



City of Palo Alto

Finance Committee Staff Report

(ID # 11844)

Report Type: Action Items

Meeting Date: 12/15/2020

Council Priority: Fiscal Sustainability

Summary Title: Preliminary General Fund Forecast Fiscal Year 2022

Title: Review and Recommend That the City Council Accept a Preliminary Forecast for Fiscal Year (FY) 2022 and FY 2022 Budget Development Guidelines

From: City Manager

Lead Department: Administrative Services

RECOMMENDATION

Staff recommends that the Finance Committee review and recommend that the City Council accept the General Fund preliminary forecast for Fiscal Year (FY) 2022 and the FY 2022 annual Budget Development Guiding Principles (Attachment A) and direct staff to use this forecast as the starting point for the initiation of the FY 2022 budget process.

EXECUTIVE SUMMARY

Historically, the City has presented a ten-year General Fund Long Range Financial Forecast (LRFF) in December that marks the beginning of the annual budget process. Based on the current economic climate and continued unknown impacts of the COVID-19 pandemic, staff is presenting a preliminary forecast that focuses on FY 2022 in order to highlight the near-term view and begin discussions around the FY 2022 budget process. This preliminary forecast is based on the most current information available, estimated revenues for FY 2021, and expected experience through FY 2022. General Fund expenditures are based on current City Council approved service levels compared to projected revenues over the next year.

This preliminary General Fund forecast projects a gap of \$4.7 million in FY 2022. This forecast should be used for planning purposes; a data point to assist the City Council as it considers any policy changes and prospective impacts against a likely “status quo” version of the future. As to be expected, the level of uncertainty in this forecast is at historically high levels. The City continues to manage through a pandemic unlike any seen in modern history.

City staff will continue to review and refine these projections to establish the FY 2022 budget and use this preliminary forecast to begin internal planning for budget balancing solutions.

Based on this forecast, it is anticipated that the prioritization of spending and consideration of reduction in costs are necessary to ensure continued financial stability. More detailed guidelines or Budget Policies to inform the development of the FY 2022 budget are discussed at the end of this document (Attachment A).

Looking forward, the City continues to face several fiscal pressures ranging from the financial impacts of the COVID-19 shelter in place and stay at home orders and funding the 2014 Council approved Infrastructure Plan projects, to the growing costs of pension benefits and labor costs due to the current labor market and cost of living around Palo Alto. The continued policy direction from the City Council regarding proactively addressing the pension obligations, including the direction to assume a lower discount rate in calculating pension costs, is contained in the forecast model. The City continues to face critical choices to balance short term reductions in revenue projections based on the current economic situation and unknown impacts of the pandemic, with future financial challenges including any unforeseen program needs, and any additional proactive funding contributions to pension liabilities. The review of this preliminary forecast and the fiscal and budget planning that follows is significant as the City Council weighs current community requests like reducing rent to tenants and several key programs that the community would like the City to fund and move forward.

Included in this report and subsequent documents are the following:

- Discussion of the current financial climate of the United States to the local economy of the City of Palo Alto
- Preliminary forecast including Revenue and Expense assumptions in FY 2022
 - o Current financial status of the General Fund as of the FY 2021 Adopted Budget, and a brief discussion of revised FY 2021 revenue estimates by category
- Alternate revenue assumptions to demonstrate a range of outcomes that could happen depending on the resolution of many unknown factors surrounding the economic impacts from the COVID-19 pandemic
- FY 2022 Budget Development Guidelines to inform the Budget process (Attachment A)

BACKGROUND

A preliminary forecast for FY 2022 is being presented instead of the normal ten-year General Fund Long Range Financial Forecast (LRFF) based on the current economic situation and continued unknown impacts of the COVID-19 pandemic. The forecast for FY 2022 reflects staff's best estimates on the projected revenues and expenditures based on the information that is currently available at this time. It is important to note that this forecast 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 this forecast that will be revised and refined as more information becomes available through the FY 2022 budget development process. As the pandemic continues to evolve, and State and County restrictions change, it is important that our planning continue to adapt to the changing elements of the pandemic and potential for vaccine distribution.

This preliminary forecast 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 workforce, and the current labor contracts in effect. This forecast also assumes the service changes approved in the FY 2021 Adopted Budget continue through FY 2022. Many approved budget adjustments assumed possible restoration after two years, and this forecast assumes that direction continues based on ongoing impacts from the COVID-19 pandemic and subsequent review of the current economy and various economically sensitive revenues such as Sales Tax, Documentary Transfer Tax, Property Tax, and Transient Occupancy Tax.

Since the Great Recession, the City has approved many strategies to mitigate rising costs, especially the growth in salaries and benefits. Strategies that have been used include: a second pension tier, employees sharing in health plan cost increases, and shifting from employer-paid member contributions to employee pick-up of a portion of the employer share for pensions. These strategies have helped to create the financial capacity to invest proactively in the City's Pension Trust, supporting the City's commitments to employees while ensuring fiscal sustainability.

The City Council continues to invest in the community and approved significant improvements in June 2014 with the Infrastructure Plan (IP) in the original amount of \$125.8 million. However, the nine projects identified in the plan are estimated to cost substantially more due to updated designs, rising construction costs, and minimum and prevailing wage requirements. In addition, a tenth project was approved by the Council to be added to the IP in the FY 2020 Adopted Budget. These changes have led to an updated cost of approximately \$260.5 million for the IP projects. The largest of the IP projects is the New Public Safety Building budgeted at an estimated cost of \$118.0 million, is planned for construction award in FY 2021. The estimated annual debt service costs associated with the bond funding for the project is a long-term cost that will be evaluated by the City Council before awarding the construction contract. Capital projects are one example of known items that are not fully included in this Forecast. Both the capital cost to build and the operating and maintenance costs once projects are completed and the new facilities are actively used, are estimated with the most current information available. These estimates will be refined during the budget process as more information becomes available and the projects are closer to award and completion.

The City Council provided direction on May 4, 2020 (staff report [11315](#)) to assume a conservative revenue estimate, a loss of \$39 million in General Fund tax revenues, in the development of the FY 2021 budget. This reflected the severity of the current public health emergency and its impacts on the City's financial status. The City Council reviewed the FY 2021 Proposed Operating Budget along with staff reports [11322](#) and [11376](#) and other at places materials over the course of a series of public budget hearings that took place May 11 through May 13, 2020 and provided tentative approvals, changes, and areas for further follow up. These actions resulted in revenue and expense adjustments to the FY 2021 Proposed Budget. The City

Council adopted a balanced budget that incorporated all feedback and changes from the budget hearings in staff report [11330](#) on June 22, 2020. Approximately half of the expense reductions were executed through service reductions in General Fund departments. Those adjustments are summarized below and outlined in detail in staff report 11330. This forecast assumes that these service reductions continue in FY 2022 as noted during the budget deliberations and adopted by the City Council in June 2020.

Public Safety: FY 2021 adjustments included an increase of \$1.55 million in program revenues and a reduction of \$7.3 million in expenses in the General Fund, including 33.27 full-time and 2.28 part-time staffing freezes. These actions included suspensions of specialized police units such as the traffic enforcement and investigation units to maintain minimal police patrol services and shift the priority of police services to urgent calls, lowering capacity to respond to nonurgent calls. Limited officer training, promotional testing, uniform purchases and eliminated or changed to full cost recovery for non-essential programming such as school resource officers. Curtailed 9-1-1 dispatch, police communication and community engagement, and emergency preparedness services, as well as modified fire emergency incident response and training and work to adopt fees to increase revenue for first responder and ambulance subscription.

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

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

Internal Services & Council Appointed Officers: FY 2021 reductions included \$2.9 million in operating expenses in the General Fund, including 5.9 full-time and 0.96 part time staffing freezes. Internal Services departments include the Information Technology, Human Resources,

and Administrative Services Departments as well as the Council and appointed officers (City Manager, City Attorney, City Auditor and City Clerk). Reductions in these areas align with the changes in services, increasing timeframes for assistance and review in areas such as recruitments, procurements, performance reporting, and risk management. Technology solutions will be constrained to only essential contracts and systems and support equipment needs as most of our workforce continues to work from home. The City Council, Innovation and Special Events, and Human Resources contingency accounts were eliminated in FY 2021 on a one-time basis.

Since this time of course, staff has reported to the Council that as the City and the County move through different phases of pandemic recovery, the City adapts operations to best support and serve the community. As a result of County Public Health Orders and State Public Health restrictions, these changes impact both the cost of delivering City services and the revenues that pay for them (both taxes and fees). Often, staff finds that it takes increased resources to deliver the same quantity of service in modified ways to ensure the safety of the community and employees. For example, the library is offering sidewalk services at some City libraries. To offer these services staff must manually process each item several times, where past practice allowed use of automation to return and sort materials. ([CMR #11596](#))

The Economy

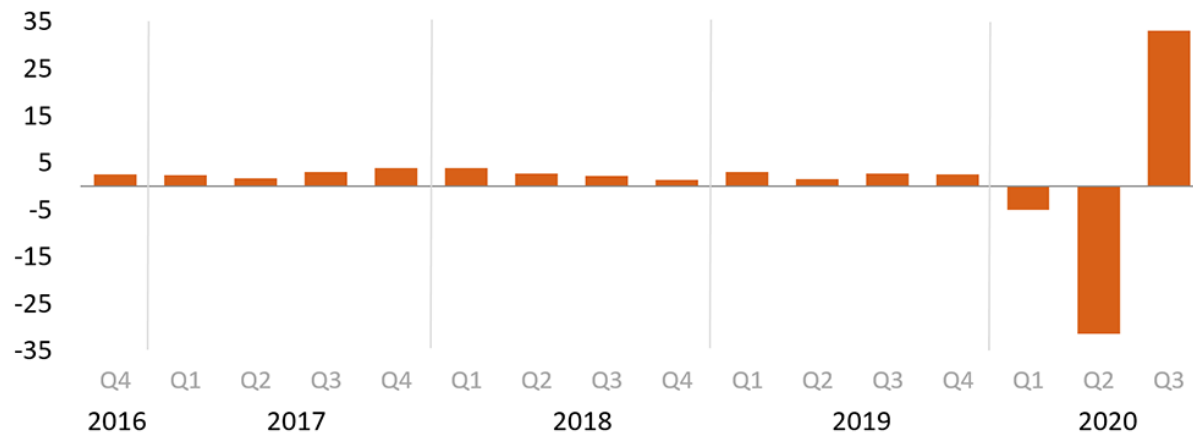
National, state, regional and local economic indicators show promising third quarter calendar year 2020 results and economic recovery relies on continued resumption of economic activity, a viable vaccine, and containing the spread of COVID-19. The economic indicators discussed below are as of the third quarter of calendar year 2020. The full economic effects of the COVID-19 pandemic and its recent resurgence is difficult to predict and becomes less certain as the new round of virus spread has led to activity restrictions in Santa Clara County and across the Bay Area, state and nation. Although Federal stimulus packages have contributed to the positive economic indicators at the end of the third quarter, two more months have passed without a new federal stimulus package as some income and business supports will expire by year end. More restaurants and other small businesses in Palo Alto have closed either temporarily or permanently. While there has been recent positive news regarding a coronavirus vaccine, major benefits are not expected until the next fiscal year when distribution is widespread.

Staff will continue to monitor short-term economic trends and report back to the Council as new information is available. At the time of the printing of this report, the statistics of managing the spread of the virus continue to show alarming trends that may significantly impact the data from third quarter calendar year 2020 and ultimately FY 2021 forecasts. This uncertainty is clear in the daily communications throughout the state including the current stay at home orders issued this week by the Governor.

According to the US Bureau of Economic Analysis, the U.S. economy's national gross domestic product (GDP) grew by 33.1 percent in the third quarter of calendar year 2020 following a

record plunge of 31.4 percent in the second quarter. The increase in the third quarter reflects a surge in personal spending as efforts to reopen businesses and resume activities that were postponed or restricted due to the COVID-19 pandemic. The national consumer price index (CPI), as of the third calendar quarter has grown 0.2 percent and trails behind larger increases in July and August, respectively 0.6 percent and 0.4 percent. The following graphs depict the GDP over the past few years.

Table 1:
Real GDP: Percent change from preceding quarter

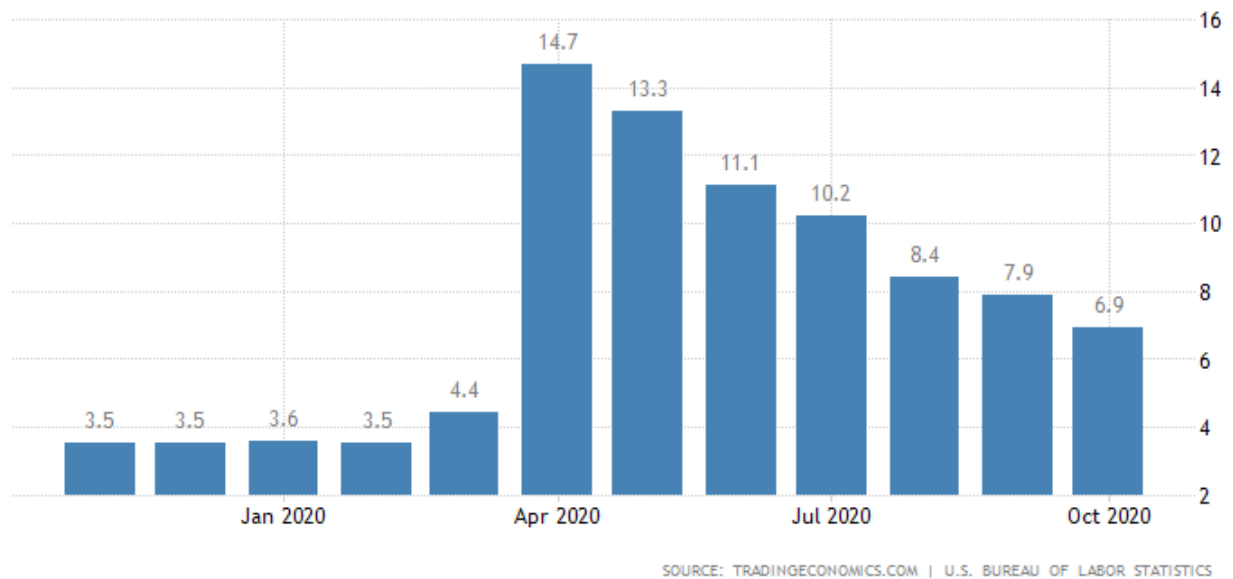


U.S. Bureau of Economic Analysis

Seasonally adjusted at annual rates

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

Table 2: U.S. Unemployment Rate



DISCUSSION

As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document. For example, General Fund revenues may exceed or fall below expectations based on changes in economic or non-economic conditions. Various cost elements can also vary from year to year.

The following table displays the actual General Fund revenues and expenditures for FY 2019 and FY 2020, the FY 2021 Adopted Budget, and forecasted revenue and expenditure amounts for FY 2021 and FY 2022. The hard work of the City in FY 2021 to proactively balance the budget due to estimated COVID-19 financial impacts is reflected in the forecast. However, due to the continued public health crisis and recent surge that caused the State and County to issue more restrictive “purple tier” orders and risk reduction orders, promising economic indicators seen in the third quarter of calendar year 2020 are annulled and replaced by uncertainty. The forecasted FY 2021 and FY 2022 amounts reflect this uncertainty, and the forecast contemplates no restoration of service reductions implemented in FY 2021.

Alternative forecasted revenue scenarios are presented to illustrate how changes in the City’s economically sensitive revenues, sales tax and transient occupancy tax (TOT), may impact the General Fund’s bottom line surplus or budget gap. The table below models how a one, 10, and 15 percent increase in sales tax and TOT will change the City’s FY 2022 financial picture, assuming expenditure levels remain the same.

When compared to the FY 2021 Adopted Budget, the revenue forecast for FY 2021 decreases by 1.8 percent and is driven by decreases in economically sensitive tax revenues. It is estimated that FY 2022 will result in a \$4.7 million budget shortfall and this gap is mainly the result of increases to Salary and Benefit costs including the restoration of concessions taken in FY 2021

by Management/Professional employees and the City's Public Safety labor groups (Police Officers Association, Police Management Association, International Association of Fire Fighters, Fire Chief's Association). Further information and analysis of the constantly changing fiscal impacts from the public health crisis will continue to inform the development of the FY 2022 Budget to proactively plan for changes and ensure a structurally balanced budget.

TABLE 3: FY 2021 and 2022 Forecasts

	Actual 2019	Actual 2020	Adopted 2021	Forecast 2021	Forecast 2022	% Chg	FY 2022 Revenue Sensitivity Models		
							1.0%	10.0%	15.0%
Total Revenue	225,756	209,516	196,475	192,928	198,848	3%	199,235	202,716	204,650
Total Expenditures	223,475	227,015	196,949	192,570	203,555	6%	203,618	204,185	204,499
Net One-Time Surplus/(Gap)	\$2,281	(\$17,499)	(\$474)	\$358	(\$4,707)		(\$4,383)	(\$1,469)	\$151

The FY 2021 Adopted Budget is balanced. The budget gap shown in this table is offset by utilization of the Development Services Reserve Fund.

Revenue Assumptions

On October 19, 2020, the City Council reviewed and discussed the preliminary Q1 FY 2021 financial status report (staff report [11596](#)). This report provided a snapshot in time, with some revenues expected to continue to do significantly worse than originally projected, others are trending above expected levels, while uncertainty of the pandemic grows. Tax revenues constitute slightly more than 60 percent of General Fund resources and the FY 2021 forecast projects a 3.3 percent, or \$3.4 million, decrease that is driven by TOT revenues being lower than expected. In FY 2022, the forecast projects a \$7.7 million, or 7.0 percent, tax revenue increase compared to the FY 2021 forecast. These tax increases are partially offset by reductions in other revenue categories.

At the present time, this preliminary forecast projects an increase in revenues of \$5.9 million, or 3.1 percent, in FY 2022. The FY 2022 forecast assumes that sales tax will rebound from conservative levels assumed in the FY 2021 Adopted Budget and, in contrast, TOT will decrease based on occupancy and room rate trends since April 2020. The changes by revenue category, as well as the current expected FY 2021 status of many of the categories, are discussed in greater detail below. The table below models alternative revenue scenarios for sales tax and TOT revenues; if these tax revenues were to trend higher by one percent, 10 percent, and 15 percent compared to the FY 2022 Forecast.

TABLE 4: General Fund Revenue Summary

	Actual 2019	Actual 2020	Adopted 2021	Forecast 2021	Forecast 2022	% Chg	FY 2022 Revenue Sensitivity Models		
							1.0%	10.0%	15.0%
Revenue & Other Sources									
Sales Taxes	36,508	30,563	20,500	24,000	28,230	18%	28,512	31,053	32,465
Property Taxes	47,327	51,089	52,000	53,173	50,223	-6%	50,223	50,223	50,223
Transient Occupancy Tax									
General Purpose	16,957	11,568	8,344	2,573	4,155	61%	4,196	4,570	4,778
Infrastructure	8,692	6,986	6,556	2,177	6,295	189%	6,358	6,925	7,240
Documentary Transfer Tax	6,923	6,903	4,700	6,577	6,828	4%	6,828	6,828	6,828
Utility Users Tax	16,402	16,140	15,100	15,153	15,614	3%	15,614	15,614	15,614
Other Taxes and Fines	1,888	1,172	1,925	1,925	1,925	0%	1,925	1,925	1,925
Subtotal: Taxes	134,697	124,421	109,125	105,578	113,270	7%	113,657	117,138	119,072
Charges for Services	26,669	23,557	25,418	25,418	24,934	-2%	24,934	24,934	24,934
Permits and Licenses	9,088	8,038	8,336	8,336	8,273	-1%	8,273	8,273	8,273
Return on Investments	2,018	1,419	1,100	1,100	894	-19%	894	894	894
Rental Income	16,411	16,037	16,022	16,022	15,531	-3%	15,531	15,531	15,531
From Other Agencies	951	1,529	551	551	551	0%	551	551	551
Charges to Other Funds	10,684	11,099	11,992	11,992	11,494	-4%	11,494	11,494	11,494
Other Revenue	5,084	2,848	2,572	2,572	2,539	-1%	2,539	2,539	2,539
Total: Non-Tax Revenue	70,905	64,527	65,991	65,991	64,216	-3%	64,216	64,216	64,216
Operating Transfers-In	20,154	20,568	21,359	21,359	21,362	0%	21,362	21,362	21,362
Total Sources of Funds	\$225,756	\$209,516	196,475	\$192,928	198,848	3%	\$199,235	\$202,716	\$204,650
Total Expenditures	223,475	227,015	196,949	192,570	203,555		203,618	204,185	204,499
Net One-Time Surplus/(Gap)	\$2,281	(\$17,499)	(\$474)	\$358	(\$4,707)		(\$4,383)	(\$1,469)	\$151

The FY 2021 Adopted Budget is balanced. The budget gap shown in this table is offset by utilization of the Development Services Reserve Fund.

Sales Tax

Sales tax receipts have seen significant declines as the City's revenue base is dependent on many high-end goods and dining options at regional destinations, such as Stanford Shopping Center. The City saw a greater decline in four categories than declines seen in the region and statewide. These significant declines were partially offset by business to business sales, the one sector that outpaced other areas with a small 1 percent growth. Based on activity and receipts for the recent quarter, it is estimated that sales tax revenue will exceed the FY 2021 Adopted Budget by \$3.7 million, or 17.9 percent, and will generate a total of \$24.0 million by year-end of FY 2021. In FY 2022, sales tax is expected increase to \$28.2 million, or 18.0 percent, above the revised FY 2021 forecast. Segments contributing to this growth include restaurants, office equipment, and auto sales and leases. Department and furniture/appliance sales experienced declines.

Property Tax

Property tax revenue is the General Fund's largest revenue source and represents approximately 25 percent total revenues. Historically, property tax has seen annual growth of on average 6 percent. Although not in decline, trends currently indicate a delay in timing and therefore are expected to remain flat through FY 2022 as that year will reflect activity in 2020, where average and median home prices currently reflect a slight downward trend and the expected CPI will remain below the two percent maximum. In addition, fiscal years 2018, 2019, and 2020 included receipts of \$1.4 million, \$2.7 million, and \$3.9 million respectively, for excess Educational Revenue Augmentation Fund (ERAF) distributions from the County of Santa Clara. ERAF is the fund used to collect and disburse property taxes that are shifted to/from cities, the County, and special districts prior to their reallocation to K-14 school agencies. When the state shifts more local property tax than required to support schools these funds are returned and known as 'excess ERAF.' Because of the volatility of ERAF, it is not considered a permanent local revenue source.

The FY 2021 Adopted Budget assumes \$52.0 million in total property tax and is expected to grow to \$53.2 million, a \$1.2 million increase, by year-end which includes \$3.2 million in Excess ERAF. FY 2022 property tax is expected to remain relatively flat (in alignment with prior recessionary trends) and, considering the uncertainties surrounding the continued receipt of Excess ERAF, these funds have been removed from the FY 2022 forecast, resulting in a net \$3.0 million decrease in the Property Tax revenue category.

Transfer of ownership continues to be significant driver of growth and at a macro level, the number of sales has been on the decline even pre-pandemic, and the growth in value, or the difference between the assessed value before the sale and the assessed value after the sale has also continued to decline. Through July 2020, the City of Palo Alto was one of the three cities in Santa Clara County whose median sales price decreased (from \$2.8 million to \$2.7 million).

Transient Occupancy Tax (TOT)

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

Compared to the FY 2021 Adopted Budget, the FY 2021 estimate represents a decrease of 68.1 percent, or \$10.2 million. The FY 2022 estimate assumes a 20 percent increase from the FY 2021 forecast. Year-to-date, daily average room rates decreased by 49.2 percent from \$314.06 per day to \$159.39 per day while occupancy rate declined by 37.0 percent from 79.8 percent to 42.8 percent. According to CBRE, demand for hotel rooms nationally was down by 36.8 percent year-over-year from Q3 calendar year 2019 to 2020, and national hotel occupancy declined a

corresponding 37.9 percent year-over-year. San Francisco saw a significant 84.1 loss in Revenue Per Available Room (RevPAR), the third greatest decline in the continental U.S., behind Boston and New York. San Jose saw a loss slightly greater than 70 percent from Q3 calendar year 2019 to 2020.

Utility User's Tax (UUT)

The UUT is levied on electric, gas, and water consumption, as well as on telephone usage. In total, FY 2021 revenue was budgeted at \$15.1 million and is currently on target to be realized by the end of the fiscal year. This estimate does not consider current litigation that the City continues to work through.

Documentary Transfer Tax (DTT)

In FY 2015, DTT peaked at \$10.1 million. This milestone was a consequence of several large commercial transactions on Page Mill Road and in the Stanford Research Park. Since that time, DTT has significantly moderated, with \$6.9 million earned in FY 2020. Revenue from July through October in FY 2020 is running 10.0 percent above the same period in FY 2019 and anticipates that DDT revenues will exceed the FY 2021 Adopted Budget by 40 percent, or \$1.9 million.

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

Rental Income

Rental Income of \$15.5 million primarily reflects rent paid to the General Fund from the City's Enterprise Funds and the Cubberley Community Center. There is a slight decrease in rental income from FY 2021 to FY 2022 of \$0.5 million. This decrease represents the completion of the payments from the Refuse Fund to the General Fund associated with the Landfill in FY 2021, partially offset by a 2.0 percent CPI increase. The annual increase for rental revenue is based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August to August period, and it is expected that revenues will be reviewed and revised after this forecast based on updated information, typically the December to December change in the CCPI.

It is important to note that the City is currently allowing the deferral of rental payment from tenants in accordance with the Santa Clara County guidelines. Staff is also working on a referral from the City Council requesting options for rent forgiveness or deferral program options that was directed as part of the preliminary 1st quarter financial status review in October 2020.

Charges for Services and Permits and Licenses

Revenues in the 'Charges for Services' and the 'Permits and Licenses' categories are anticipated to be \$24.9 million and \$8.3 million, respectively, in Fiscal Year 2022. These amounts are approximately \$0.5 million lower than the FY 2021 amounts, mainly due to adjustments to revenue from new Fire Department fees discussed below. Revenues in these categories were impacted by changes in FY 2021 such as the planned opening of the newly remodeled Junior Museum and Zoo with a ticketed entry fee and membership program. These budget categories also include revenues associated with two newly proposed fees in the Fire Department, a first responder fee (assessed on commercial insurance companies) and an ambulance subscription fee (available for residents and businesses). These fees would cover the cost for initial response for first due engine and secure co-pay free ambulance transport, respectively. Both fees proposed by the Fire Department are still in development and have not generated revenue in FY 2021.

The ambulance transport fee is currently scheduled to be discussed with the Finance Committee in December 2020 before being brought forward for City Council consideration and established as a new Municipal Fee. The revenue estimates in these categories are primarily driven by the cost of staff to provide services to the community; therefore, revenues are impacted by the City's personal service costs. Typically, revenue estimates and corresponding fees are increased by rates consistent with salary and benefits and general CPI trends. Staff analysis year to date estimates that annual revenue collections in these categories will remain within current budgeted levels in FY 2021. Additionally, the return of canceled or modified services due to the pandemic are still uncertain. Revenue estimates in these categories have therefore been kept generally consistent from FY 2021 to FY 2022. 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 2022 Budget development process and bring forward adjustments, as appropriate.

Charges for Service - Stanford Fire and Dispatch Services

The City has two separate agreements with Stanford University to provide fire response services and emergency dispatch services. The City and Stanford entered into a new agreement for fire response services effective July 1, 2018 outlining both terms for service levels and a new cost allocation methodology as the baseline for the contract costs. This contract extends through June 30, 2023 with a renewal through 2028 unless otherwise terminated. The contract 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 contract, adjustments to revenue from Stanford have been aligned with the year-over-year changes to the operating expenses in the Fire Department for FY 2022. Similarly, changes to the revenue received for dispatching services have been aligned with the FY 2022 adjustments to the operating expenses in the Technical Services Division of the Police Department where the costs to provide these services are budgeted.

Charges to Other Funds

The main source of revenues in this category is General Fund administrative cost allocation plan charges to the Enterprise and Internal Service Funds. Internal support departments such as Administrative Services, Human Resources, and Council Appointed Offices provide services to Enterprise and Internal Service Funds. The costs for these services are recovered through the administrative cost allocation plan charges. The FY 2022 estimate for Charges to Other Funds of \$11.5 million reflects a slight decrease of 4.2 percent from the FY 2021 estimate of \$12.0 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 2021 Budget.

Return on Investment

The return on investment category reflects the interest earnings on the City's investment portfolio. This category is a combination of past investments, new investments at current market rates, and available investable cash which fluctuates seasonally and annually. Staff had anticipated the decline in interest rates would occur sooner and at a faster rate than it has occurred, so the City experienced a higher than anticipated return on investments in FY 2021. In addition, prudent investments further resulted in higher investment yields and earnings.

The average portfolio rate of return for the first quarter of FY 2021 was 1.85 percent, and a 2.0 percent average yield as of the fourth quarter of FY 2020. The revised FY 2021 interest earning estimate of \$0.9 million is \$0.2 million lower than the Adopted Budget of \$1.1 million. In FY 2022, the forecast is \$0.8 million which reflects the declining interest rate environment.

Operating Transfers-in

Operating Transfers-in materialize as expenses in other funds throughout the City and as a revenue in the General Fund. This budget category includes repayment of a previous loan from the General Fund to the Airport Fund, funding for police patrol in the downtown area, and the equity transfer from the Electric and Gas funds. In accordance with a methodology approved by the City Council in June 2009, the equity transfer is calculated by applying a rate of return on the capital asset base of the Electric and Gas funds. This rate of return is based on PG&E's rate of return on equity as approved by the California Public Utilities Commission (CPUC). Under previously approved methodologies, the transfer amount is calculated based on the Utility Department's projections from the Electric and Gas Five Year Financial Forecasts, as approved by the City Council in spring 2020. Overall, the Operating Transfers-in are estimated to remain the same as the FY 2021 estimated level of \$21.74 million. This estimate does not adjust for current pending litigation.

Expense Assumptions

As part of developing the FY 2022 Forecast expenditure budget, the General Fund expense categories have been adjusted by removing FY 2021 Adopted Budget one-time expenses and updating major cost elements such as salary and benefits costs. The table below displays the expense forecast and when compared to the FY 2021 estimated expenditures, growth of 5.7 percent is expected in FY 2022.

As discussed under the Revenue Assumptions section, alternative revenue scenarios have been modeled to illustrate the impact of an additional one, 10 or 15 percent in sales tax and TOT revenue would impact the General Fund financial picture. Consistent with City Council direction, TOT revenue generated through the voter-approved 3.5 percent TOT increase and the TOT revenue from new hotels that are dedicated to the Capital Improvement Fund to support the 2014 Council Infrastructure Plan, is adjusted in the below table.

TABLE 5: General Fund Expense Summary

	Actual 2019	Actual 2020	Adopted 2021	Forecast 2021	Forecast 2022	% Chg	FY 2022 Revenue Sensitivity Models		
							1.0%	10.0%	15.0%
Expenditures & Other Uses									
Salary & Benefits	121,953	133,216	124,541	124,541	132,904	7%	132,904	132,904	132,904
Contract Services	28,966	25,360	21,953	21,953	20,710	-6%	20,710	20,710	20,710
Supplies & Material	3,181	2,710	2,975	2,975	3,027	2%	3,027	3,027	3,027
General Expense	9,258	9,755	9,079	9,079	7,526	-17%	7,526	7,526	7,526
Rents & Leases	1,640	1,520	1,862	1,862	1,913	3%	1,913	1,913	1,913
Facilities & Equipment	576	462	427	427	435	2%	435	435	435
Allocated Charges	20,382	21,771	18,311	18,311	19,310	5%	19,310	19,310	19,310
Debt Service	431	-	-	-	-	-	-	-	-
Total: Non-Sal/Ben Before Transfers	186,387	194,794	179,148	179,148	185,825	4%	185,825	185,825	185,825
Operating Transfers-Out	9,574	8,049	4,334	4,334	4,428	2%	4,428	4,428	4,428
Transfer to Infrastructure - Base/Cubberley	1,864	1,864	6,911	6,911	7,007	1%	7,007	7,007	7,007
Transfer to Infrastructure-TOT	25,650	22,308	6,556	2,177	6,295	189%	6,358	6,925	7,240
Total Use of Funds	223,475	227,015	196,949	192,570	203,555	6%	203,618	204,185	204,499

Salary and Benefits

The table above (also included in Attachment A) depicts the estimated General Fund salaries and benefits costs. Consistent with prior years, the FY 2022 salaries and benefits costs represent approximately 65 percent of the General Fund budget expenditures.

Salary and Benefits are projected to increase by \$8.3 million or 6.7 percent from the prior year, from \$124.5 million to \$132.9 million. Discussed in the following sections, this is primarily attributable to increases in salaries (\$3.1 million or 4.5 percent), pension costs (\$3.1 million or 9.6 percent), and workers' compensation (\$1.1 million or 33.2 percent).

Salary

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

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

Fire and Police Departments to delay the separation of filled positions identified to be held vacant in FY 2021 (position freezes).

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

The FY 2022 forecast includes step increases for employees in applicable positions, including SEIU, IAFF, and PAPOA and merit increases for Management and Professional employees. Additional general wage adjustments of 2.0 percent are included when there is not a MOA in effect. This is consistent with prior Council direction to use the 2.0 percent increase as a forecasting model, not as a commitment to future negotiations.

Benefits

Pension: Pensions are budgeted based on CalPERS determined rates as of the June 30, 2019 valuation ([CMR 11607](#)) for the City's Miscellaneous and Safety plans. CalPERS determines the City's total contributions for a given Fiscal Year as the sum of two factors: Normal Cost (NC) and Unfunded Accrued Liability (UAL). Together the NC and the UAL expressed as a percentage of payroll is the 'blended rate' and is used to represent total costs in the discussion below.

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

In a year that CalPERS does not meet assumptions, due to plan changes, assumption changes, method changes, or plan experience (including investment gains/losses), there is an increase or decrease to the *Unfunded Accrued Liability (UAL)*. Commonly referred to as the 'catch-up' cost, the UAL is expressed as a dollar amount and is calculated over an amortized period with defined annual payments, like 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 38.4 percent in FY 2021 to 41.8 percent in FY 2022. In the safety plan, total costs are projected to increase from the current 65.3 percent in FY 2021 to 69.6 percent in FY 2022. 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 2022 forecast presumes that the miscellaneous plan will pick up 1 to 2 percent of the employer pension cost and that safety plan members will pick up 3 to 4 percent.

Consistent with current practice, the FY 2022 forecast also includes supplemental contributions to the City's irrevocable Section 115 Pension Trust ("Pension Trust Fund"). In January 2017 the City council authorized the establishment of a Pension Trust Fund with the Public Agency Retirement Service (PARS) ([CMR 7553](#)). Through FY 2021, a total of \$32.3 million in principal contributions will have been made to the PARS Trust. Contributions were initially made on an ad-hoc basis, using one-time savings or excess revenues. In October 2018, the City Council directed staff to include in budget assumptions the NC for pension benefits at an equivalent of 6.2 percent discount rate and a transfer of the additional funding beyond CalPERS actuarial determined contribution levels to the Pension Trust Fund ([CMR 9740](#)). This practice was reinforced in the development of a Pension Funding Policy, adopted by the City Council on November 30, 2020 ([CMR 11722](#)). In this forecast, an approximate \$5.1 million (\$3.0 million in the General Fund) in supplemental contributions is assumed in FY 2022, relatively constant to prior year contribution levels.

In the General Fund, it is anticipated the City will spend a total of \$35.1 million on total pension costs in FY 2022, including both CalPERS contributions and supplemental Pension Trust Fund contributions. This is approximately \$3.1 million higher than the prior year costs of \$32.0 million, or a 9.6 percent increase. These expenses represent approximately 17 to 18 percent of the General Fund's total expenses.

Retiree Medical: Retiree Medical is based on the most recent actuarial study prepared by Bartel Associates, which is completed every two years. The most recent study was completed in FY 2020 and presented to the City Council as part of the Fiscal Year 2021 Adopted Budget ([CMR 11330](#)). Consistent with City Council direction, the City continues to budget for the full payment of the Actuarial Determined Contribution (ADC) for retiree healthcare. Since CalPERS blends active employees with pre-Medicare retirees and charges the same medical premium, even though younger employees on average consume less healthcare and thereby subsidize older employees and retirees, there is an implied subsidy that effectively lowers the funding necessary to meet the ADC. In this forecast, an approximate \$8.8 million is estimated in FY 2022, relatively constant to prior year contribution levels.

The City's CERBT Trust, which contains prefunding for the City's Other Post Employment Benefit (OPEB) liabilities, maintains a very healthy fund balance. The CERBT Trust currently has over \$130 million in assets.

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

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

Contract Services

This forecast assumes contract services of \$20.7 million in FY 2022, a 5.7% decrease from the FY 2021 Adopted budget of \$22.0 million. This decrease is driven primarily by the removal of one-time costs adopted in FY 2021 including funding for legal dispute resolutions and funding to address COVID-19 pandemic recovery efforts. These decreases are partially offset by a 2.0 percent CPI cost increase in FY 2022 based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August to August period. It is expected that the estimated CPI increases will be substituted with department base budget requests as part of the FY 2022 budget process.

Contract Services - Committed Additions

The Committed Additions included in this forecast account for anticipated operating and maintenance (O&M) costs in the General Fund for capital projects anticipated to come online in FY 2022. A preliminary estimate of \$0.1 million for the cost of the maintenance agreement between the City and Caltrans is included for the Highway 101 Pedestrian Bicycle Overpass that is anticipated to come online in FY 2022.

Supplies and Materials

The FY 2021 Adopted Budget for the General Fund included \$3.0 million for Supplies and Materials, which is anticipated to increase slightly by a 2.0 percent CPI cost increase in FY 2022 based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August to August period in FY 2022. It is expected that the estimated CPI increases will be substituted with department base budget requests as part of the FY 2022 budget process.

General Expense

This category includes costs for travel and meetings, telephone and non-city utilities, contingency accounts, bank card service charges, and subsidies and grants provided through the Human Services Resource Allocation Program (HSRAP). These figures do not include General Expenses for the Cubberley Lease, which is explained in further detail below. The FY 2021 Adopted Budget of \$5.4 million included \$1.8 million in a Budget Uncertainty Reserve that has been removed in FY 2022 and accounts for the reduction to \$3.8 million in FY 2022. That reduction is partially offset by a 2.0 percent CPI cost increase in FY 2022 based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August to August period in FY 2022. It is expected that the estimated CPI increases will be substituted with department base budget requests as part of the FY 2022 budget process.

General Expense - Cubberley Lease

In FY 2015, the City and Palo Alto Unified School District (PAUSD) agreed to an extension of the Cubberley lease by five years starting January 1, 2015 and expiring December 31, 2019. On October 7, 2019, Council directed Staff to negotiate with PAUSD to extend the lease agreement an additional five years, through December 31, 2024 ([CMR 10730](#)). A new Cubberley lease was approved by the City Council on June 23, 2020 ([CMR 11460](#)). The new lease is for a smaller portion of the Cubberley site and has a correspondingly lower base rent payment, as detailed in a report on June 15, 2020 ([CMR 11386](#)). As part of the original lease agreement, the City Council approved creation of a fund for Cubberley infrastructure improvements. The new lease continues the \$1.9 million transfer to the Cubberley Property Infrastructure Fund, which is classified as an Operating Transfer Out and discussed in further detail below. With the Cubberley infrastructure funds set aside, the FY 2021 Budget funded \$3.7 million for Cubberley Lease payments; this includes extended child daycare sites and associated utility costs. This agreement and cost estimate continue in FY 2022.

Rents and Leases

The Rents and Leases expense category for FY 2022 is estimated to remain relatively consistent to prior-year levels of \$1.9 million. This category includes the lease agreement for Development Services staff at locations outside City Hall (285 Hamilton and 526 Bryant). A new lease agreement is anticipated for the Development Services office location at 526 Bryant Street, limiting the space to the basement level. This will be included in the development of the FY 2022 budget, reducing Development Services rent by approximately \$400,000, from \$1.4 million to \$1.0 million. As expenses for rent for Development Services are adjusted, a corresponding revenue adjustment will be made to ensure Development Services maintains cost recovery levels. Including the reductions to Development Services lease costs, the rent category will be reduced by approximately 21.0 percent from FY 2021 to FY 2022.

Facilities and Equipment

The Facilities and Equipment expense category is expected to increase from the FY 2021 Adopted level of \$427,000 to \$435,000 by a 2.0 percent CPI cost increase in FY 2022 based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August to August period in FY 2022. This budget category includes subscription payments for equipment like public safety radios as well as other non-capital equipment.

Allocated Charges

Allocated Charges represent expense allocations by the City's Enterprise and Internal Service Funds for services and products they provide to General Fund departments. The FY 2021 Adopted Budget for the General Fund included \$18.3 million for these expenses, including utilities usage, general liability insurance, technology costs, vehicle equipment maintenance and replacement costs and other charges. The FY 2022 allocated charges in the Forecast update the revenues and expenses for these various allocations based on the information available at the time of the Forecast development. FY 2022 is anticipated to experience an increase of 5.5 percent to a total of \$19.3 million. This change is primarily due to a general CPI cost increase of 2.0 percent and rate increases applied to various charges.

Operating Transfers Out

Operating Transfers Out include transfers from the General Fund to Debt Service Funds, the Technology Fund, and various other funds but excludes transfers to the Capital Improvement Fund, which are detailed in the following Transfer to Infrastructure section. The FY 2021 Adopted Budget included Operating Transfers Out of \$4.3 million. In FY 2022, Operating Transfers Out are anticipated to increase to \$4.4 million because of standard annual cost escalators of transfers between the General Fund and the Electric and Technology funds.

Transfer to Infrastructure

During the development of the FY 2021 budget, uncertainties from the COVID-19 pandemic were anticipated to significantly decrease TOT revenues, which represents a significant portion of the General Fund transfer to Capital Improvement Fund. The anticipated impact was reflected in the FY 2021 Adopted General Fund transfer to the Capital Improvement Fund, which was \$12.8 million and comprised of \$6.2 million base transfer including interest earnings and \$6.6 million from TOT revenue generated through an additional voter-approved 3.5 percentage point TOT increase. Incremental TOT increases from the voter-approved rate increase and new hotels are dedicated to the Capital Improvement Fund to support the 2014 Council Infrastructure Plan, consistent with City Council direction. Transfers from TOT revenues in FY 2021 are currently projected to decrease further to \$2.2 million before increasing in FY 2022 to \$6.3 million. This budget category also includes the separate \$1.9 million transfer to the Cubberley Property Infrastructure Fund, described earlier in this document.

Budget Stabilization Reserve

The City's Budget Stabilization Reserve (BSR) serves as the primary General Fund reserve. By policy, the BSR is maintained in the range of 15 to 20 percent of General Fund operating expenditures, with a target of 18.5 percent. Any reduction to the reserve below 15 percent requires City Council approval. At the discretion of the City Manager, any BSR balance above 18.5 percent may be transferred to the Infrastructure Reserve (IR), which was established to provide funding for maintenance and rehabilitation of the City's capital assets. The BSR is used to fund unanticipated one-time costs as opposed to ongoing or recurring operating expenditures. The City's intent is to fund ongoing programs and services with ongoing dollars. Maintaining the BSR at 18.5 percent also provides flexibility to the City to address 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, which also supports the City's fiscal position. Based on revenue and expense assumptions in this forecast, where expense levels outpace revenue growth, maintaining the 18.5 percent BSR target will not be achieved without further cost reductions in FY 2022.

Assumptions NOT Included in Forecast

It should be noted that this forecast does not include several potential impacts to the FY 2022 projected budget that are outlined below. This is not intended to be a comprehensive list nor in any priority order.

Labor negotiations: The City has extended agreements with public safety units by one year, through June 30, 2022. These public safety units are the Palo Alto Peace Officers Association (PAPOA), the International Association of Fire Fighters (IAFF), Fire Chiefs Association (FCA), and Palo Alto Police Management Association (PAPMA). Additionally, the City extended the Management and Professional agreement by one year, through June 30, 2021. Agreements with the Service Employees International Union (SEIU) extends through 2021 and new labor agreements are anticipated with the Utilities Management and Professional Association (UMPAPA) whose contract expired June 30, 2020. This forecast models only modest increases

to salaries in FY 2022 where there is not a contract, and the region's competition for a qualified workforce remains a significant pressure on the City's anticipated salary costs.

Capital Infrastructure Plan: As referenced earlier, the June 2014 Council approved Infrastructure Plan of \$125.8 million in projects was based on construction and design costs with data from 2012. As construction costs have increased and the City is required to pay prevailing wages, the Infrastructure Plan's funding status has shifted. The FY 2021 Adopted Capital Budget anticipated that these projects would cost \$260.5 million. 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 City is currently in the process of determining the number and type of grade separations to pursue. Therefore, the financial impacts remain difficult to define. Additionally, it may make sense to undertake a coordinated area plan for transit in the downtown area to synchronize with the grade separation process. Costs for these items are not included in this forecast. Measure B funds were expected to be a significant portion of the funding for grade separation, but at the November 12, 2020 Valley Transportation Authority (VTA) Policy Advisory Committee meeting there was a presentation of the Measure B Base Case in which all funding in FY 2022 was allocated to BART Phase II instead of allocated to member cities by project category, as initially planned. This decision would result in a revenue impact of approximately \$1.3 million to the capital improvement fund and a \$1.0 million impact to the grade separation project.

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

Racial Equity Work: The Race & Equity Framework and action plan was approved in June 2020 ([CMR 11441](#)) and corresponding funding is available in FY 2021. As Council provides direction, projects may emerge that require additional funding. These will be brought forward through the FY 2022 budget process.

Foothills Park Opening to Non-Residents: In November 2020, the City Council approved opening Foothills Nature Preserve to the general public ([CMR 11706](#)), lifting the resident-only access restriction. The magnitude of impacts is uncertain at this time and depend on additional analysis of visitor usage, , environmental analysis completed, potential implementation of entry fees, and other park management options anticipating for Council consideration in spring 2021. Staff will monitor these impacts and may request budgetary adjustments for Council's consideration, as appropriate.

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

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 Palo Alto History Museum, the Ventura Child Care Center, the Junior Museum and Zoo, nor the Sea Scout Building. As costs of potential capital or operating investments for these assets solidify, staff will return to City Council to address them as appropriate.

Cubberley Community Center Concept Plan: The City is in the process of designing a Cubberley Community Center Concept Plan; however, costs to implement that concept plan more than the dedicated Cubberley infrastructure funding included in the existing agreement between the PAUSD and the City are not assumed in this Forecast.

Loans for special projects: From time to time the City's General Fund will assist other City operations with modest cash flow loans to bridge fiscal years. For example, the City provided over \$3 million in loans to the Airport Fund as it works to secure significant grant funding from the Federal Aviation Administration (FAA) for capital improvement costs. As of FY 2020, the Airport Fund began paying back the loan to the General Fund. Additions and other initiatives funded in other funds may need financial support from the General Fund to ensure they are fully implemented. Additional loans from the General Fund are not assumed in this forecast.

Legislative Updates: Various actions at the state and federal level that could impact the City of Palo Alto have not been incorporated into this forecast due to the changing context and uncertainty of the quantitative impacts of potential legislative changes. This includes the Cadillac Healthcare Tax at the federal level, property tax changes at a state level, and state-level efforts focused on the provision of affordable housing. As uncertainty regarding the potential impact of various legislative initiatives is clarified, appropriate adjustments will be identified and brought forward as part of the development of the FY 2022 Budget.

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

FY 2022 Budget Development Guidelines

As discussed earlier in this document, this preliminary forecast represents the initial steps of the FY 2022 budget development process. In the FY 2021 – FY 2030 Long Range Financial Forecast, staff included budget development guidelines based on the trends that were identified and the anticipated fiscal condition of the City. Due to the clear overlap of projecting the City's fiscal condition and the need to shape service level expectations, staff recommends that the inclusion of Budget Development Guidelines be incorporated into the discussions at the beginning of an annual budget process.

As the City and the County move through different phases of recovery from the COVID-19 pandemic, the City adapts operations to best support and serve the community. County Public

Health Orders and State Public Health restrictions impact both the cost of delivering City services and the revenues that pay for them (both taxes and fees). Often, staff finds that it takes increased resources to deliver the same quantity of service in modified ways to ensure the safety of the community and employees. This will continue as the public health situation evolves.

The FY 2022 Budget Development Guidelines are detailed in Attachment A. They are meant to reflect the anticipated fiscal condition of the City and to provide high-level budgetary direction to the organization. These guidelines will shape and inform the annual financial planning and the allocation of resources across the organization, especially in the General Fund. Further, strategic work is underway focused on a Community and Economic Recovery Strategy. Staff held a study session on November 30, 2020 ([CMR 11790](#)) for City Council discussion and consideration of focus areas to inform and build a Palo Alto specific recovery strategy. Key to the City Council's and staff's fiscal and recovery planning is the important work underway to understand the fiscal implications of possible recovery scenarios. This includes the potential for City actions to affect economic recovery and associated impacts on City revenues. This, in turn, affects the level and nature of services the City can deliver to the community.

When the Fiscal Sustainability Workplan ([CMR 10267](#)) was approved by the City Council on April 22, 2019 drafting a budget development policy was listed as part of the "Newly proposed or potential activities proposed to be completed". The inclusion of Budget Development Guidelines in 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 can proactively address anticipated changes in its fiscal condition through the budget process.

Conclusion

The financial impacts of the COVID-19 pandemic and health orders have significantly restrained consumer spending, resulting in a weakened job market, and uncertainty of how and when the economy will rebound. This preliminary forecast provides context to begin discussions on how to approach the budget constraints faced by the City for FY 2022, along with a view of how changes in revenues that are sensitive to the impacts of public health restrictions may change the City's immediate financial picture. Although economic indicators in the past month show some promise and have resulted in slightly improved estimates for FY 2021, the surge in COVID-19 infections in the late fall reverted cities in Santa Clara County to a more restrictive "purple tier." The positive economic trends we have seen in September and October may not continue as more restrictions are imposed and containment of the virus hinges on the viability of an effective vaccine.

The forecast does not assume restoration of the service changes experienced in FY 2021 nor are incoming resources enough to sustain the current expense levels in FY 2022. As the fiscal year

progresses and as trends for this year materialize, prioritizing spending and services the City wishes to continue will be paramount in the City's financial stability.

STAKEHOLDER ENGAGEMENT

The preliminary forecast for FY 2022 represents the beginning of the fiscal year 2022 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 2021, 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 2022 budget.

ENVIRONMENTAL IMPACT

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

Attachments:

- Attachment A: FY 2022 Budget Development Guidelines

FY 2022 Budget Development Guidelines

- 1) Develop a structurally balanced budget that brings ongoing revenues and expenses into alignment. Develop a plan for any structural imbalance to ensure that the City maintains its fiscal sustainability over the short, medium, and long-term.
- 2) Allocate one-time resources for one-time needs rather than committing one-time resources to ongoing services. Examine appropriate uses of revenue surpluses that exceed forecasted levels including planning for recession needs.
- 3) Ensure appropriate resource allocation for City Council's existing priorities.
- 4) Focus on business process redesign to enhance quality, flexibility, and cost-effectiveness of service delivery (include examining opportunities to streamline, simplify, reorganize, and reallocate resources to avoid duplication of effort).
- 5) Explore alternative service delivery models (such as partnerships with non-profits or other public/private sector groups) to minimize overlap, maximize cost share, and effectively use resources.
- 6) Continue to thoroughly analyze non-personnel/equipment/other costs, such as contract services, for cost savings opportunities.
- 7) Explore the expansion of existing revenue sources or the addition of new revenue sources, including the alignment of existing charges for services and the opportunity to establish new fees, when appropriate.
- 8) Continue to analyze and prioritize resource augmentations, seeking to offset augmentations with reductions elsewhere for net-zero impacts to the budget whenever possible.