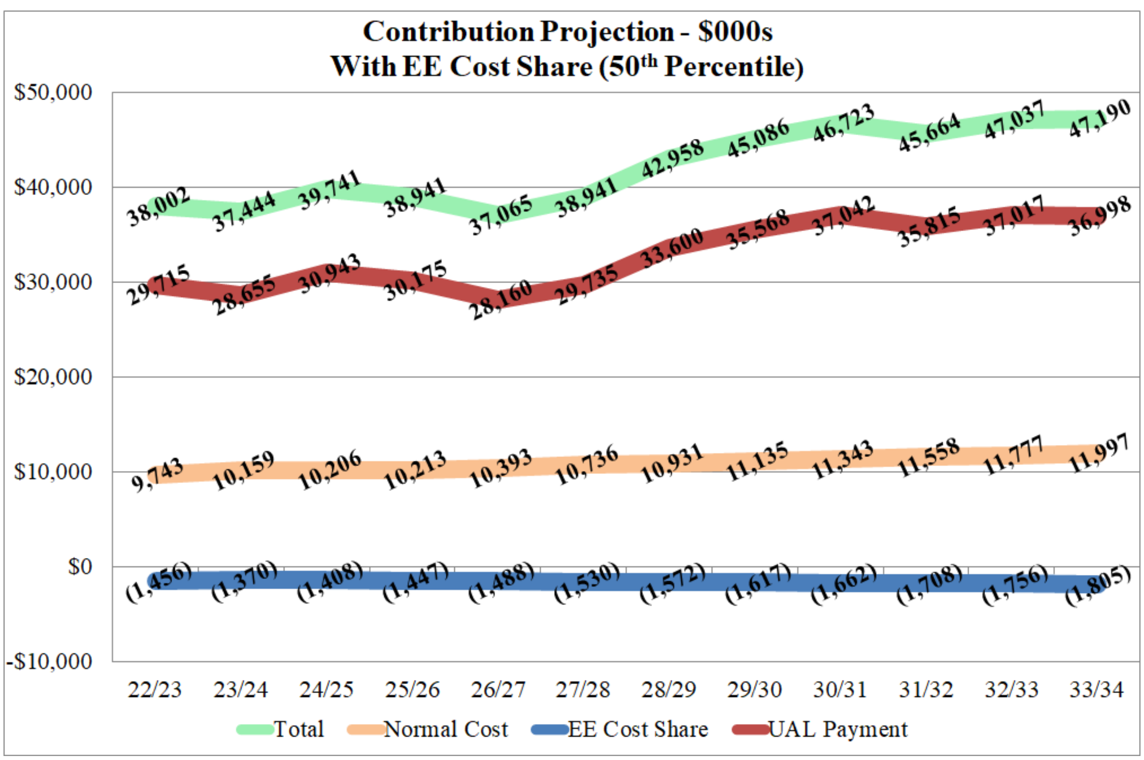
CONTRIBUTION PROJECTION - MISCELLANEOUS



CONTRIBUTION PROJECTION - MISCELLANEOUS



CONTRIBUTION PROJECTION - MISCELLANEOUS



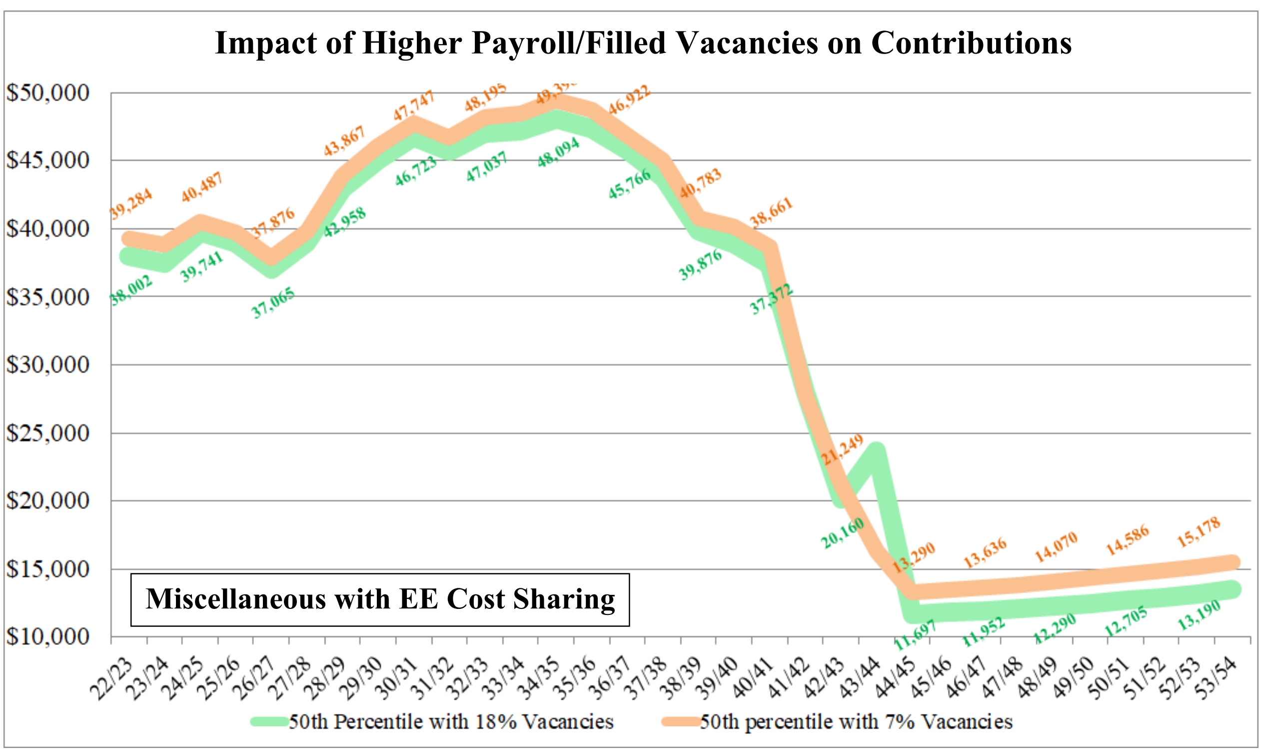
FILLING VACANCIES ANALYSIS - MISCELLANEOUS

Filling Employee Vacancies – Miscellaneous

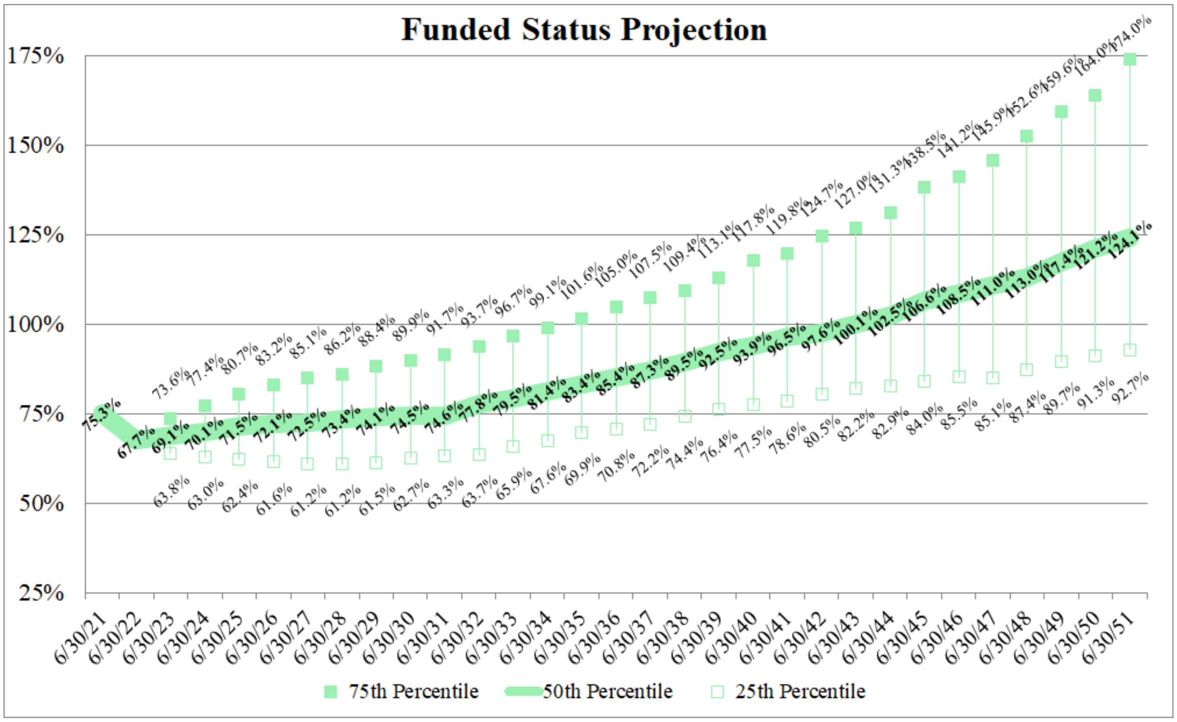
- All payroll increase over CalPERS projections is assumed to be from newly hired PEPRA employees, increasing only Normal Cost
  - Payroll growth from permanent, higher-than-expected pay increases for current employees would also add to the City's UAL.

	Payroll
■ August 2022 payroll	$ 86,382,700
■ FY 2022/23 budget	104,962,800
■ Current % employee vacancy	18%
■ Expected % employee vacancy	7%
■ Current projected 2023/24 CalPERS payroll from 6/30/2021 valuation report	$ 86,604,600
■ New projected 2023/24 payroll for analysis (22/23 budget with one year salary inflation, * 93%)	100,000,000

FILLING VACANCIES ANALYSIS - MISCELLANEOUS



FUNDED STATUS - MISCELLANEOUS



FUNDED STATUS - MISCELLANEOUS

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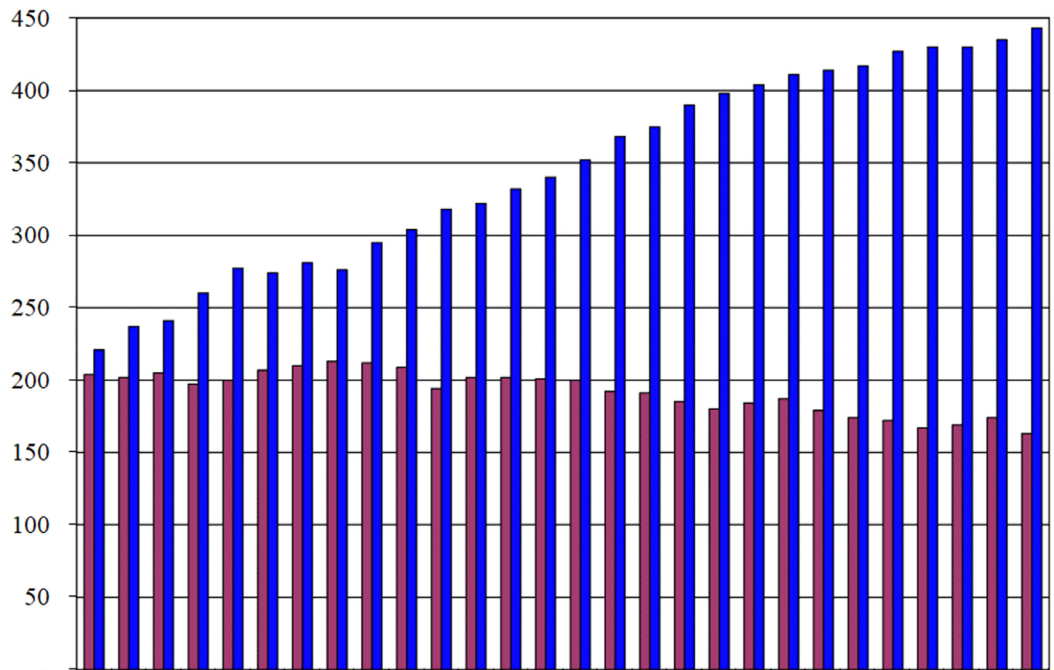
SUMMARY OF DEMOGRAPHIC INFORMATION - SAFETY

	2001	2011	2020	2021
Actives				
■ Counts	213	185	174	163
■ Average				
• Age	41	41	41	42
• City Service	13	12	11	12
• PERSable Wages	$ 81,800	$ 123,100	$ 155,700	$ 157,900
■ Total PERSable Wages	17,400,000	22,800,000	27,100,000	25,700,000
Inactive Members				
■ Counts				
• Transferred	60	62	55	56
• Separated	28	34	49	51
• Retired				
☐ Service	193	198	241	247
☐ Disability	56	157	146	144
☐ Beneficiaries	27	35	48	52
☐ Total	276	390	435	443
■ Average Annual City Provided Benefit for Service Retirees[7]	$ 25,200	$ 47,200	$ 70,400	$ 71,500

[7] Average City-provided pensions are based on City service & City benefit formula, and are not representative of benefits for long-service employees.

SUMMARY OF DEMOGRAPHIC INFORMATION - SAFETY



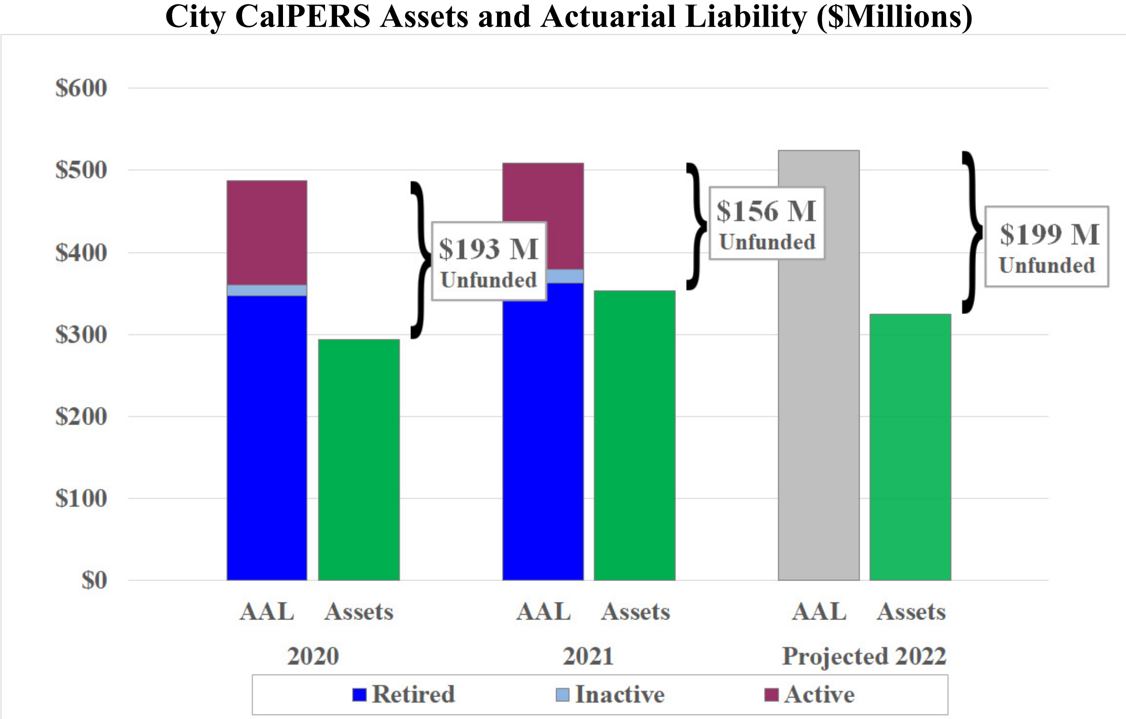
	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21
■ Active	204	202	205	197	200	207	210	213	212	209	194	202	202	201	200	192	191	185	180	184	187	179	174	172	167	169	174	163
■ Receiving Payments	221	237	241	260	277	274	281	276	295	304	318	322	332	340	352	368	375	390	398	404	411	414	417	427	430	430	435	443

Plan Funded Status - Safety

	June 30, 2020	June 30, 2021
■ **Actuarial Accrued Liability**		
● Active	$ 126,300,000	$ 130,300,000
● Retiree	347,200,000	362,600,000
● Inactive	13,700,000	16,300,000
● Total	487,200,000	509,200,000
■ **Assets**	293,900,000	353,300,000
■ **Unfunded Liability**	193,300,000	155,900,000
■ **Funded Ratio**	60.3%	69.4%
■ **Average funded ratio for CalPERS Public Agency Safety Plans**	69.2%	80.9%

Plan Funded Status - Safety

City CalPERS Assets and Actuarial Liability ($Millions)



PLAN FUNDED STATUS - SAFETY

Discount Rate Sensitivity

June 30, 2021

	Discount Rate		
	6.80%	**6.30%[8]**	**5.80%**
AAL	$509,200,000	$542,500,000	$575,700,000
Assets	353,300,000	353,300,000	353,300,000
Unfunded Liability	155,900,000	189,200,000	222,400,000
Funded Ratio	69.4%	65.1%	61.4%

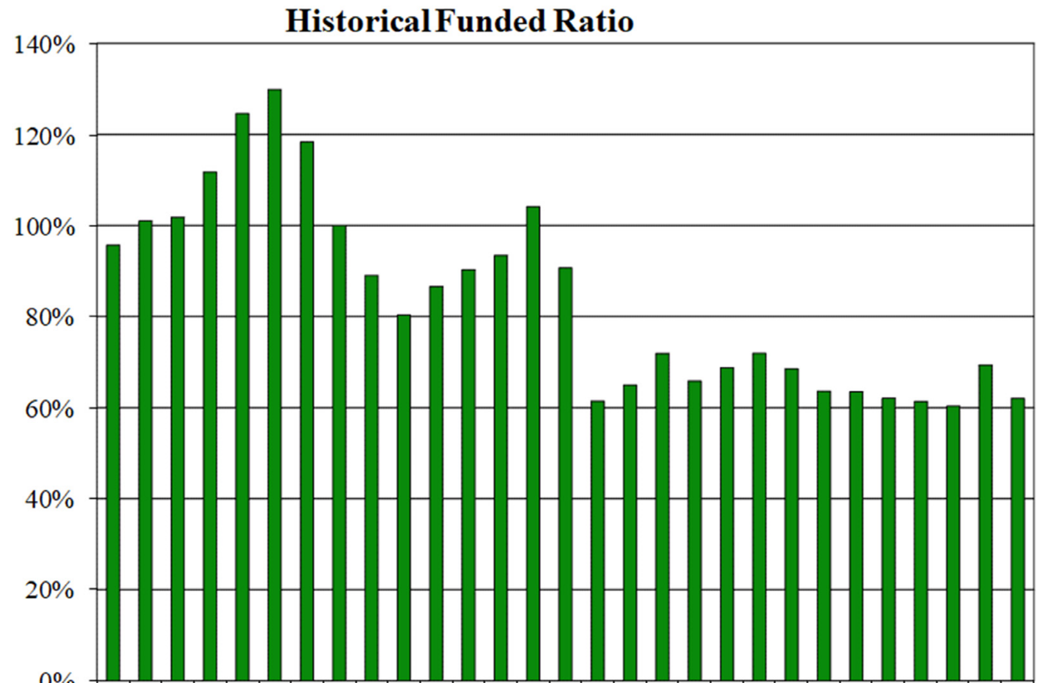
[8] Estimated by Foster & Foster.

PLAN FUNDED STATUS - SAFETY

Unfunded Accrued Liability Changes

■ **Unfunded Accrued Liability on 6/30/20**		$193,300,000
■ **Expected 6/30/21 Unfunded Accrued Liability**		195,300,000
■ **Changes**		
• Assumption Change (demographics)	1,800,000	
• Discount Rate 7% to 6.8%	11,600,000	
• Asset Loss (Gain) (21.2% return for FY 2021)	(46,600,000)	
• Contribution & Experience Loss (Gain)	(6,200,000)	
• Total		(39,400,000)
■ **Unfunded Accrued Liability on 6/30/21**		155,900,000
■ **Projected Unfunded Accrued Liability on 6/30/22**		198,700,000

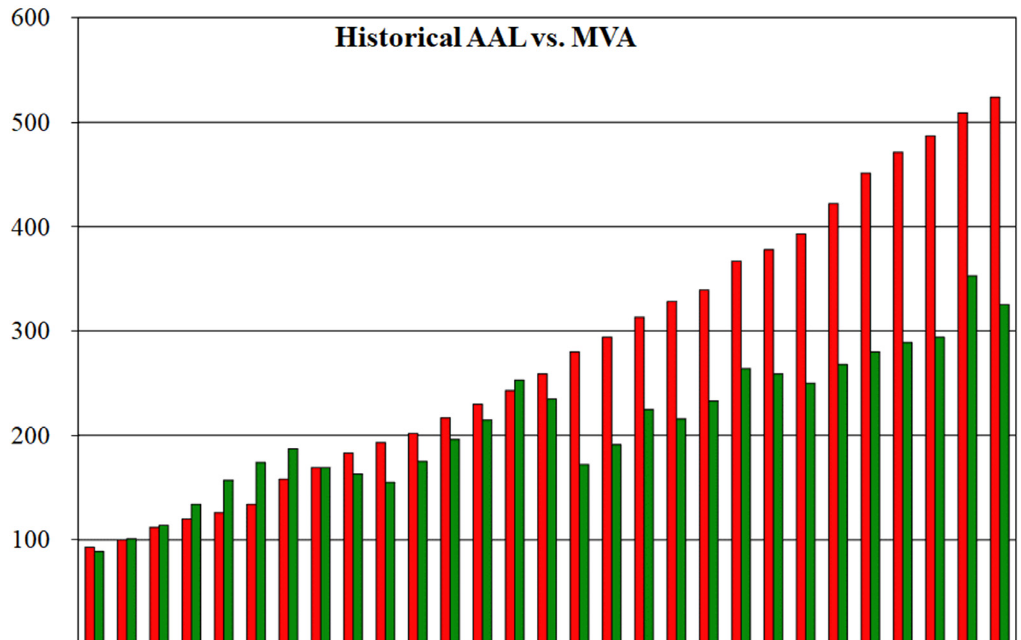
FUNDED RATIO - SAFETY



	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22
Funded Ratio - MVA/AAL	96%	101%	102%	112%	125%	130%	118%	100%	89%	80%	87%	90%	93%	104%	91%	61%	65%	72%	66%	69%	72%	69%	64%	64%	62%	61%	60%	69%	62%

6/30/22 funded status estimated

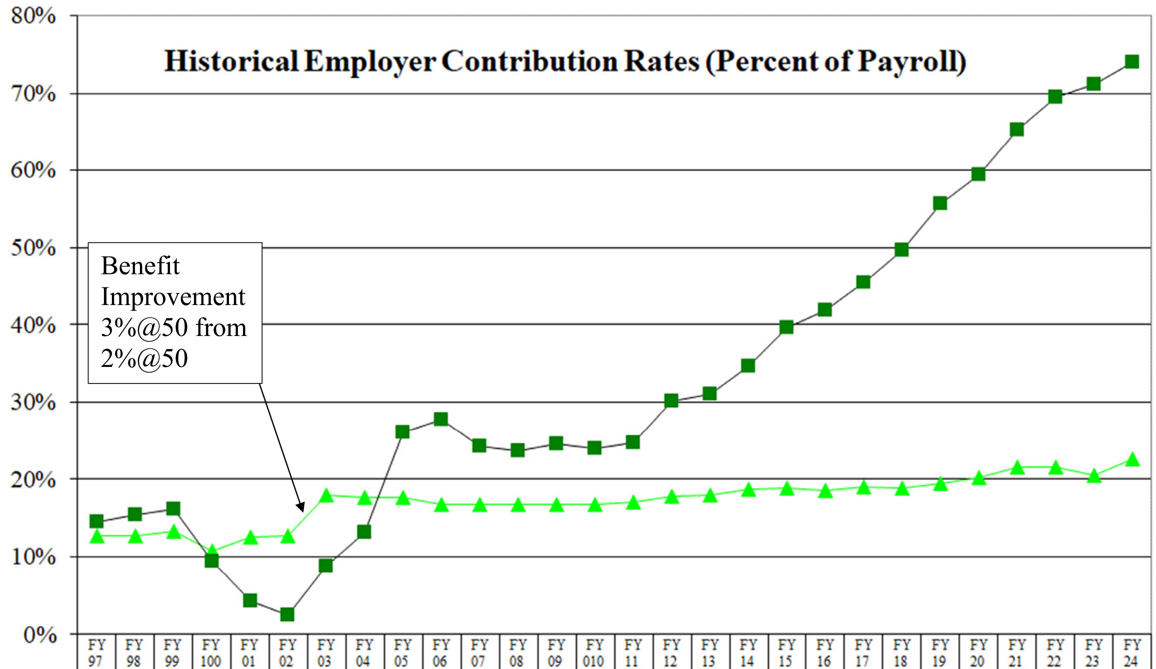
FUNDED STATUS (MILLIONS) - SAFETY



	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22
AAL	93	100	112	120	126	134	158	169	183	193	202	217	230	243	259	280	294	313	328	339	367	378	393	422	451	471	487	509	524
Assets	89	101	114	134	157	174	187	169	163	155	175	196	215	253	235	172	191	225	216	233	264	259	250	268	280	289	294	353	325

6/30/22 funded status estimated

CONTRIBUTION RATES - SAFETY



	FY 97	FY 98	FY 99	FY 100	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 010
Normal Cost	12.7%	12.8%	13.3%	10.8%	12.6%	12.6%	17.9%	17.7%	17.7%	16.7%	16.7%	16.8%	16.8%	16.8%
Total Rate	14.5%	15.4%	16.2%	9.3%	4.3%	2.5%	8.8%	13.2%	26.0%	27.8%	24.2%	23.6%	24.5%	23.9%

	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17	FY 18	FY 19	FY 20	FY 21	FY 22	FY 23	FY 24
Normal Cost	17.0%	17.8%	18.0%	18.7%	18.9%	18.6%	19.0%	18.9%	19.4%	20.2%	21.6%	21.5%	20.6%	22.6%
Total Rate	24.7%	30.1%	31.0%	34.7%	39.5%	41.9%	45.4%	49.7%	55.6%	59.4%	65.3%	69.6%	71.1%	74.0%

CONTRIBUTION RATES - SAFETY

	6/30/20 2022/2023	6/30/21 2023/2024
■ Total Normal Cost	30.4%	32.5%
■ Employee Normal Cost	9.8%	9.9%
■ Employer Normal Cost	20.6%	22.6%
■ Amortization Payments	50.6%	51.4%[9]
■ Total Employer Contribution Rate	71.1%	74.0%

■ 2022/23 Employer Contribution Rate	71.1%
• Payroll less than Expected	3.7%
• 6/30/17 Discount Rate & Inflation (5th Year)	0.6%
• 6/30/18 Discount Rate change (4th Year)	1.2%
• 6/30/21 Demog. Assumption change (1st Year, no ramp)	2.0%
• 6/30/21 Risk Mitigation (Normal Cost change)	1.4%
• Other (Gains)/Losses mainly net investment gain	(6.1%)
■ 2023/24 Employer Contribution Rate	74.0%

[9] Equivalent to 13.5% of UAL. One year, 6.8% interest on the UAL is 16.7% of payroll. 2023/24 amortization payment exceeds interest on the UAL, so there is no "negative amortization."

CONTRIBUTION PROJECTION - SAFETY

- Market Value Investment Return:
  - June 30, 2022 (6.1%)[10]
  - Future returns based on stochastic analysis using 1,000 trials

Single Year Returns at[11]	25th Percentile	50th Percentile	75th Percentile
Current investment mix – first 10 years, without risk mitigation	**-1.8%**	**6.0%**	**14.7%**
Current investment mix – after 10 years, without risk mitigation	**-0.7%**	**7.5%**	**16.4%**

  - Assumes investment returns will generally be lower over the next 10 years and higher beyond that.
- Discount Rate decreases due to Risk Mitigation policy – Ultimate rate 6.0%
- No Other: Gains/Losses, Method/Assumption Changes, Benefit Improvements
- Different from CalPERS projection
- Impact of Risk Mitigation Policy:
  - Net impact of investment gain and discount rate change amortized over 20 years with 5 year ramp up
  - Same amortization method for all future years

[10] Gross return based on July 2022 CalPERS press release.
[11] Nth percentile means N percentage of our trials result in returns lower than the indicated rates.

CONTRIBUTION PROJECTION - SAFETY

- New hire assumptions:
  - All new hires assumed PEPRA members and none are Classic members

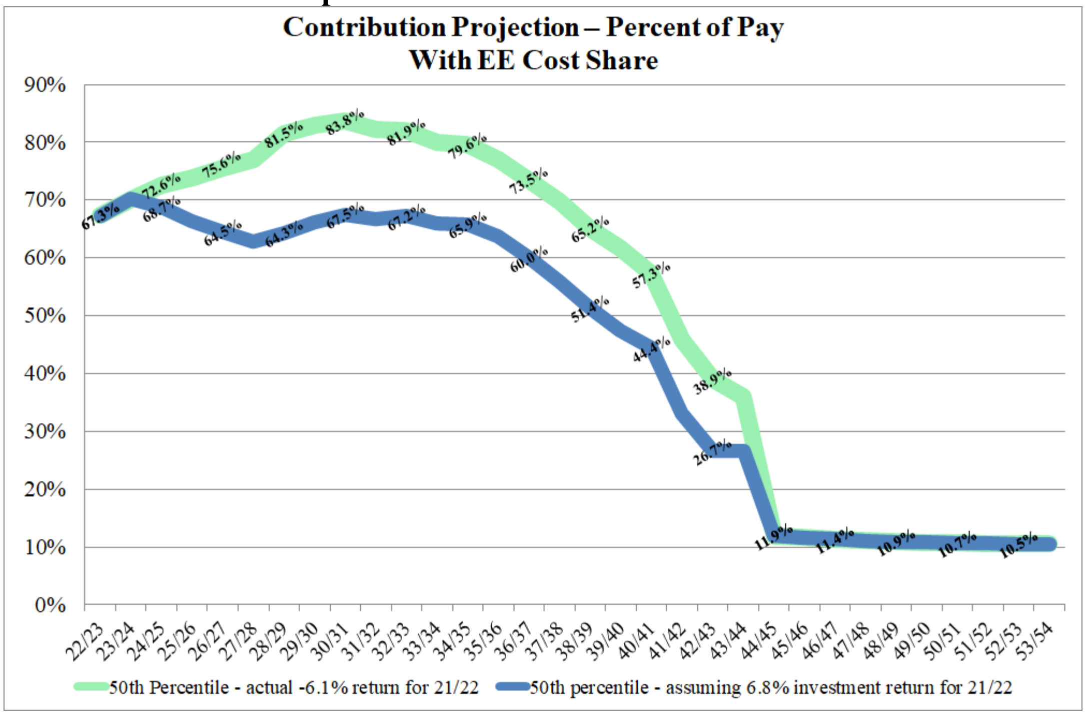
- 6/30/21 employee distribution:

Benefit Tier	Count	20/21 Payroll
● 3%@50 FAE1	92	$15,866,300
● 3%@55 FAE3	13	2,048,900
● 2.7%@57 FAE3 (PEPRA)	58	7,830,300

- Employee Cost Sharing by Bargaining Group (% of pay):
  - PAPOA: 3.5% of pay effective 7/1/2019
  - All other Safety: 4% of pay after 7/1/2021
  - Payroll: 43% PAPOA and 57% all other groups

CONTRIBUTION PROJECTION - SAFETY

Impact of 21/22 Investment Return



CONTRIBUTION PROJECTION - SAFETY

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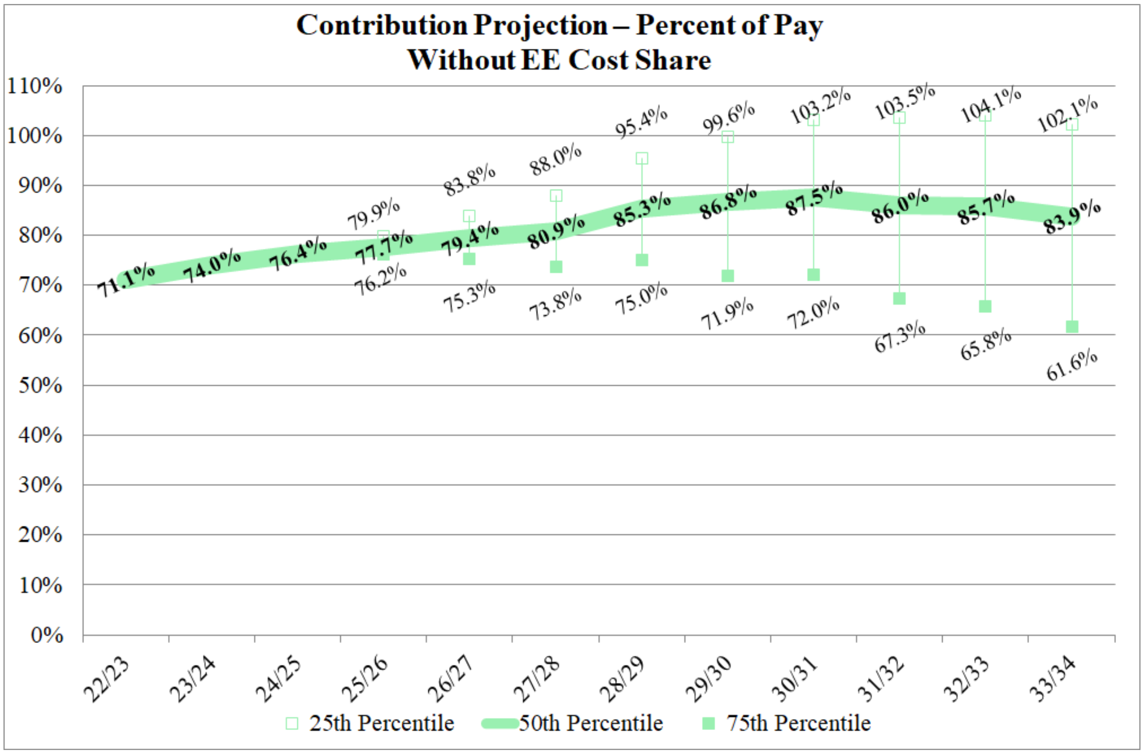

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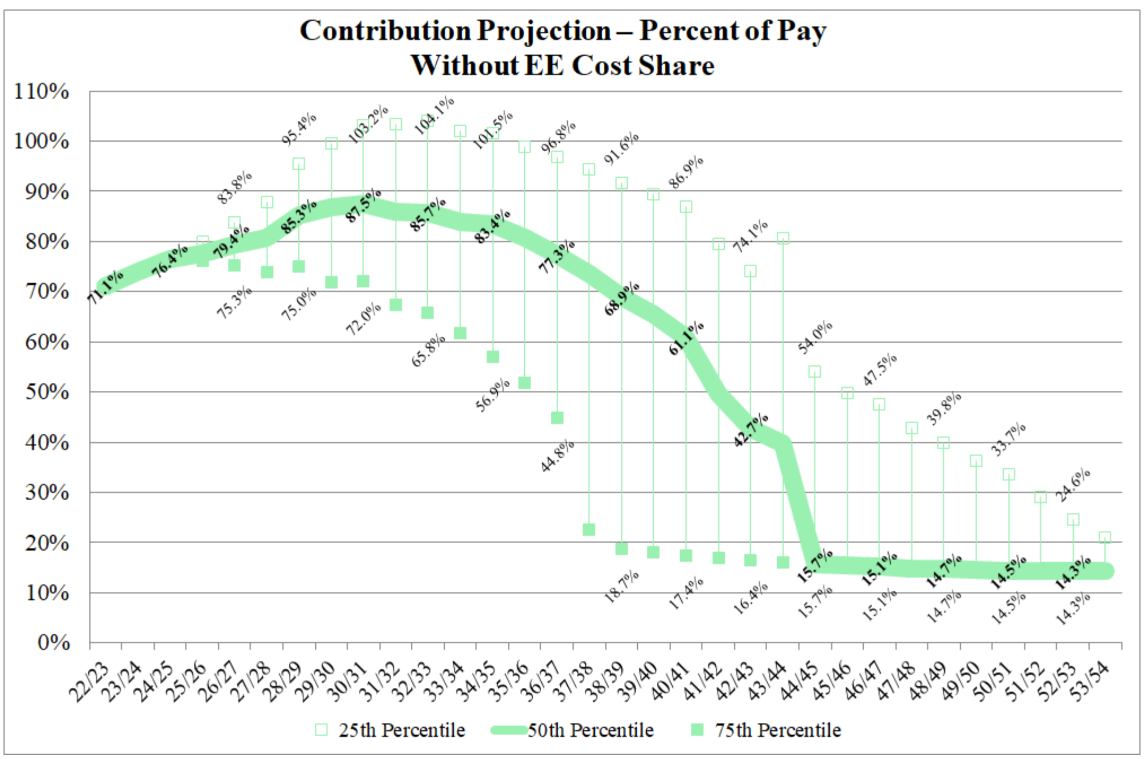

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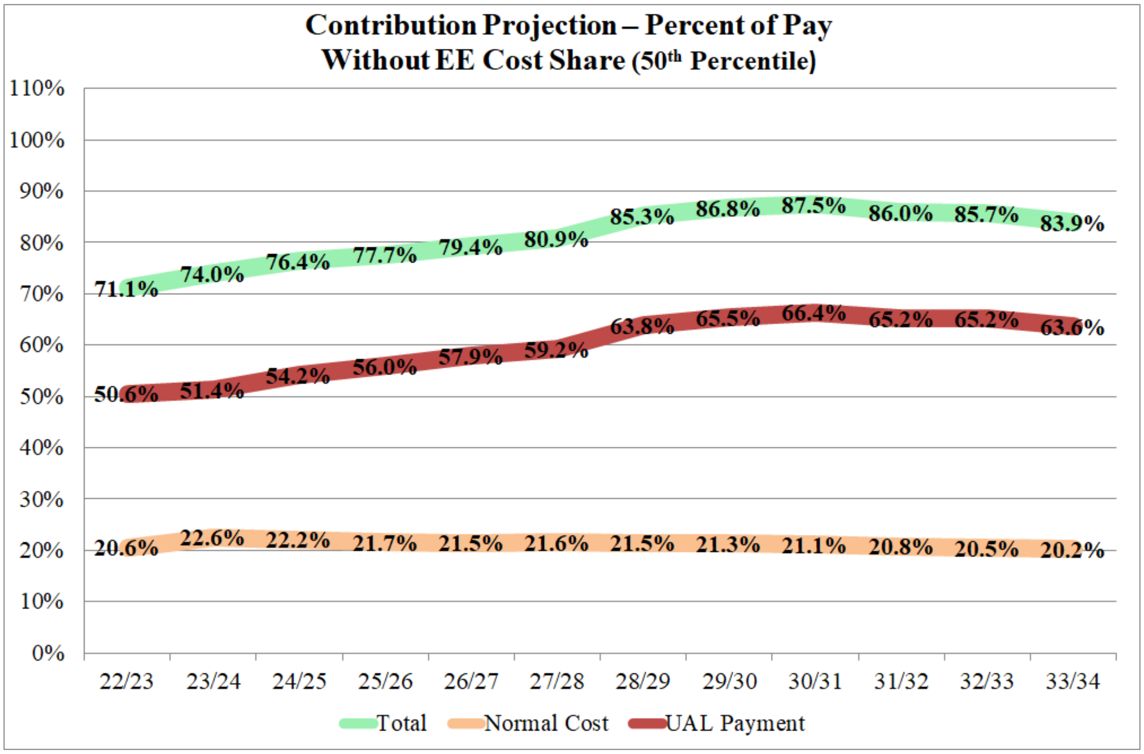

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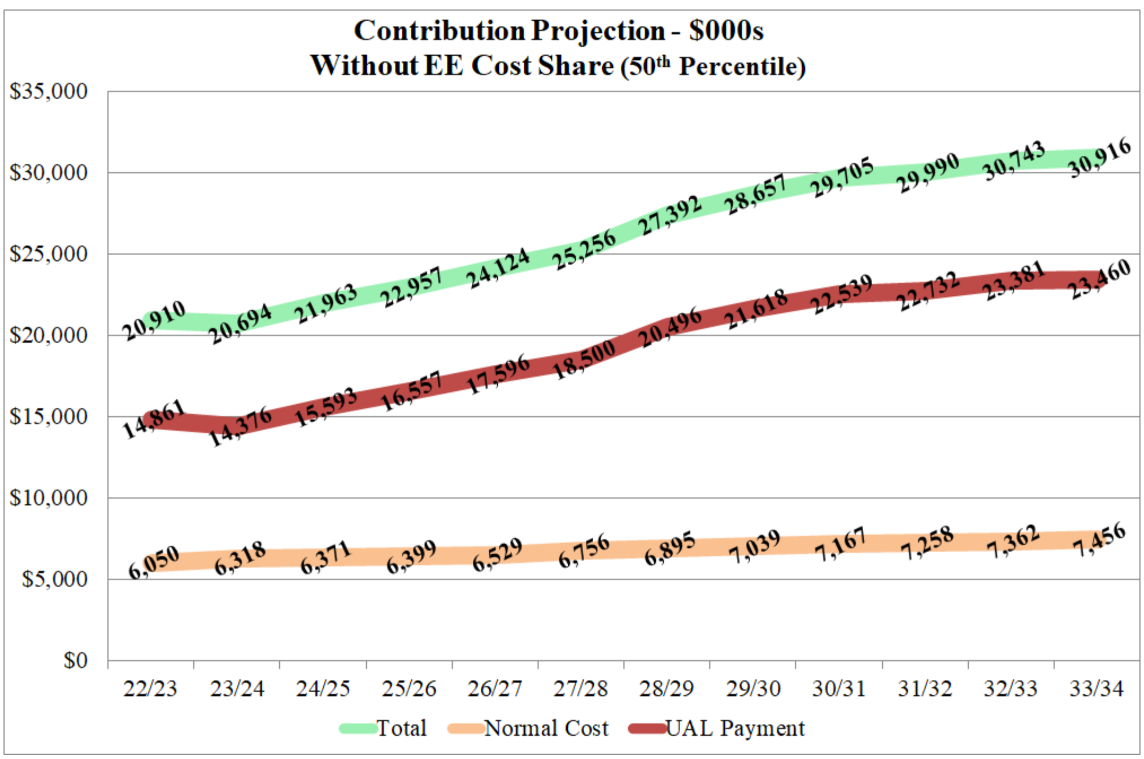

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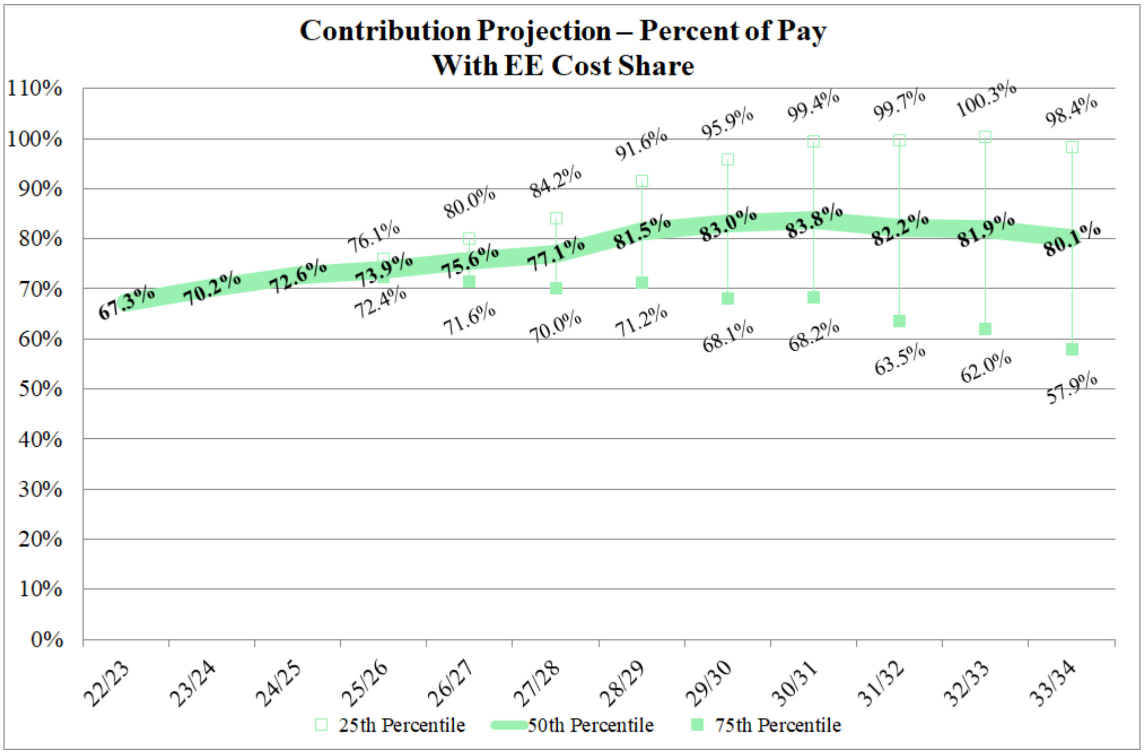

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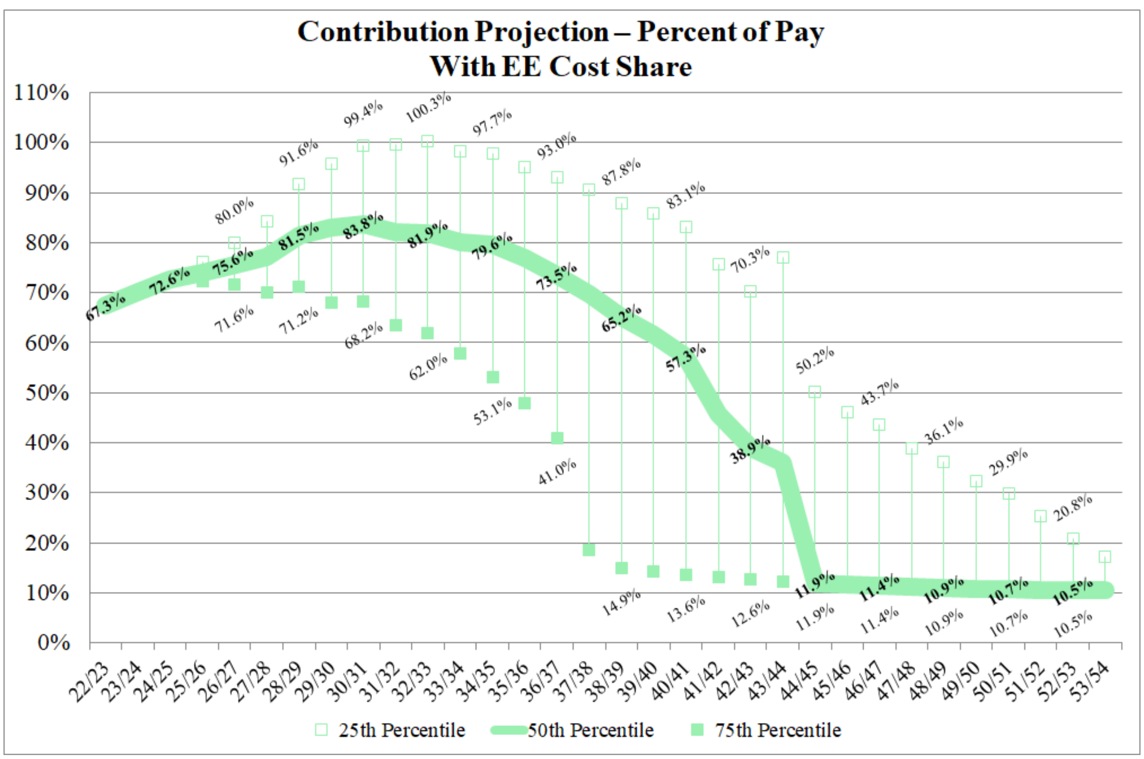

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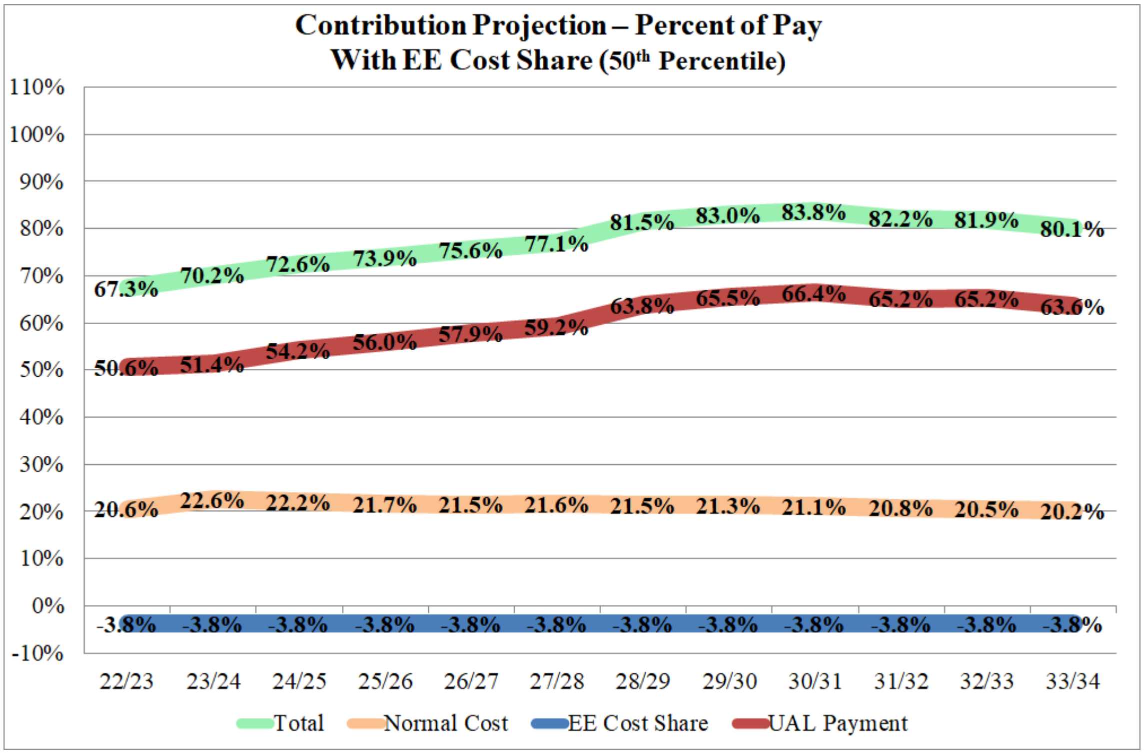

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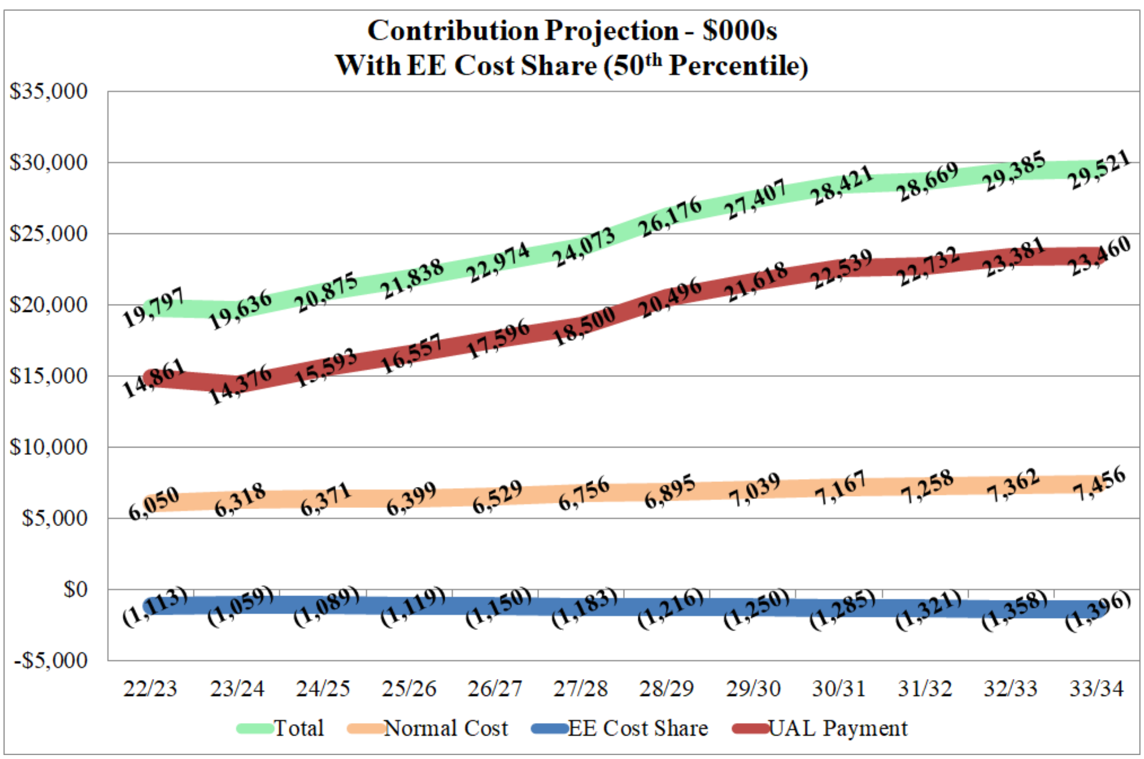


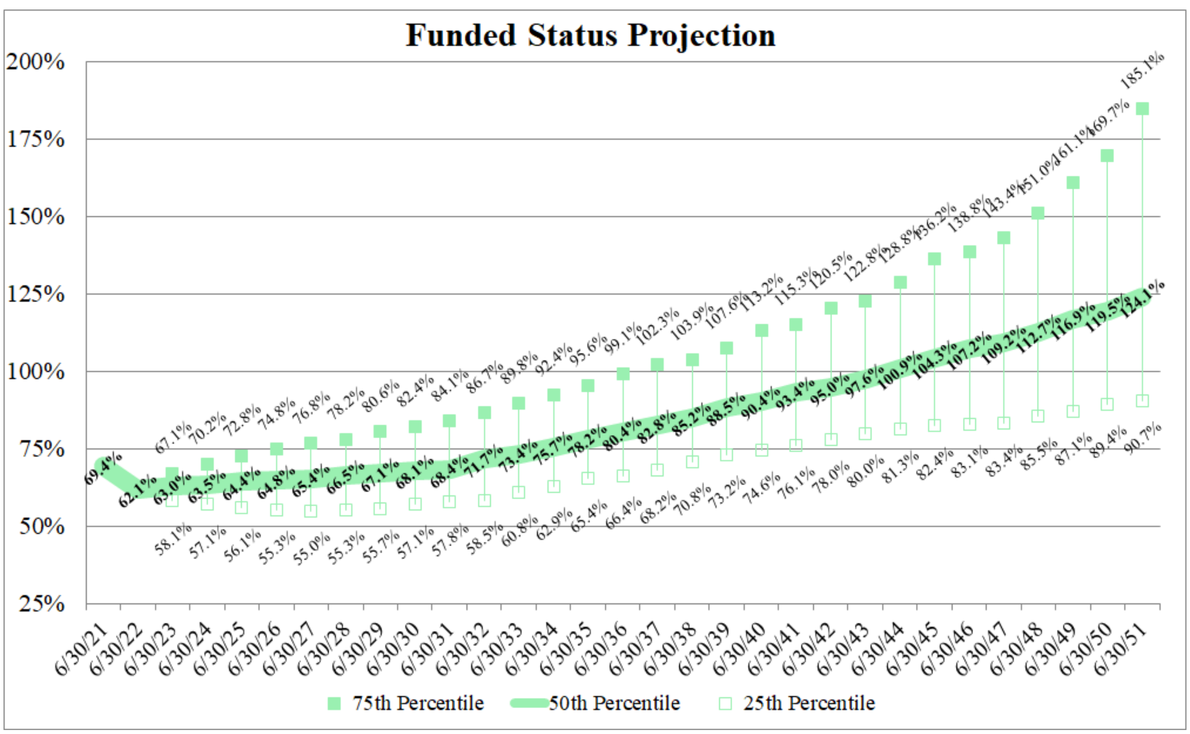
FILLING VACANCIES ANALYSIS - SAFETY

Filling Employee Vacancies – Safety

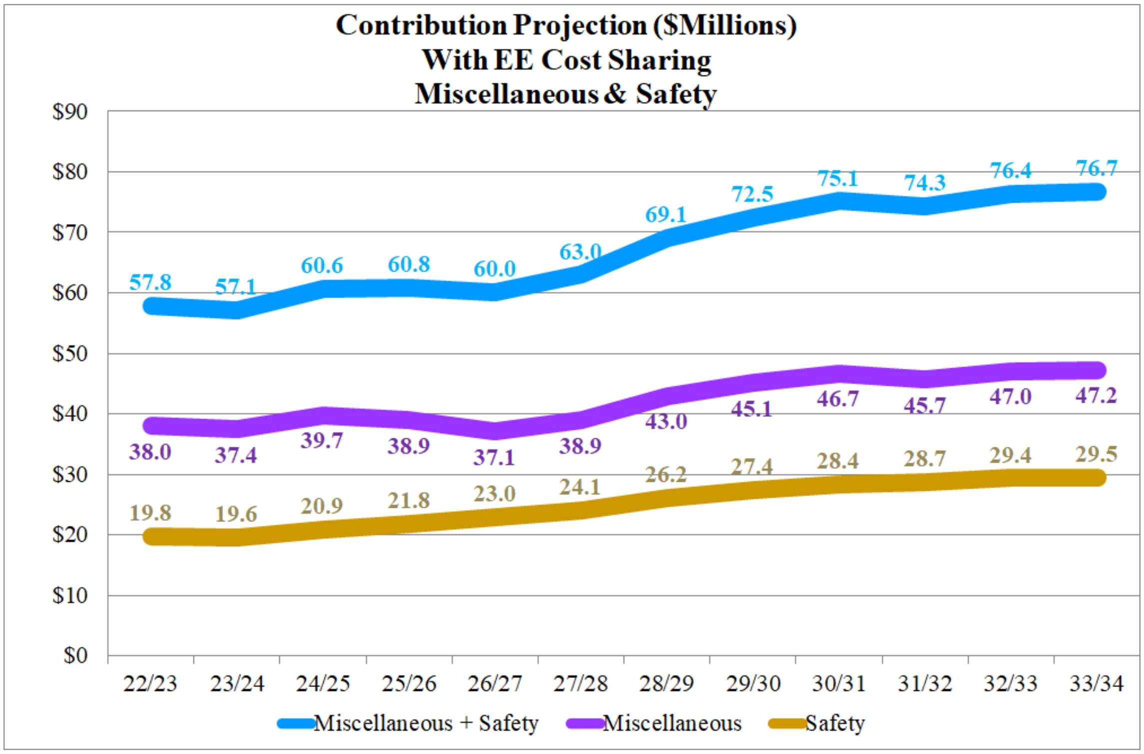
- All payroll increase over CalPERS projections is assumed to be from newly hired PEPRA employees, increasing only Normal Cost
  - Payroll growth from permanent, higher-than-expected pay increases for current employees will also add to the City's UAL
- No adjustment has been made to CalPERS projected Safety payroll in this analysis

	Payroll
August 2022 payroll	$ 22,597,100
FY 2022/23 budget	27,077,300
Current % employee vacancy	16%
Expected % employee vacancy	7%
Current projected 2023/24 CalPERS payroll from 6/30/2021 valuation report	$ 27,969,300
New projected 2023/24 payroll for analysis (2022/23 budget with one year's salary growth * 93%)	$24,500,000
Result: Use CalPERS projected payroll for this study, with no adjustment	

FUNDED STATUS - SAFETY



COMBINED – MISCELLANEOUS & SAFETY



COMBINED – MISCELLANEOUS & SAFETY

Funded Status Summary on June 30, 2021

(Amounts in $Millions)

	Miscellaneous	Safety	Total
■ AAL	$ 956	$ 509	$1,465
■ Assets	720	353	1,073
■ Unfunded AAL	236	156	392
■ Funded Ratio	75.3%	69.4%	73.2%

Projected Funded Status Summary on June 30, 2022

(Amounts in $Millions)

	Miscellaneous	Safety	Total
■ AAL	$ 987	$ 524	$1,511
■ Assets	668	325	993
■ Unfunded AAL	319	199	518
■ Funded Ratio	67.7%	62.1%	65.7%

LEAVING CALPERS

- Participation in CalPERS is governed by State law and CalPERS rules
- The following are considered "withdrawing" from CalPERS:
  - Exclude new hires from CalPERS & giving them a different pension
  - Stop accruing benefits for current employees
- "Withdrawal" from CalPERS:
  - Treated as plan termination
  - Liability increased for conservative investments
  - Liability increased for future demographic fluctuations
  - Liability must be funded immediately by withdrawing agency
  - Otherwise, retiree benefits are cut

LEAVING CALPERS

CalPERS Termination Estimates on June 30, 2021 (Amounts in Millions)

	Ongoing Plan	Termination Basis	
Discount Rate	**6.80%**	**1.00%**	**2.25%**
Miscellaneous			
Actuarial Accrued Liability	$ 956	$2,053	$1,704
Assets	720	720	720
Unfunded AAL (UAAL)	236	1,333	984
Safety			
Actuarial Accrued Liability	$ 509	$ 1,152	$ 951
Assets	353	353	353
Unfunded AAL (UAAL)	156	799	598
Total			
Unfunded AAL (UAAL)	392	2,132	1,582
Funded Ratio	73.2%	33.5%	40.4%

PEPRA COST SHARING

- Target of 50% of total normal cost paid by all employees
- *PEPRA members* must pay greater of 50% of total normal cost or bargained amount if higher
- Employer cannot pay any part of *PEPRA member* required employee contributions
- Employer may impose current employees pay 50% of total normal cost (limited to 8% of pay for Miscellaneous and 12% for Safety) if not agreed through collective bargaining
- Miscellaneous Plan 2023/24:

	Classic Members		New Members
	Tier 1 2.7%@55 FAE1	Tier 2 2%@60 FAE1	PEPRA 2%@62 FAE3
Employer Normal Cost	15.7%	12.2%	7.00%
Member Normal Cost	8.0%	7.0%	7.25%
Total Normal Cost	23.7%	19.2%	14.25%
50% Target	11.9%	9.6%	7.13%

PEPRA COST SHARING

- Safety Plan 2023/24:

	Classic Members		New Members
	Tier 1 3%@50 FAE1	Tier 2 3%@50 FAE3	PEPRA 2.7%@57 FAE3
Employer Normal Cost	27.3%	26.6%	12.39%
Member Normal Cost	9.0%	9.0%	11.75%
Total Normal Cost	36.3%	35.6%	24.14%
50% Target	18.2%	17.6%	12.07%

- PEPRA Member Contributions:

	2022/23		2023/24			
Group	Total NC (Basis)	Member Rate	Total Normal Cost	Change	Member Rate	Method
Miscellaneous	12.50%	6.25%	14.25%	**1.75%**	**7.25%**	PEPRA Members
Safety	23.54%	11.75%	23.84%	0.30%	11.75%	All Active Members

Paying Down the UAL & Rate Stabilization

- Where do you get the money from?
- How do you use the money?

Where Do You Get the Money From?

- POB:
  - Usually thought of as interest arbitrage between expected earnings and rate paid on POB
  - No guaranteed savings
  - PEPRA prevents contributions from dropping below normal cost
    - Savings offset when investment return is good
  - GFOA Advisory
- Borrow from General Fund similar to State
- One time payments
  - Governing body resolution to use a portion of one time money, e.g.
    - 1/3 to one time projects
    - 1/3 to replenish reserves and
    - 1/3 to pay down unfunded liability

ADDITIONAL PAYMENTS TO CALPERS

- Internal Service Fund
  - Typically used for rate stabilization
  - Restricted investments:
    - Likely low (0.5%-1.0%) investment returns
    - Short term/high quality, designed for preservation of principal
  - Assets can be used by governing body for other purposes
  - Does not reduce Unfunded Liability

ADDITIONAL PAYMENTS TO CALPERS

- Make payments directly to CalPERS:
  - Likely best long-term investment return
  - Must be considered an irrevocable decision
    - Extra payments cannot be used as future “credit”
    - PEPRA prevents contributions from dropping below normal cost
  - Option #1: Request shorter amortization period (Fresh Start):
    - Higher short term payments
    - Less interest and lower long term payments
    - Likely cannot revert to old amortization schedule
      - Savings offset when investment return is good (PEPRA)

ADDITIONAL PAYMENTS TO CALPERS

- Make payments directly to CalPERS (continued):
  - Option #2: Target specific amortization bases with an "Additional Discretionary Payment "ADP" :
    - Extra contribution's impact muted by reduced future contributions
      - CalPERS can't track the "would have been" contribution
    - No guaranteed savings
      - Larger asset pool means larger loss (or gain) opportunity
    - Paying off shorter amortization bases: larger contribution savings over shorter period:
      - e.g. 10 year base reduces contribution 13.7¢ for $1
      - Less interest savings vs paying off longer amortization bases
    - Paying off longer amortization bases: smaller contribution savings over longer period:
      - e.g. 25 year base reduces contribution 8.2¢ for $1
      - More interest savings vs paying off shorter amortization bases
    - Maintaining the current payment schedule – not letting payments reduce due to extra payment – gives the greatest long-term savings

IRREVOCABLE SUPPLEMENTAL (§115) PENSION TRUST

- Can only be used to:
  - Reimburse City for CalPERS contributions
  - Make payments directly to CalPERS
- Investments significantly less restricted than City investment funds
  - Fiduciary rules govern Trust investments
  - Usually, designed for long term returns
- Assets don't count for GASB accounting
  - Are considered Employer assets
- Over 100 trusts established, mostly since 2015
  - Trust providers: PARS, PFM, Keenan
  - California Employers' Pension Prefunding Trust (CEPPT) effective July 2019
    - Strategy 1: 48% stocks / 52% bonds
    - Strategy 2: 22% stocks / 78% bonds

IRREVOCABLE SUPPLEMENTAL (§115) PENSION TRUST

- More flexibility than paying CalPERS directly
  - City decides if and when and how much money to put into Trust
  - City decides if and when and how much to withdraw to pay CalPERS or reimburse Agency
- Funding strategies typically focus on:
  - Reducing the unfunded liability
    - ☐ Fund enough to make total CalPERS UAL = 0
    - ☐ Make PEPRA required payments from Trust when overfunded
  - Stabilizing contribution rates
    - ☐ Mitigate expected contribution rates to better manage budget
  - Combination
    - ☐ Use funds for rate stabilization/budget predictability
    - ☐ Target increasing fund balance to pay off UAL sooner

IRREVOCABLE SUPPLEMENTAL (§115) PENSION TRUST

- Consider:
  - How much can you put into Trust?
    - ☐ Initial seed money?
    - ☐ Additional amounts in future years?
  - When do you take money out?
    - ☐ Target budget rate?
    - ☐ Year target budget rate kicks in?
      - ○ Before or after CalPERS rate exceeds budgeted rate?

Comparison of Options

- **Supplemental Trust**
  - Flexible
  - Likely lower long-term return
  - Investment strategy choice
  - Does not reduce net pension liability for GASB reporting
  - More visible
- **CalPERS**
  - Locked In
  - Likely higher long-term return
  - No investment choice
  - Reduces net pension liability for GASB reporting
  - More restricted

Assumptions for Section 115 Trust Projections

- Starting Balances at 6/30/2022
  - Miscellaneous: $26,375,724+2,273,824 = $28,649,549
  - Safety: $12,663,549+685,066 = $13,348,616
- Future trust earnings assumed to be 4.5%, for PARS Moderately Conservative fund.
- If the Section 115 Trust balance exceeds the CalPERS required contribution, the excess is transferred to CalPERS as an ADP.
  - Treated as a gain amortized (reducing future contributions) as a level 20-year amortization payment

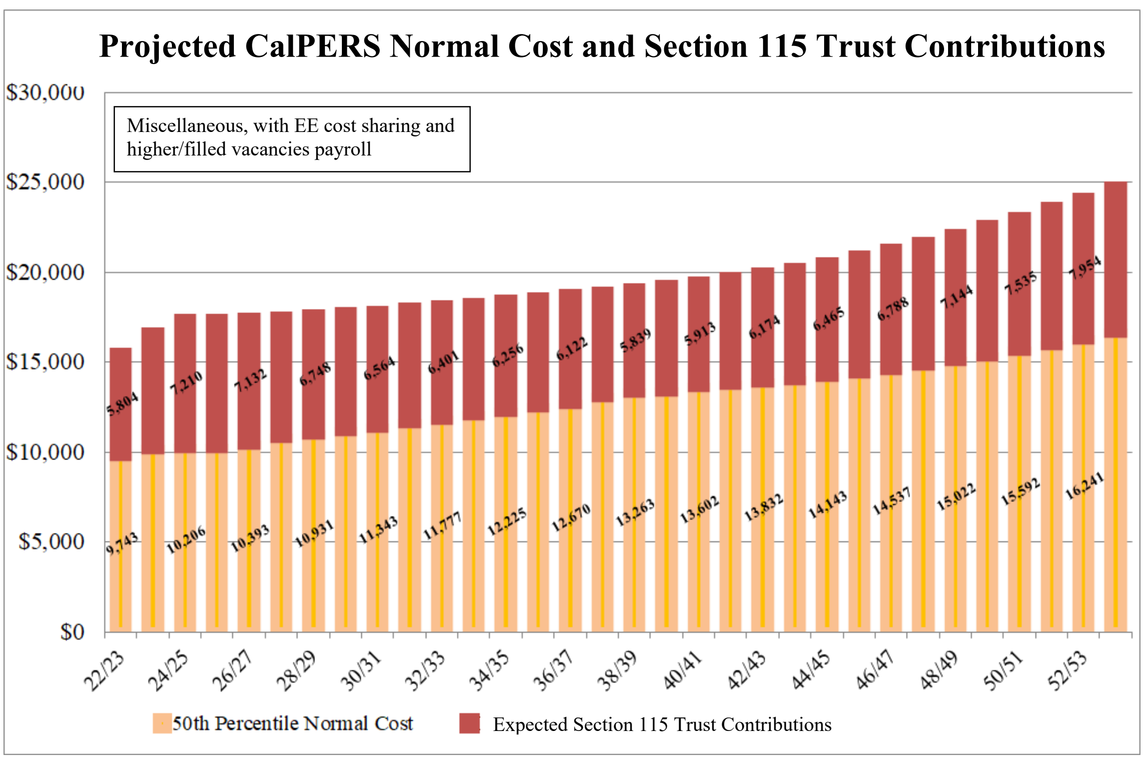
PROJECTED SECTION 115 TRUST CONTRIBUTIONS (MISC)

Projected Low Discount Rate Normal Cost[12]

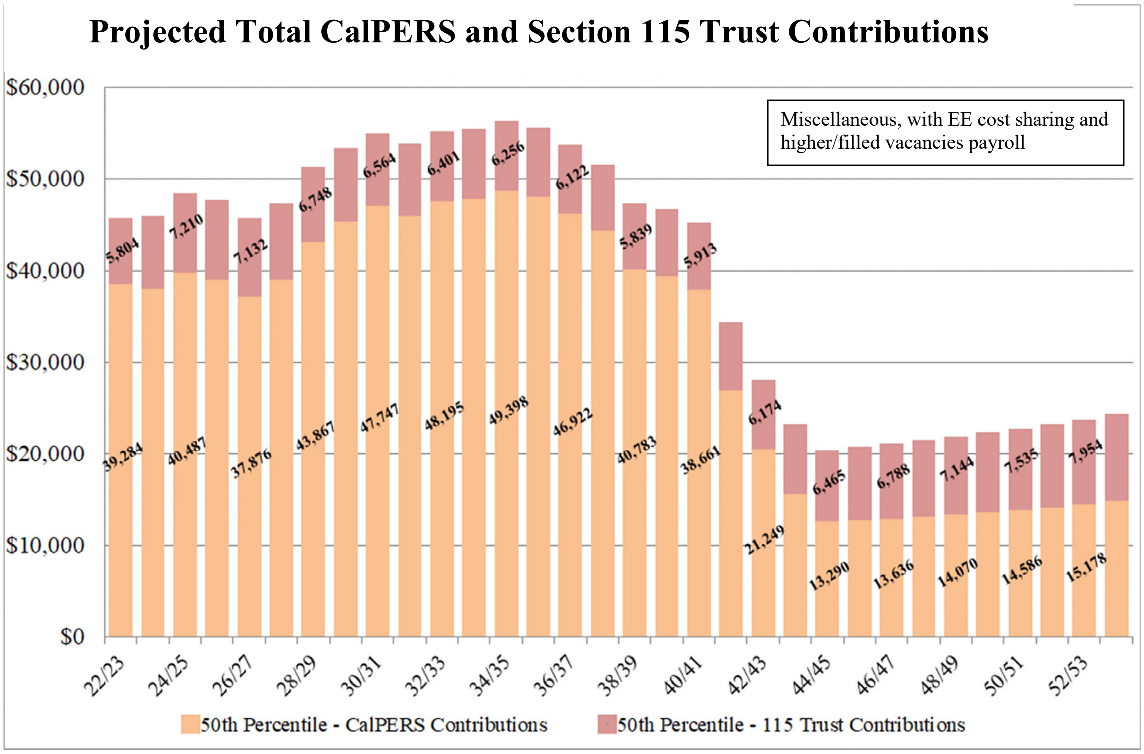
Fiscal Year	Current ER Normal Cost		Low Discount		
	Miscellaneous[13]	Safety	Discount Rates	ER Normal Cost Miscellaneous	ER Normal Cost Safety
2022/23	$11,250	$6,050	5.8%	$15,887	$ 8,194
2023/24	11,730	6,318	5.3%	18,243	9,280
2024/25	11,170	6,371	5.3%	18,380	9,381
2025/26	11,204	6,399	5.3%	18,456	9,455
2026/27	11,423	6,529	5.3%	18,555	9,541
2027/28	11,818	6,756	5.3%	18,668	9,640
2028/29	12,055	6,895	5.3%	18,803	9,742
2029/30	12,303	7,039	5.3%	18,956	9,851
2030/31	12,556	7,167	5.3%	19,120	9,945
2031/32	12,818	7,258	5.3%	19,299	10,000
2032/33	13,086	7,362	5.3%	19,487	10,073

[12] Includes movement from Classic to PEPRA employees.
[13] Includes higher “filled vacancies” payroll for Miscellaneous

PROJECTED SECTION 115 TRUST CONTRIBUTIONS (MISC)



NO TRANSFER FROM 115 TRUST TO CALPERS (MISC.)



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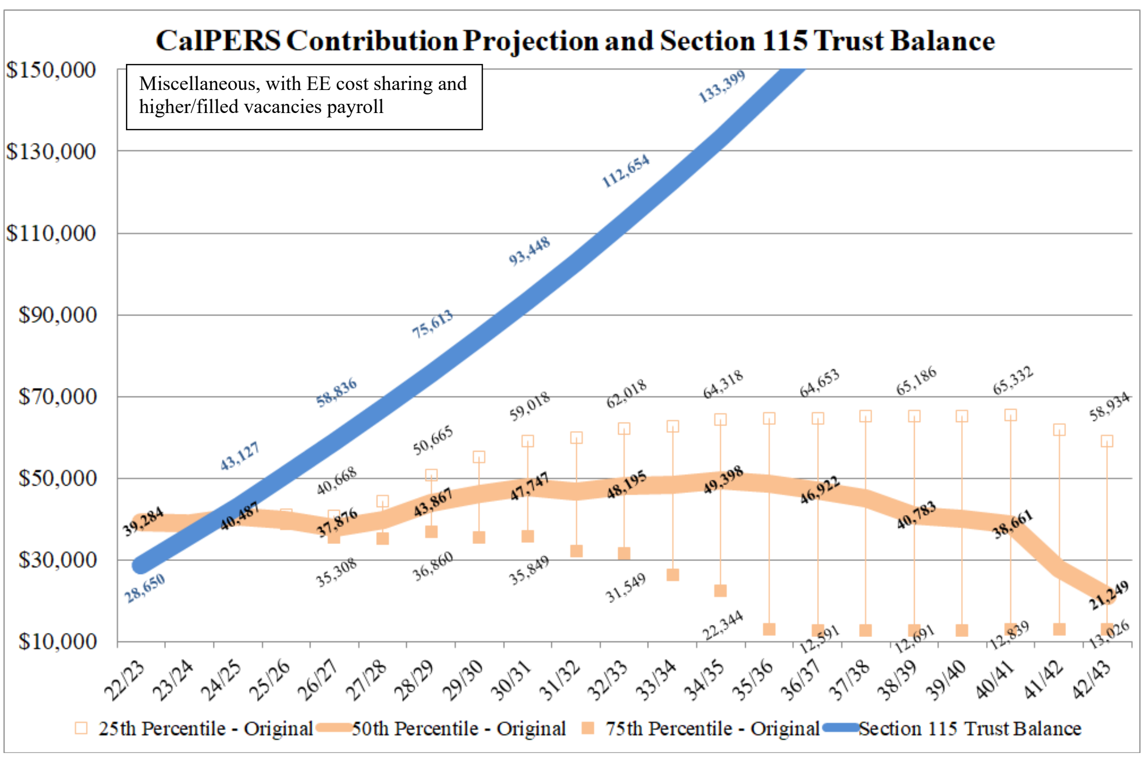

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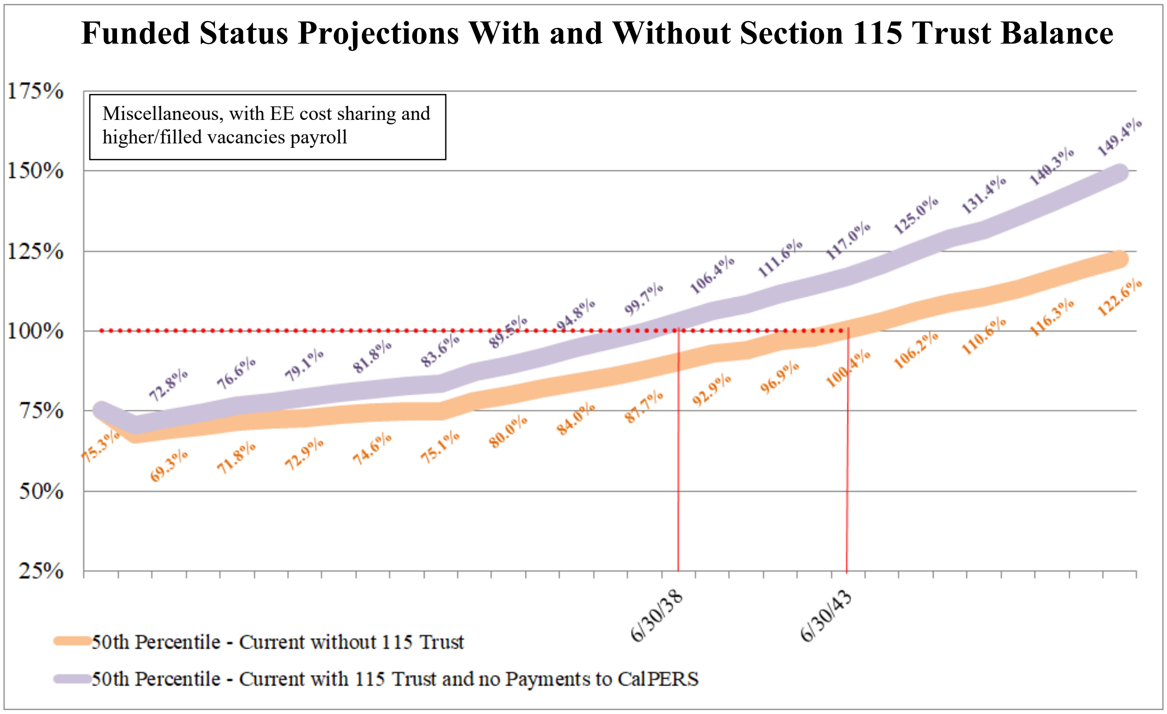

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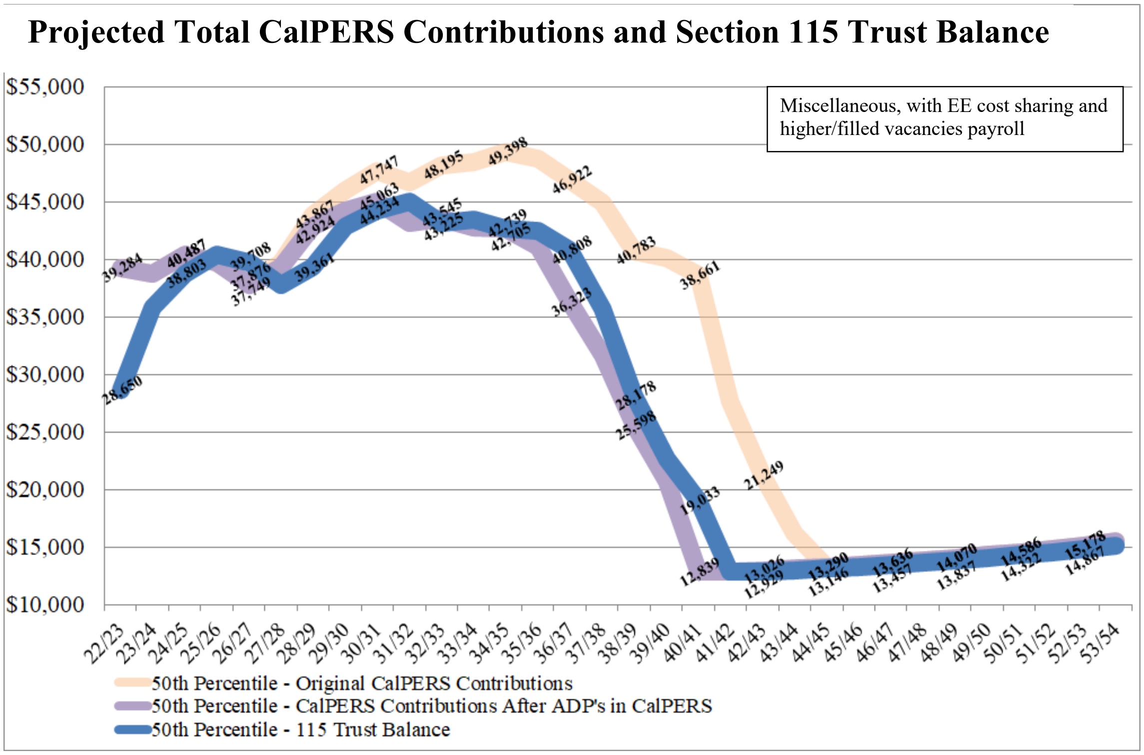
TRANSFERS FROM 115 TRUST TO CALPERS (MISC.)



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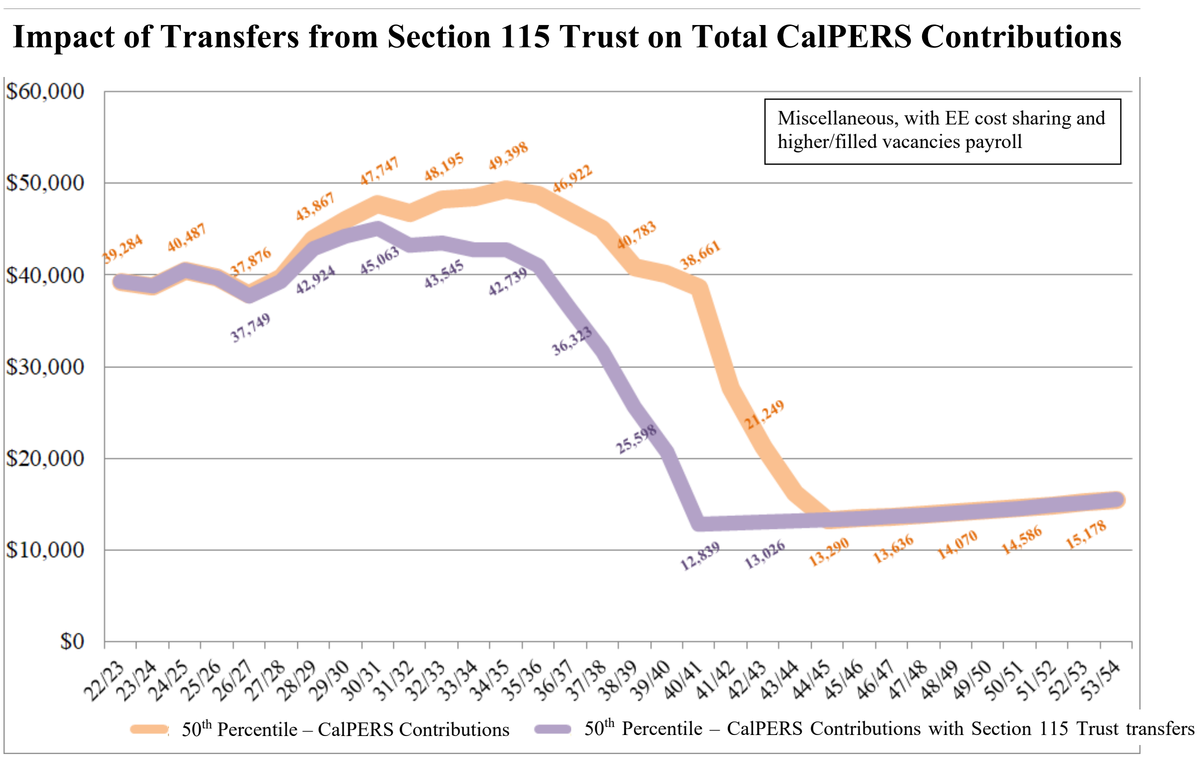

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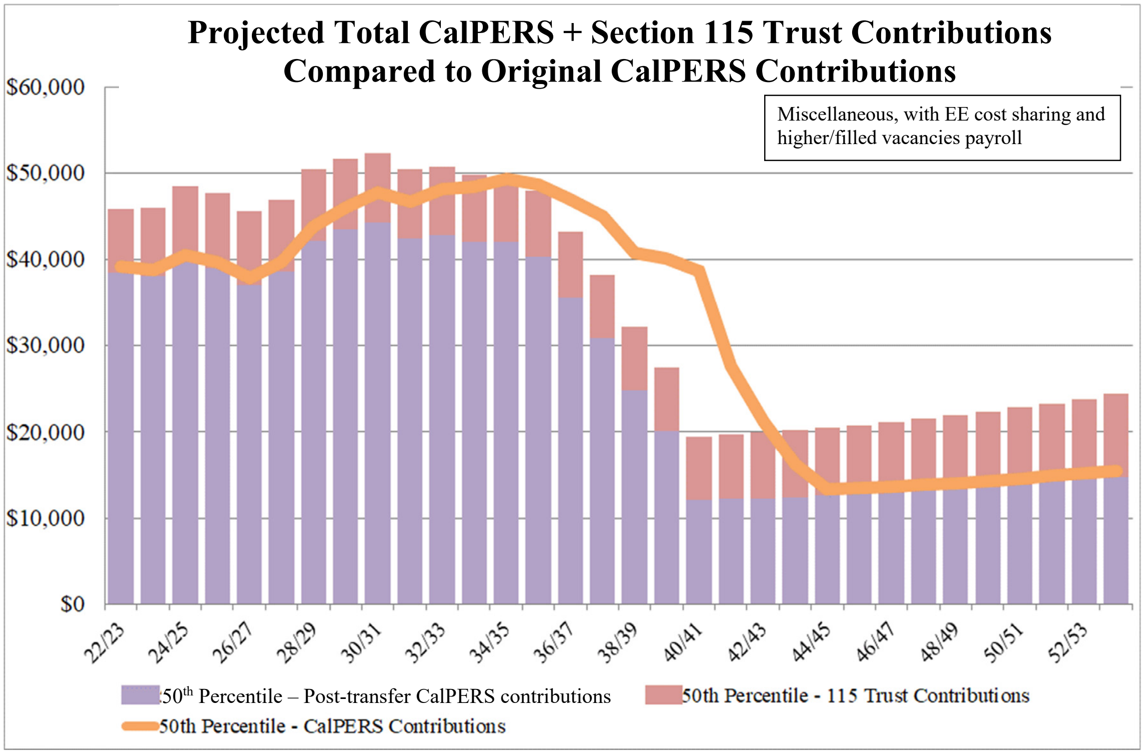

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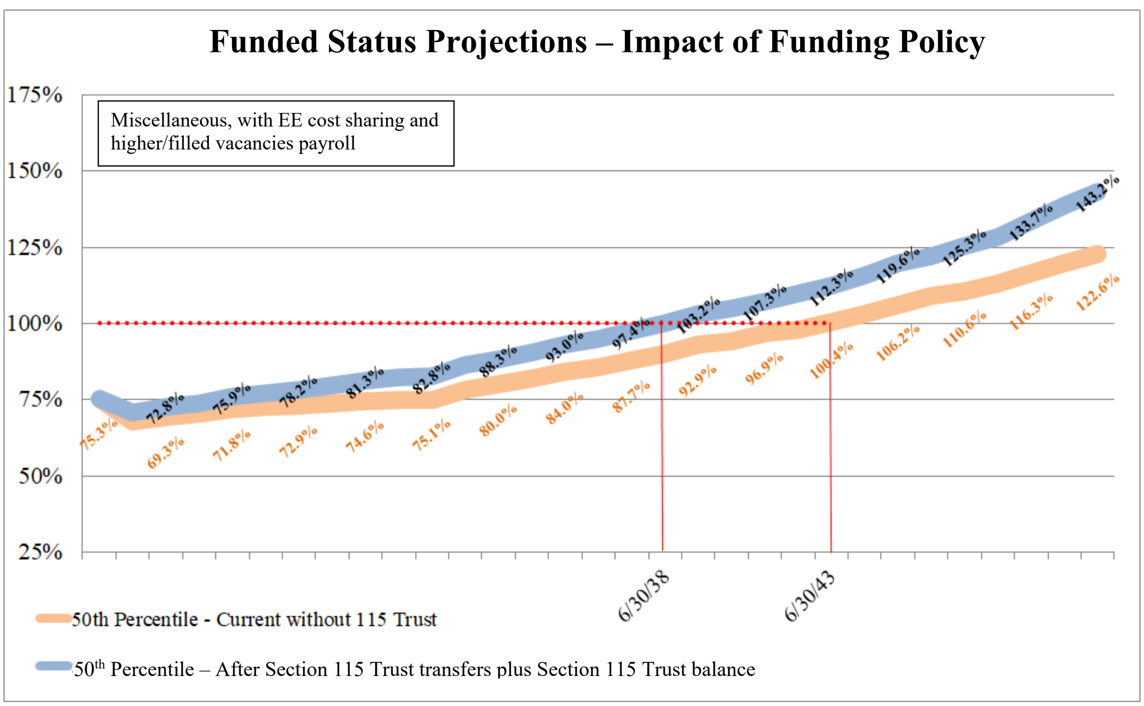
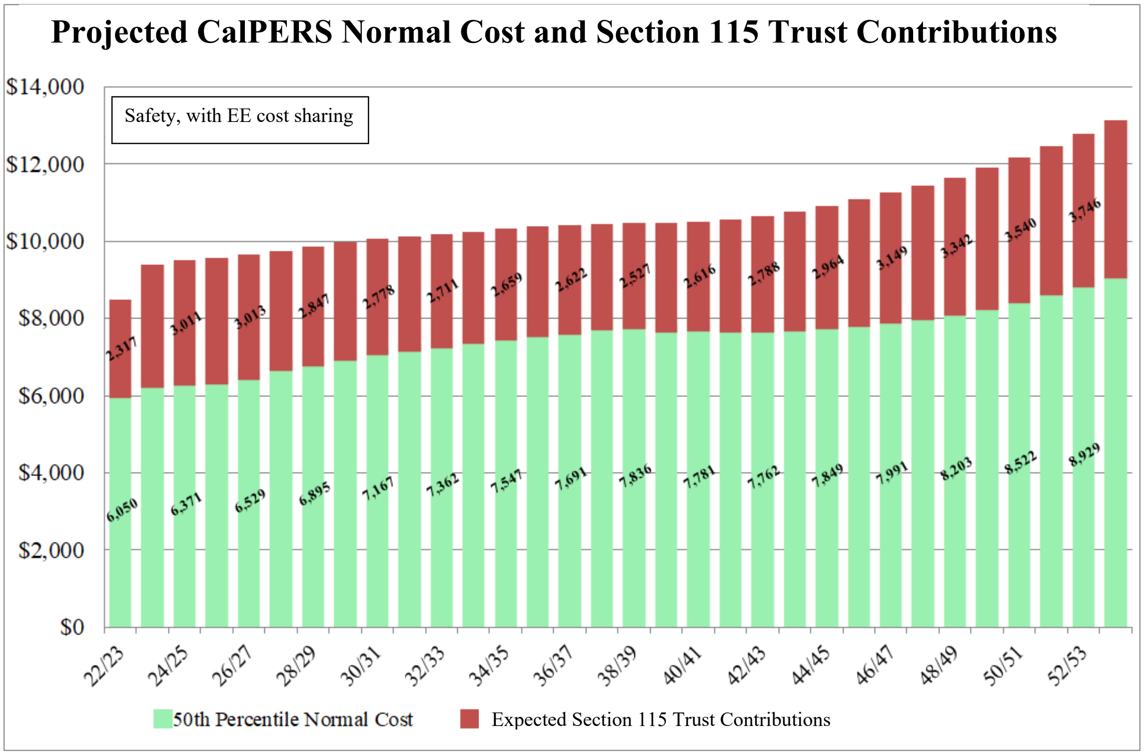
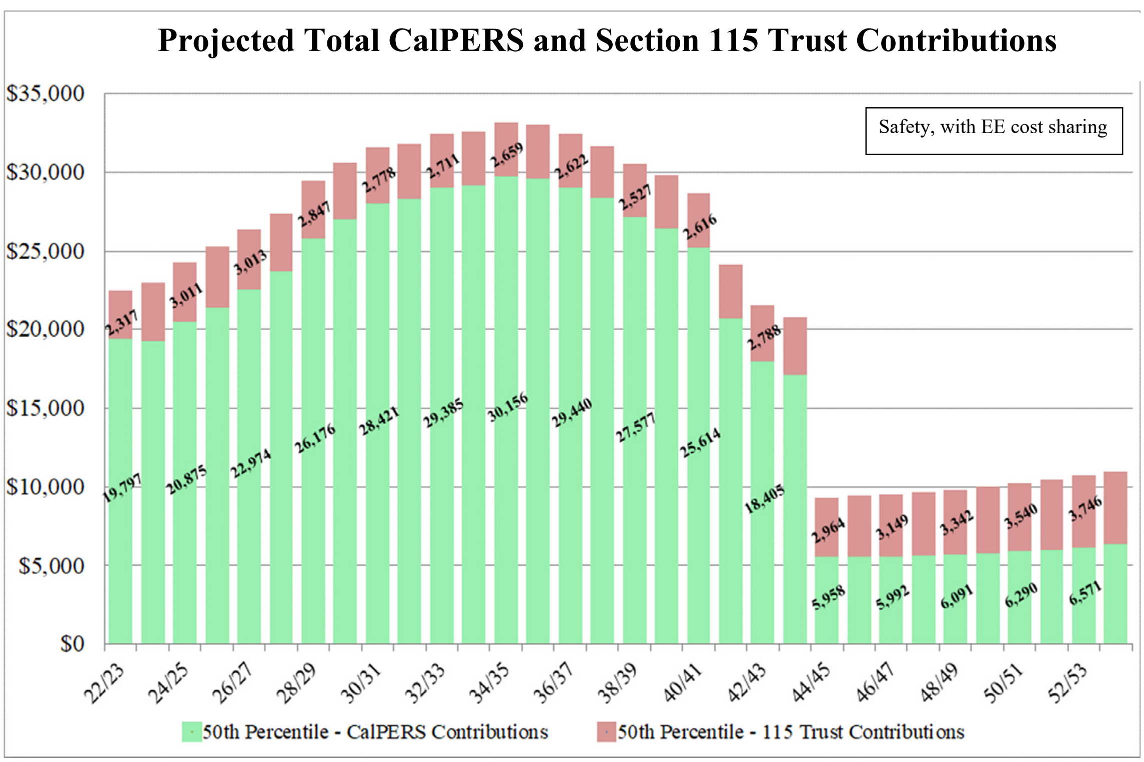


PROJECTED SECTION 115 TRUST CONTRIBUTIONS (SAFETY)



NO TRANSFER FROM 115 TRUST TO CALPERS (SAFETY)



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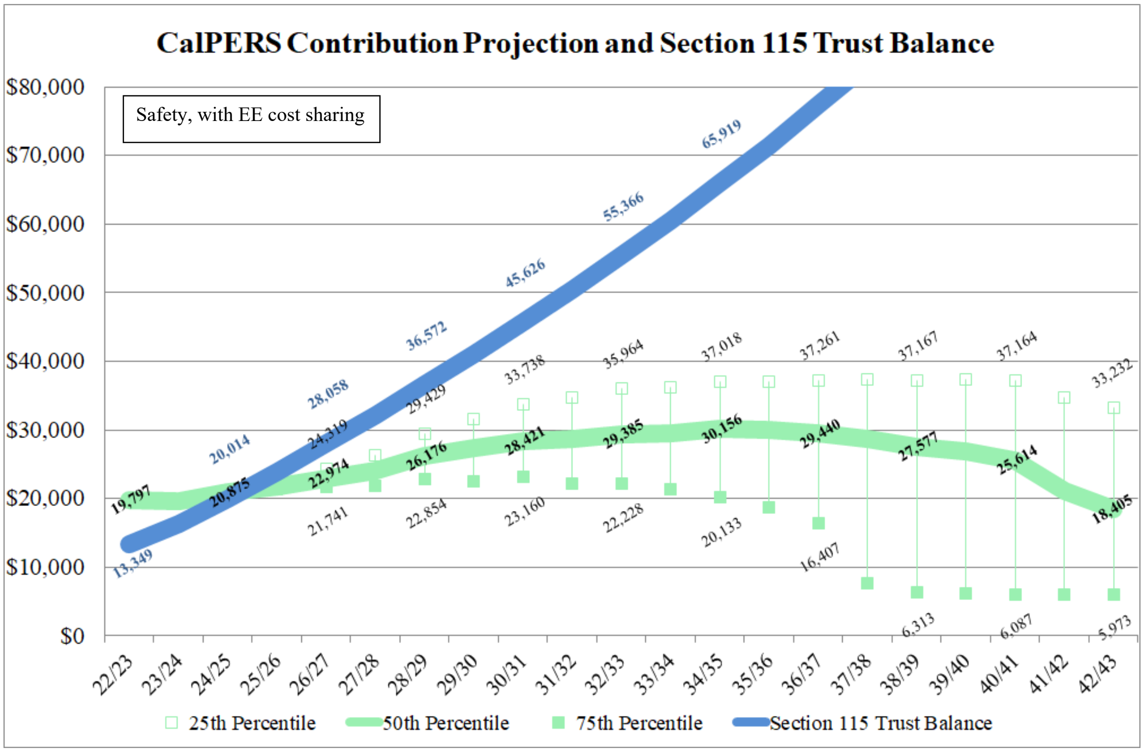

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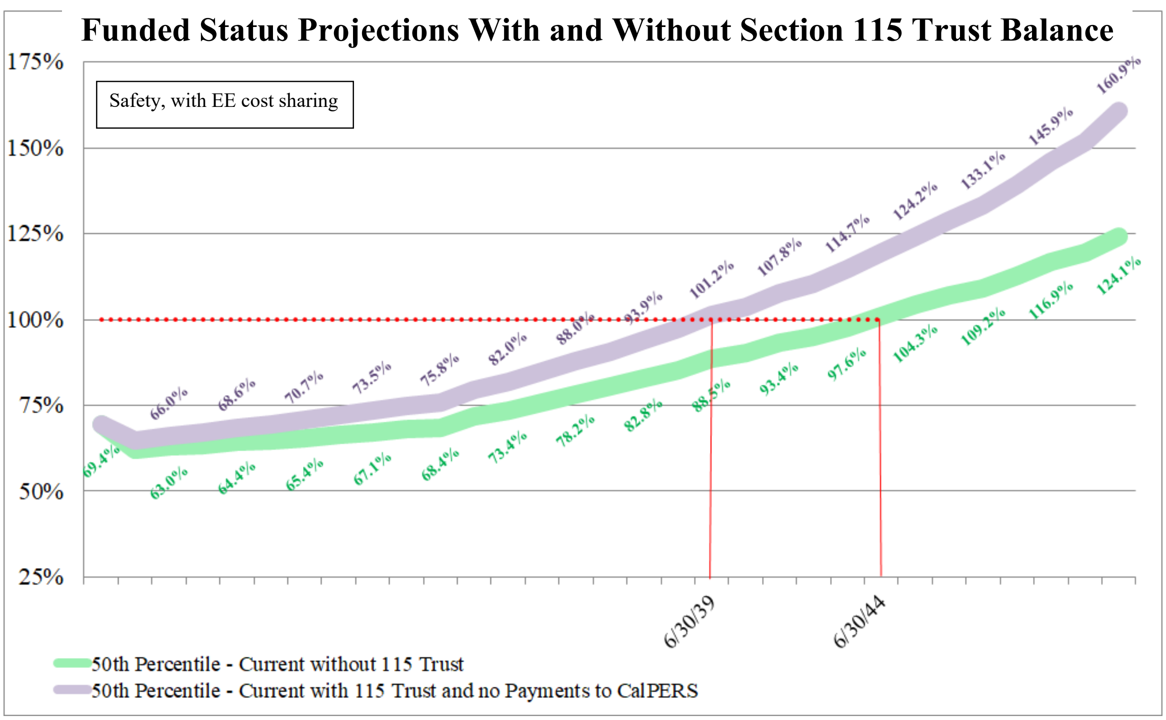

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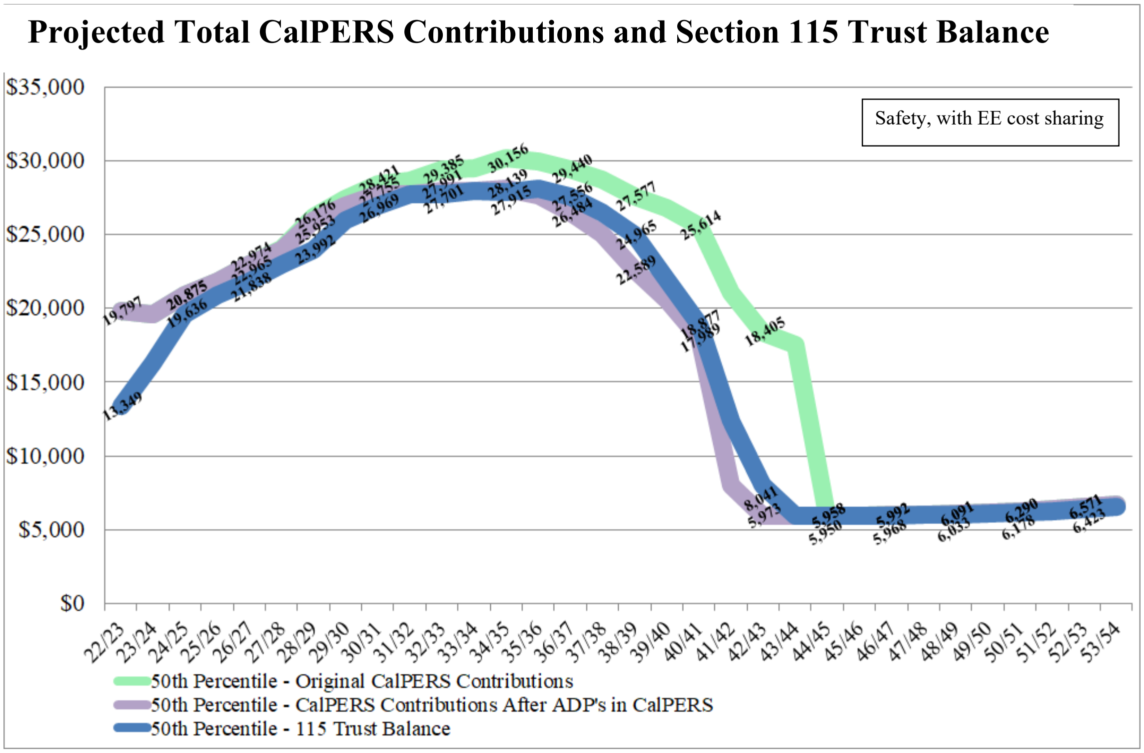

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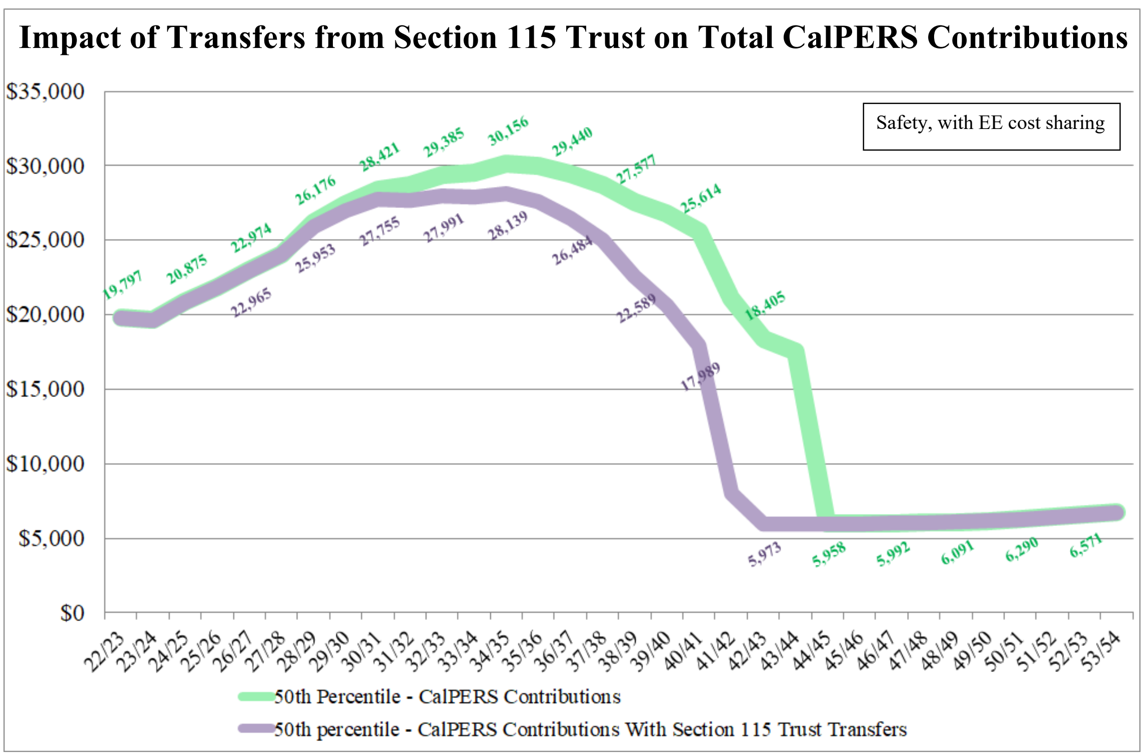

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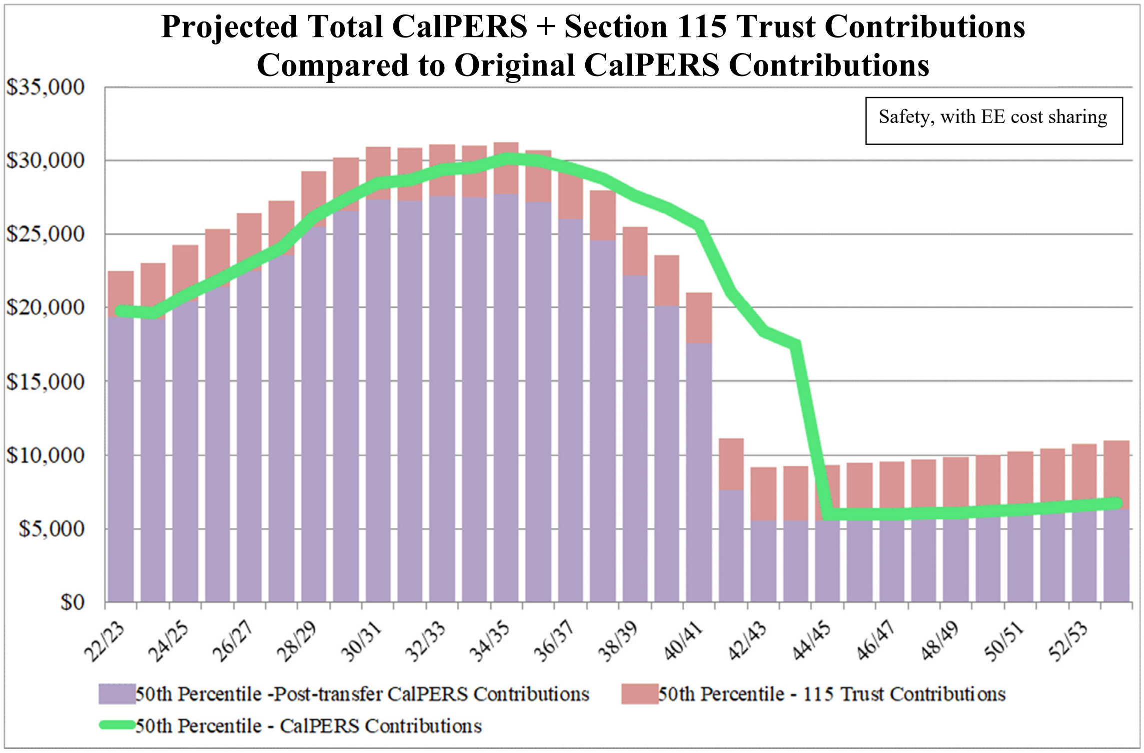

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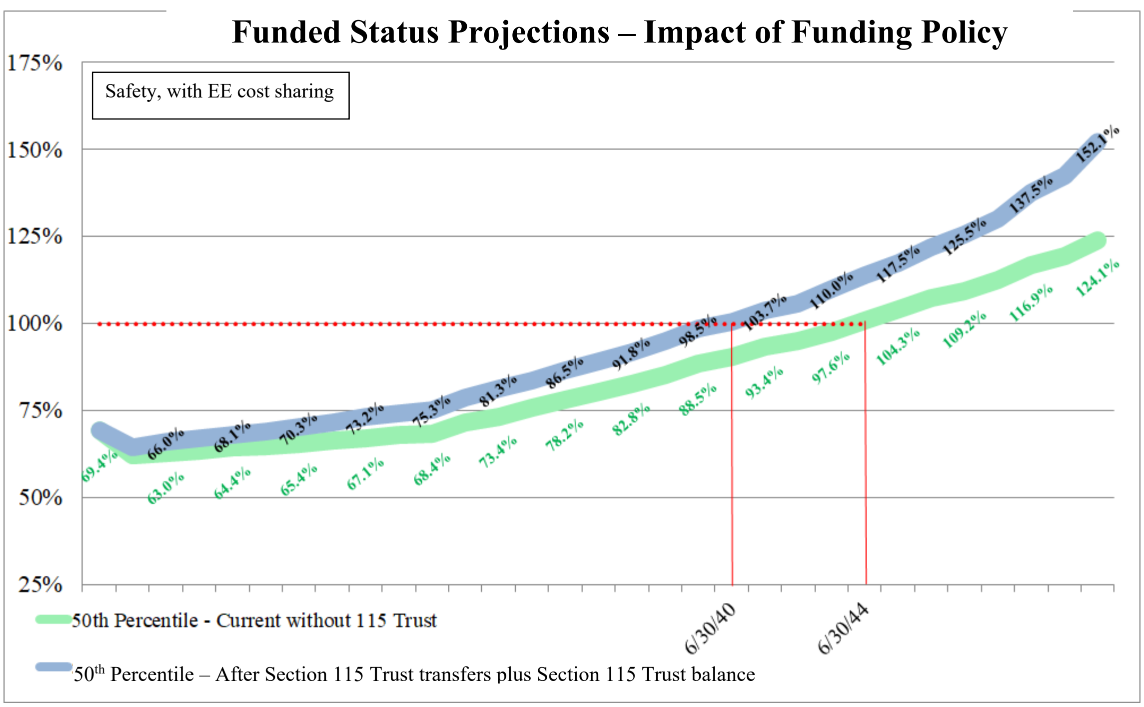

Actuarial Certification

This report presents analysis of the City of Palo Alto's CalPERS pension plans. The purpose of this report is to provide the City:

- Historical perspective on the plan investment returns, assets, funded status and contributions.
- Projections of likely future contributions and the impact of investment volatility

The calculations and projections in this report are based on information contained in the City's June 30, 2021 and earlier CalPERS actuarial valuation reports. We reviewed this information for reasonableness, but do not make any representation on the accuracy of the CalPERS reports.

Future investment returns and volatility are based on Foster & Foster's Capital Market model which results in long term returns summarized on page 25.

Future results may differ from our projections due to differences in actual experience as well as changes in plan provisions, CalPERS actuarial assumptions or methodology. Other than variations in investment return, this study does not analyze these.

To the best of our knowledge, this report is complete and accurate and has been conducted using generally accepted actuarial principles and practices. As members of the American Academy of Actuaries meeting the Academy Qualification Standards, we certify the actuarial results and opinions herein.

Respectfully submitted,

DRAFT

Mary Elizabeth Redding, FSA, EA, FCA, MAAA
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DRAFT

ATTACHMENT B: Pension Funding Policy Overview and Potential Revisions

	CalPERS Pension (baseline)	Current Pension Policy	Potential Policy Revisions	
Title	-	Pension Funding Policy	(-) Retiree Benefits Funding Policy; add similar language for OPEB	
Funded Status	100%	90%	-	
Time frame	30 years	15 Years (FY 2036)	-	
Funding Components	Actuarial Determined Contribution (ADC): ▪ Normal Cost (NC) or 'pay-go', and ▪ Unfunded Accrued Liability (UAL) amortized over 20 years (gains/losses)	(+) Use 6.2% discount rate for the calculation of Pension Normal Cost, more conservative than CalPERS 7.0% (+) 50% of excess BSR may be allocated for pension costs (all funds contribute equally)	▪ (+) Use the CalPERS ALM review or other external investment projections to inform discount rates for the calculation of supplemental contributions ▪ (+) Consider alternative calculations for economic and demographic assumptions to align with anticipated experience	
			<u>Pensions (FY23/FY24)</u> ▪ (-) Discount rate reduced from 6.2% to 5.3% for NC, phase-in over two years	<u>OPEB (FY23/24)</u> ▪ (+) Discount rate reduced from 6.25% to 5.75% for ADC ▪ (+) Alternative Assumptions[1]
	Employee Contributions	(+) Cost-sharing with employees	-	-
	Investment Returns	-	-	-
Investment Alternatives	-	(+) Pension Trust invested in a Moderately Conservative portfolio (+) OPEB/Retiree Healthcare Trust (CERBT) invested in a Strategy 1 portfolio	<u>Pension Trust</u> ▪ (+) More conservative strategy when reach 75-80% funded status	<u>OPEB Trust</u> ▪ (+) More conservative strategy when reach 75-80% funded status or when actuary recommends disbursements (first to occur); set aside 2-3 years of estimated disbursements

[1] Finance Committee on June 7, 2022 approved several alternative assumptions for OPEB ADC including a zero percent return for 2021-22 (one-time), 5.75% discount rate (6.25% assumed for Strategy 1), shortened amortization from 22 to 15 years, and additional funding for new staff (CMR 14112 as amended by CMR 14502)

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Allowable Uses of Funding	The CalPERS Trust is used to pay retiree pension benefits for miscellaneous and safety plans and does not contemplate use of the City's Pension Trust	Use of Pension Trust to be addressed through annual budget process or separate City Council approved action. City Manager to identify Impacts to funding goal and timeframe Additional Discretionary Payments (ADPs) from PARS to CalPERS for amounts exceeding 1-yr employer contribution	Pension Trust ▪ (+) Rate stabilization to smooth volatility in employer contributions, or in difficult economic times ▪ (-) Additional Discretionary Payments (ADPs) ○ Alternative 1: No ADPs ○ Alternative 2: ADPs for excess BSR and/or normal cost	OPEB Trust ▪ (+) Actuarial determined disbursements recommended to fund a portion of the 'pay-go' costs once investment goals are met (above)
Reporting Requirements	-	Every three years, staff will consult with an actuary to inform the City Council on the progress towards goals	▪ (-) Every four years; align with the CalPERS ALM study	
	-	Status of Pension Trust reported in the annual budget process, including recommended contributions and potential ADPs for the coming fiscal year	-	OPEB Trust ▪ (+) Status of OPEB Trust reported bi-annually using outside actuary consultancy services (current practice)
(+) Indicates that this is in addition to the step to the left while (-) indicates that this is instead of the step to the left.				