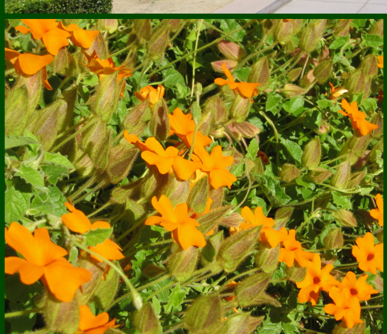
2008-18 Long Range Financial Forecast



City of Palo Alto CALIFORNIA

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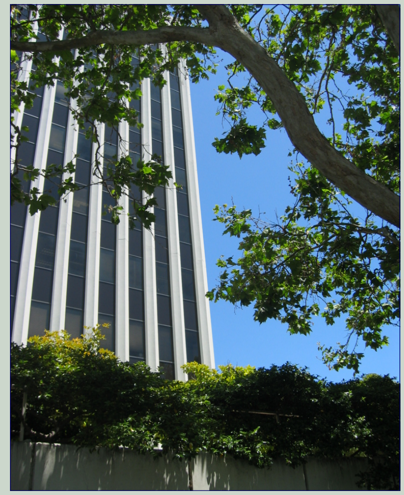

INTRODUCTION

PURPOSE OF THE FORECAST

The Long Range Financial Forecast takes a forward look at the City's General Fund revenues and expenditures. Its purpose is to identify financial trends, shortfalls, and issues so the City can proactively address them. It does so by projecting out into the future the fiscal results of continuing the City's current service levels and policies, providing a snapshot of what the future will look like as a result of the decisions made in the recent past. Any needed course corrections are thereby illuminated.

This Long Range Financial Forecast is not intended as a budget, nor as a proposed plan. The City has changed the name of the report from "Long Range Financial *Plan*" to "Long Range Financial *Forecast*" to make it clear that this document does not present a comprehensive financial plan for achieving City or Council objectives.

The purpose of this Forecast is to identify financial trends and issues so they can be proactively addressed by the City.

The Long Range Financial Forecast sets the stage for the upcoming budget process, facilitating both the City Manager and Council in establishing priorities and allocating resources appropriately. In this year's forecast the concept of a "sustainable" budget is introduced. The word "sustainable" raises fundamental questions about what services and programs can be supported over a long period of time within the revenue constraints faced by the City. These questions are designed to initiate a process and plan that ensure future balanced budgets and services to the community.

EXECUTIVE SUMMARY

Over the past three years the economy has slowly but steadily recovered from the dot-com bust of 2001-2004. To address the fall-off in revenues during the downturn as well as rising benefit costs, the City made changes resulting in long-term, structural cost reductions of $20 million. This included the reduction of 70 General Fund positions, or 10 percent. As a result of the expenditure curbs and a gradually improving revenue environment, the City is in a relatively stable financial position to address the significant financial challenges that lie ahead.

These challenges include the need, for example, to:

- Maintain annual funding for the retiree medical liability
- Enhance funding for infrastructure due to sharp increases in construction costs and a consequent backlog in projects
- Deal with threats to the City's economic base such as erosion of the City's Utility Users Tax (UUT) telephone revenue stream and the loss of key revenue generators such as automobile dealerships
- Increase healthcare costs
- Address new facility needs and consequent increases in equipment and operating costs

Examples of the significant changes the City has made that result in long-term cost controls include:

- This fiscal year, SEIU and Management/Professional employees began contributing to their PERS retirement fund – for the first time since 1983
- This fiscal year, the City will limit its funding to the second-most-expensive health plan for employees and future retirees—setting a new precedent of capping the City's liability for health care premiums
- New hires must have 20 years of service to qualify for the full retiree medical benefit
- The elimination of 70 General Fund positions and $20 million from the base budget

In addition to reigning in costs, the City has been active in maintaining and enhancing revenues. Recent voter approval of the Transient Occupancy Tax (TOT) rate increase from 10 to 12 percent marked a revenue milestone for the community and will add an estimated $1.2 million to General Fund revenues. Moreover, the City has been active in working with automobile dealerships to identify sites that will allow them to stay in Palo Alto. Whether located on the recently purchased Los Altos Treatment Plant site, or on other City owned land along the freeway, a solution will hopefully result in the space and visibility required by modern dealerships and in additional revenues for the City.

This ten-year forecast assumes that the City will continue to invest, above base funding, $4.0 million annually in the Infrastructure Reserve; sufficient funds will be set aside to fund the annual required contribution for the retiree medical liability; the local economy and City revenues will continue to grow slowly; and a mild recession will appear in 2010-11, following the once-per-decade pattern of the State's recession history. Given those assumptions, the General Fund breaks even until 2011-12, when annual deficits begin to appear.

It is important to note, however, that there are a number of adverse economic developments that could eventually influence the local economy. These include the severe downturn in the housing market, the credit crisis and losses facing major financial institutions, the steep increase in oil prices, and the deficit the State faces which could be as high as $10 - $12 billion. A slowdown in the sales tax revenue growth rate emerged in the 1st quarter of 2007-08 and this may be an indication of eroding consumer confidence. On the positive side, local job growth continues at an annual rate of 1-2 percent, technology company profits remain robust, and exports are strong. At of this writing, the local economy appears to have weathered the negative forces affecting the state and national economies. The duration of these forces, however, will be key to the future condition of the local economy.

In an effort to reduce the length of the text describing the forecast, some information has been moved to the Appendices. The Appendices include: the definitions of the revenue and expenditure categories; a general summary of the Forecast's methodology; a variety of professional economic forecast information; and historical trends in City revenues, expenditures, population, and other demographic information.

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TEN-YEAR FORECAST

KEY POINTS

The following highlights the significant issues incorporated into the 2008-18 Long Range Financial Forecast:

Revenues

- Sales tax revenues reflect a slowdown for 2007-08. The growth rate is less than 1 percent for 2007-08. This is supported by the actual first quarter results for 2007-08 received in September
- Transit Occupancy Tax revenues reflect the voter approved 2 percent increase effective January 2008
- A two year recession beginning in 2010-11 has been factored into the forecast

Expenditures and Transfers to Other Funds

- $2.9 million has been included to meet the Retire Medical liability expense. This is funding for the General Fund portion of the annual required contribution
- An additional $4 million is transferred to the Infrastructure Reserve beginning in 2007-08 and is inflated through 2017-18

Also included in this year's Long Range Financial Forecast is a line (shaded) depicting the anticipated non-operating items that will either draw down or add to the General Fund Budget Stabilization Reserve (BSR). By year, they are as follows:

2007-08

- $2.3 million drawdown on the BSR for the purchase of the Los Altos Treatment Plant property (LATP). This is the first of three payments
- $0.4 million drawdown on the BSR for the payment of the purchase option at Park Boulevard for the new Police building. This is the first of three payments
- $1.0 million drawdown on the BSR for a short-term inter-fund loan to the Storm Drain Fund for CIP projects

2008-09

- $2.3 million drawdown on the BSR for the purchase of the LATP property
- $0.3 million drawdown on the BSR for the payment of the purchase option at Park Boulevard for the new Police building

2009-10

- $2.2 million drawdown on the BSR for the final payment to purchase the LATP property
- $0.2 million drawdown on the BSR for the final payment on the purchase option at Park Blvd for the new Police building
- $0.5 million add back to the BSR for the loan re-payment from the Storm Drain fund

2010-11

- $0.5 million add back to the BSR for the loan re-payment from the Storm Drain fund

It is important to note that the $5.1 million surplus realized in 2006-07 (which will go to the General Fund BSR) nearly offsets the one-time transactions that appear from 2007-08 through 2010-11.

Finally, the narrative includes a discussion on “Sustainable Budget” and a new chapter has been added that begins the process of incorporating the Enterprise Utility Funds into a citywide Long Range Financial Forecast.

LONG RANGE FINANCIAL FORECAST MODEL 2007 ($000)

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
	Actual	Projected										
Revenues												
Sales Taxes	22,195	22,400	23,072	23,649	23,294	22,712	24,245	26,003	27,563	28,665	29,668	30,410
Property Taxes	21,467	22,685	23,487	24,203	24,341	24,482	26,098	27,823	29,735	31,782	33,815	36,066
Utility User Tax	9,356	9,793	10,522	11,123	11,742	12,371	13,169	14,029	14,832	15,688	16,586	17,568
Transient Occupancy Tax	6,708	7,500	8,424	8,748	8,625	8,418	8,846	9,430	10,193	10,917	11,473	12,058
Other Taxes, Fines & Penalties	8,757	8,260	8,531	8,813	8,927	8,912	9,466	10,080	10,703	11,281	11,819	12,346
Subtotal: Taxes	**68,483**	**70,638**	**74,036**	**76,536**	**76,929**	**76,895**	**81,824**	**87,365**	**93,026**	**98,333**	**103,361**	**108,448**
Service Fees & Permits	17,916	19,091	19,756	20,692	21,234	21,717	22,117	22,757	23,649	24,577	25,543	26,545
Joint Service Agreements (Stanford University)	6,822	7,260	7,690	7,934	8,402	8,765	9,162	9,558	9,999	10,464	10,953	11,468
Interest Earnings	2,365	2,291	2,383	2,471	2,557	2,653	2,759	2,883	3,033	3,181	3,333	3,474
Other revenues	16,371	14,633	14,943	15,181	15,428	15,707	13,918	14,270	14,632	15,005	15,389	15,785
Reimbursements from Other Funds	9,896	10,680	11,053	11,428	11,874	12,187	12,514	12,917	13,410	13,942	14,487	15,055
Total Revenues	**121,853**	**124,593**	**129,861**	**134,242**	**136,424**	**137,924**	**142,294**	**149,750**	**157,749**	**165,502**	**173,066**	**180,775**
Transfers from Other Funds	15,644	17,207	17,807	18,930	19,648	19,635	20,162	20,811	21,605	22,463	23,340	24,256
TOTAL SOURCE OF FUNDS	**137,497**	**141,800**	**147,668**	**153,172**	**156,072**	**157,559**	**162,456**	**170,561**	**179,354**	**187,965**	**196,406**	**205,031**
Expenditures												
Salaries & Benefits	84,043	86,920	91,542	94,831	99,250	102,391	105,595	109,399	114,111	119,044	124,207	129,613
Retiree Medical Liability	2,900	2,940	3,028	3,119	3,213	3,309	3,408	3,511	3,616	3,724	3,836	3,951
Contract Services	9,135	10,409	10,747	11,123	11,374	11,544	11,717	11,893	12,226	12,618	12,996	13,386
Supplies & Materials	2,656	3,569	3,685	3,814	3,900	3,958	4,018	4,078	4,192	4,326	4,456	4,590
General Expense	8,734	9,802	10,088	10,392	10,678	10,934	11,205	11,503	11,828	12,106	12,390	12,681
Rents, Leases, & Equipment	985	1,166	1,204	1,246	1,274	1,293	1,312	1,332	1,369	1,413	1,456	1,499
Allocated Expenses	14,101	13,566	14,007	14,497	14,823	15,046	15,271	15,653	16,123	16,606	17,105	17,618
Total Expenditures	**122,554**	**128,372**	**134,301**	**139,023**	**144,512**	**148,475**	**152,527**	**157,370**	**163,466**	**169,837**	**176,446**	**183,338**
Transfers to Other Funds												
GF transfer for Infrastructure CIP	6,987	7,600	7,880	8,180	8,501	8,844	9,211	9,604	10,024	10,474	10,955	11,470
GF transfer for other capital projects	1,749	2,077	1,682	1,579	1,626	1,675	1,725	1,776	1,828	1,882	1,936	1,993
Debt Service	1,092	1,162	1,171	1,177	1,173	929	752	749	649	763	763	763
Other	19	948	13	13	13	14	14	15	15	15	15	15
TOTAL USE OF FUNDS	**132,401**	**140,159**	**145,047**	**149,971**	**155,825**	**159,937**	**164,229**	**169,513**	**175,982**	**182,970**	**190,115**	**197,579**
Net Operating Surplus/(Deficit)	**5,096**	**1,641**	**2,621**	**3,201**	**247**	**(2,378)**	**(1,773)**	**1,048**	**3,372**	**4,995**	**6,291**	**7,452**
Other One-time Increases/(Decreases)	0	(3,733)	(2,567)	(1,916)	518	0	0	0	0	0	0	0
To/(From) Reserves	**5,096**	**(2,092)**	**54**	**1,285**	**765**	**(2,378)**	**(1,773)**	**1,048**	**3,372**	**4,995**	**6,291**	**7,452**

PERCENTAGE CHANGES IN FORECAST FOR REVENUES AND EXPENSES

	2006-07 % Change	2007-08 % Change	2008-09 % Change	2009-10 % Change	2010-11 % Change	2011-12 % Change	2012-13 % Change	2013-14 % Change	2014-15 % Change	2015-16 % Change	2016-17 % Change	2017-18 % Change
Revenues												
Sales Taxes	9.25%	0.92%	3.00%	2.50%	(1.50%)	(2.50%)	6.75%	7.25%	6.00%	4.00%	3.50%	2.50%
Property Taxes	14.61%	5.67%	3.54%	3.05%	0.57%	0.58%	6.60%	6.61%	6.87%	6.88%	6.40%	6.66%
Utility User Tax	6.80%	4.67%	7.44%	5.71%	5.57%	5.36%	6.45%	6.53%	5.72%	5.77%	5.72%	5.92%
Transient Occupancy Tax	4.93%	11.81%	12.32%	3.85%	(1.41%)	(2.40%)	5.08%	6.60%	8.09%	7.10%	5.09%	5.10%
Other Taxes, Fines & Penalties	4.61%	(5.68%)	3.28%	3.31%	1.29%	(0.17%)	6.22%	6.49%	6.18%	5.40%	4.77%	4.46%
Subtotal: Taxes	**9.45%**	**3.15%**	**4.81%**	**3.38%**	**0.51%**	**(0.04%)**	**6.41%**	**6.77%**	**6.48%**	**5.70%**	**5.11%**	**4.92%**
Service Fees & Permits	7.82%	6.56%	3.48%	4.74%	2.62%	2.27%	1.84%	2.89%	3.92%	3.92%	3.93%	3.92%
Joint Service Agreements (Stanford University)	5.13%	6.42%	5.92%	3.17%	5.90%	4.32%	4.53%	4.32%	4.61%	4.65%	4.67%	4.70%
Interest Earnings	5.25%	(3.13%)	4.02%	3.69%	3.48%	3.75%	4.00%	4.49%	5.20%	4.88%	4.78%	4.23%
Other revenues	5.87%	(10.62%)	2.12%	1.59%	1.63%	1.81%	(11.39%)	2.53%	2.54%	2.55%	2.56%	2.57%
Reimbursements from Other Funds	4.39%	7.92%	3.49%	3.39%	3.90%	2.64%	2.68%	3.22%	3.82%	3.97%	3.91%	3.92%
Total Revenues	**7.96%**	**2.25%**	**4.23%**	**3.37%**	**1.63%**	**1.10%**	**3.17%**	**5.24%**	**5.34%**	**4.91%**	**4.57%**	**4.45%**
Transfers from Other Funds	1.68%	9.99%	3.49%	6.31%	3.79%	(0.07%)	2.68%	3.22%	3.82%	3.97%	3.90%	3.92%
TOTAL SOURCE OF FUNDS	**7.21%**	**3.13%**	**4.14%**	**3.73%**	**1.89%**	**0.95%**	**3.11%**	**4.99%**	**5.16%**	**4.80%**	**4.49%**	**4.39%**
Expenditures												
Salaries & Benefits	1.34%	3.42%	5.32%	3.59%	4.66%	3.16%	3.13%	3.60%	4.31%	4.32%	4.34%	4.35%
Retiree Medical Liability	0.00%	100.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Contract Services	5.46%	13.95%	3.25%	3.50%	2.25%	1.50%	1.50%	1.50%	2.80%	3.20%	3.00%	3.00%
Supplies & Materials	(1.63%)	34.38%	3.25%	3.50%	2.25%	1.50%	1.50%	1.50%	2.80%	3.20%	3.00%	3.00%
General Expense	2.08%	12.23%	2.92%	3.01%	2.75%	2.40%	2.48%	2.66%	2.83%	2.35%	2.35%	2.35%
Rents, Leases, & Equipment	(77.48%)	18.38%	3.26%	3.48%	2.25%	1.50%	1.50%	1.50%	2.80%	3.20%	3.00%	3.00%
Allocated Expenses	18.85%	(3.79%)	3.25%	3.50%	2.25%	1.50%	1.50%	2.50%	3.00%	3.00%	3.00%	3.00%
Total Expenditures	**2.91%**	**4.75%**	**4.62%**	**3.52%**	**3.95%**	**2.74%**	**2.73%**	**3.18%**	**3.87%**	**3.90%**	**3.89%**	**3.91%**
Transfers to Other Funds												
GF transfer for Infrastructure CIP	73.38%	8.77%	3.68%	3.80%	3.92%	4.04%	4.15%	4.26%	4.38%	4.48%	4.60%	4.70%
GF transfer for other capital projects	74.90%	18.75%	(19.02%)	(6.12%)	2.98%	3.01%	2.99%	2.96%	2.93%	2.95%	2.89%	2.95%
Debt Service	(6.44%)	6.38%	0.76%	0.50%	(0.29%)	(20.84%)	(19.07%)	(0.40%)	(13.34%)	17.54%	0.00%	0.00%
Other	(96.82%)	4889.47%	(98.63%)	0.00%	2.84%	2.84%	2.84%	2.84%	2.84%	0.00%	0.00%	0.00%
TOTAL USE OF FUNDS	**5.18%**	**5.86%**	**3.49%**	**3.39%**	**3.90%**	**2.64%**	**2.68%**	**3.22%**	**3.82%**	**3.97%**	**3.90%**	**3.93%**
Net Operating Surplus/(Deficit)	**115.08%**	**(67.80%)**	**59.73%**	**22.13%**	**(92.28%)**	**(1062.19%)**	**(25.45%)**	**(159.12%)**	**221.72%**	**48.12%**	**25.97%**	**18.45%**

GENERAL FUND RESERVE SUMMARY ($000)

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Budget Stabilization Reserve												
Beginning Balance	22,731	27,480	25,388	25,442	26,727	27,492	25,114	23,341	24,389	27,761	32,756	39,047
To/(From) Reserves	5,096	(2,092)	54	1,285	765	(2,378)	(1,773)	1,048	3,372	4,995	6,291	7,452
Yearly BAOs	(347)	0	0	0	0	0	0	0	0	0	0	0
Ending Balance	**27,480**	**25,388**	**25,442**	**26,727**	**27,492**	**25,114**	**23,341**	**24,389**	**27,761**	**32,756**	**39,047**	**46,499**
% of Total Expenditures	20.8%	18.1%	17.5%	17.8%	17.6%	15.7%	14.2%	14.4%	15.8%	17.9%	20.5%	23.5%

KEY DRIVERS AND ASSUMPTIONS AFFECTING THE FORECAST

The Long Range Financial Forecast is based on assumptions regarding what will happen in the regional and State economy over the next few years, and on near-term and long-term revenue and expenditure drivers.

ECONOMIC ASSUMPTIONS

The Forecast assumes continued slow economic growth over the next few years, followed by a recession beginning in 2010-11. These assumptions are based on both the local economy's recent performance and on outside expert forecasts. The presumed recession is based upon the fact that, in the past, California has had a recession approximately once per decade. A recession could come sooner or later than projected. The rationale for including a recession in the model is that cyclical economic downturns will occur, and fiscal discipline is necessary to cope with consequent revenue declines.

The Forecast assumes continued slow economic growth.

The General Economic Outlook

The general economic picture is decidedly mixed. On the one hand, the housing market, credit crisis, and higher oil prices threaten to throw the national economy into recession. On the other hand, GDP, productivity, and job growth remain steady. Silicon Valley appears to be doing well as exports, corporate profits, and jobs increase.

In testimony before Congress' Joint Economic Committee (as reported by Forbes.com, November 8, 2007), the Federal Reserve Chairman, Ben Bernanke, stated that the U.S. economy is in for a rough winter and a better spring. Mr. Bernanke went on to say that, the moderate 3.9% gross domestic product growth rate of the economy in the third quarter will slow in the months ahead, amid turmoil in the housing and credit markets and rising energy prices, but "by spring, the broader resiliency of the economy" will help it recover "to a more reasonable growth pace."

In another report (AFP, Google News, November 8, 2007), the Fed chief said the contraction in housing-related activity "seemed likely to intensify" because of tighter credit, and that consumer spending is likely to grow more slowly in view of higher energy prices, credit issues and continuing weakness in housing. As for corporate spending, he observed that "heightened uncertainty about economic prospects could lead business spending to decelerate as well."

Consumer confidence is taking a drubbing as reported by the Reuters/University of Michigan Surveys of Consumers, "U.S. consumer sentiment posted a surprisingly sharp fall in early November, hitting its lowest in two years as higher energy costs and falling home prices pummeled confidence." Within a month's time the consumer sentiment index fell from 80.9 in October to 75.0 in November – the lowest reading since the index hit 74.2 in October 2005. Adding to this bleak news, "the outlook for the future also looked grim, with consumer expectations slumping to a two-year low of 64.7 from 70.1 last month." (Reuters.com, November 9, 2007)

Housing Crisis

While the comments above address national trends, they have implications for the State and region. As the State Department of Finance reported in its October 2007 Monthly Finance Bulletin, "sales of existing single-family homes slowed for the sixth consecutive month in August to 319,200 units on a seasonally adjusted annual rate basis. This was nearly 28 percent below the year-ago pace. August was thus the 23rd consecutive month of declining year-over-year home sales." As the inventory of for-sale homes increases, downward pressure on housing prices and construction activity occurs. This, in turn, leads to real and perceived drops in equity values that typically have a negative effect on consumer spending and can lead to lower sales tax revenue.

Credit Crisis

A crisis has emerged in the credit markets due to: the incredibly lax lending standards in the subprime market during the housing boom; the formation and sale of collateralized debt obligations based on subprime loans; and the subsequent failure of subprime borrowers to meet their mortgage payments upon the resetting of interest rates. This crisis could throttle loans to businesses, depressing economic activity, and undermine consumer spending through higher interest rates on credit cards and other loans. Lenders and financial institutions have suffered billions of dollars in losses and the stock market has been shaken by these losses and the tightening of credit. As the Chief Investment Strategist for Charles Schwab stated, "We have an economy driven very much by access to credit. If it gets worse form here, it's hard to believe it wouldn't have a real impact on the economy." (SF Chronicle, October 10, 2007)

Energy price spikes were taken in stride.

Energy Prices Spikes

To date the economy has shown resiliency in absorbing rising energy prices. But since prices have risen from $70 and $80 per barrel to nearly $100 per barrel, it is likely that this leap will have an effect on the economy, especially as the holiday season approaches. Rising oil prices create a double dilemma: they affect the purchasing power of the consumer adversely while driving up the inflation rate. Since the latter is a major concern of the Federal Reserve, it is less likely to lower interest rates which generally spur consumer and business spending and stimulate the economy.

Expert Economic Forecasts

Information from economic forecasters is ambiguous. Between April to November, a number of forecasters shifted to more sober projections.

In April, the Federal Reserve Bank of San Francisco's President and CEO, Janet Yellen, stated that after the nation's economy displayed resilience in the face of the energy price shocks and the hurricanes, she expected "economic activity to settle back to a more trend-like and sustainable rate as the year progresses." This forecast was later tempered by the more recent testimony of the Federal Reserve Chairman cited above.

These expert forecasts provide the underpinnings of the Long Range Financial Forecast's moderate growth assumptions.

In May, The Legislative Analyst's Office (LAO) predicted continued, steady growth in both state and national economies, with annual job growth in the 1.2 percent to 1.4 percent range through 2008 for the nation and between 1.8 percent and 2.0 percent in California. In November, the LAO modified this picture saying "statewide employment has been clearly hurt in the areas of construction and financial services. However, job growth has continued to occur in the rest of the economy, although the pace has only been modest." Of equal concern is the status of the State's revenue picture: "One result of slower economic growth is that State revenues have come in below forecast in recent months. For the period May through September 2007, they were $1 billion below forecast." (Legislative Analyst's Office Website, Publication "The Subprime Mortgage Situation," November 1, 2007)

In its third quarterly report of 2007, the UCLA Anderson Forecast for California indicated that "the end of 2007 will mark the peak of subprime, adjustable rate mortgage resets, and mortgage defaults are expected to peak sometime in the first half of 2008. The real estate markets will continue to be a drag on California growth for at least a year to come. With no other sectors picking up the slack, the Forecast expects to see overall job growth of less than 1 percent through this time next year, with unemployment reaching a peak of 5.9 percent at the end of next year, with corresponding weakness in personal income and gross state product." (Press Release of September 12, 2007, UCLAForecast.com)

In a recent staff interview (November 6, 2007), Stephen Levy, the Director and Senior Economist at Palo Alto's Center for Continuing Study of the California Economy, was hopeful about the local economy. He cited Silicon Valley's exports and link with a robust worldwide economy, its decent job and income growth, its innovative bent, and its prosperous populous as reasons for withstanding the emerging and downward pressure of the housing and credit crises. Mr. Levy did not expect the local economy to succumb to the current turbulence in the market as it did during the dot-com bust.

Mr. Levy did state, however, that the State of California could be facing a $10 to $12 billion deficit in the next year. This plus slowing job growth could pose local problems. Staff notes that whenever the State faces fiscal difficulties, these difficulties usually percolate down to local jurisdictions in the form of revenue takeaways. From 1992-93 through this fiscal year, the State has taken a cumulative $52 million in property taxes and other revenue from the City of Palo Alto to solve their budget deficits. Although passage of Proposition 1A provided some protection against State raids on revenue, a fiscal crisis could negate its purpose.

As a consequence of the above forecasts combined with local revenue information, the Long Range Financial Forecast reflects a cautious view of the economy and a somewhat conservative projection of the City's major revenue sources in the next several years. It is important to remain fiscally prudent in the event a recession does occur.

Revenue Drivers

The City realized solid revenue growth in 2006-07. Total revenues grew by 8.5 percent over the prior year. Economically sensitive and major revenue sources such as sales, property, transient occupancy, and documentary transfer taxes grew steadily. In November 2007, Palo Alto voters overwhelmingly approved a 2 percent rate increase in the Transient Occupancy Tax, raising the rate from 10 to 12 percent. This increase is factored into the forecast beginning in January 2008 when the rate takes effect. The forecast assumes a 3.65 percent compound annual growth rate for total revenues from 2007-08 through 2017-18. This relatively modest growth rate primarily results from the expected recession and a near-term slowdown in sales tax growth.

The following describes the trends in the City's major revenue sources.

Sales Tax

In 2006-07, sales tax revenues rose 9.3 percent or $1.9 million over 2005-06 levels. Economic segments that showed particular strength in 2006-07 were business to business (e.g., electronic equipment), department store, and restaurant sales. Those displaying some weakness include furniture/appliance outlets and business services. It is of concern that growth in sales tax receipts began to slow in the first quarter of 2007-08. Whereas prior quarter growth rates ranged from 5.3 to 12.8 percent, the first quarter's growth rate was a fairly anemic 1.5 percent above the prior year's 1st quarter rate. This might portend a slowing in this revenue category and requires careful monitoring. In addition, a significant amount of the growth in 2006-07 was concentrated in one electronic equipment maker. In the past, this sector has shown considerable volatility. This spike in company revenue also merits tracking. A growth rate of 0.9 percent is projected for 2007-08 and 3.0 percent for 2008-09. These projections are in alignment with the City's sales tax consultant.

Property Tax

Secured property tax revenues rose by 9.6 percent or $1.3 million in 2006-07 over the prior year. This healthy increase can be attributed to a strong commercial real estate market and a fairly steady residential market. While there is no firm evidence yet for a softening of home prices and no information from the county on residential assessment appeals or decreases, a softening in this revenue source lags an economic downturn by a few years. Therefore a slower growth rate of around 5.7 percent in property tax revenues is estimated for 2007-08 and 3.5 percent for 2008-09. These numbers correlate closely with Santa Clara County estimates.

Transient Occupancy Tax

As stated, voters approved an increase in the TOT rate to 12 percent starting January 2008. TOT revenue should grow by $0.6 million in 2007-08 and by another $0.6 million in 2008-09.

Average occupancy rates have moved up steadily during the past 3 years: from 61 percent in 2004-05 to 72 percent in 2006-07. Preliminary data for 2007-08 show occupancy rates at 77 percent. Likewise, average room rates have risen from $119 to $137 during the same period. TOT revenues are expected to show solid growth as long as local business conditions remain robust. Additional competition may be expected, however, when new hotels come on line in Menlo Park. The building of a "high-end" hotel in the Stanford Shopping Center sometime in the future should place Palo Alto in a strong competitive position.

Documentary Transfer Tax

Documentary Transfer Tax (DTT) revenue is acutely sensitive to the volume and value of property sales and the mix of residential and commercial transactions. In 2006-07, DTT revenue rose to $5.8 million, 1.9 percent over the prior year. This is the highest DDT level in 10 years and is due to a vibrant commercial sector and steady residential sector. This revenue source is projected to grow at a compound annual rate of 4.7 percent over the next 10 years.

Refuse Fund

With the landfill expected to close in 2010-11, annual rental payments from the Refuse Fund to the General Fund will drop from $4.3 million to $2.1 million starting in 2012-13. The Forecast incorporates this expected revenue loss. Council established a policy to extend the rent payment schedule through 2020-21 based on an updated analysis of the landfill area (CMR:104:07).

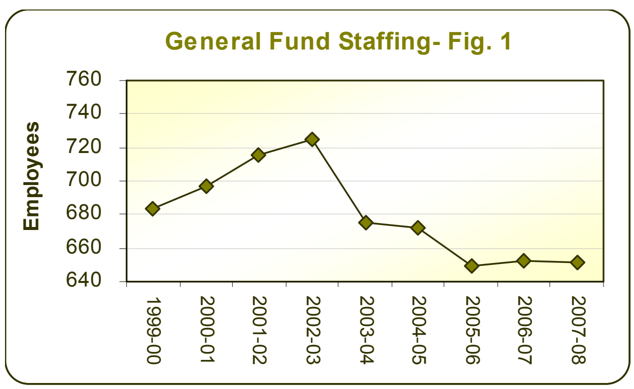
Expenditure Drivers

Salaries and Benefits

Salaries and benefits represent approximately 64 percent of the 2007-08 General Fund budget. Upward pressure on salary and benefits is continual, due to the cost of living in Silicon Valley and the labor market in which the City negotiates with its bargaining units.

In 2007-08 the City is scheduled to complete negotiations with the Palo Alto Peace Officer's Association (PAPOA) and the Fire Chiefs' Association (FCA). Staff expects negotiations to focus on salary and benefit changes. PAPOA negotiations have demonstrated that Palo Alto is experiencing significant salary and recruitment competition, especially with surrounding jurisdictions.

Contract negotiations were concluded last year with the International Association of Fire Fighters (IAFF), and Service Employee's International Union (SEIU), with the IAFF contract scheduled to expire in 2010 and the SEIU contract set to expire in 2009. Council approved an average



annual 3.25 percent increase for IAFF over the four-year contract and an average annual 2.5 percent increase for SEIU over a three-year period.

There are two remaining groups that are not represented by a union: Management/ Professional and Limited Hourly. For 2007-08, Council approved a one-time 3.5 percent increase for the Management/Professional group.

Over the past few years General Fund staffing has been reduced by 70 positions, or 10 percent. (see figure 1) The annual growth for salaries and benefits over the next ten years is projected at 4.0 percent. Within that category, salary and overtime growth are assumed at 3.5 percent per year, benefits are assumed to grow by 5.0 percent, including retiree medical.

Within the benefits category, the largest drivers are Pension and Healthcare Costs.

Pension Expense

CalPERS retirement system pension costs have increased substantially since 2000. However, the rapid growth of these costs has subsided in the past two years. In 2005, the CalPERS Board enacted a new rate policy that spreads market gains and losses over 15 years rather than over three years when calculating the value of assets. The impact of this new policy appeared for the first time in 2005-06, with rates reduced by 3-4 percent compared to the prior year. The rates for 2006-07 showed a further decline of 1-2 percent. Moreover, CalPERS investments have improved dramatically since the period 2000 through 2002.

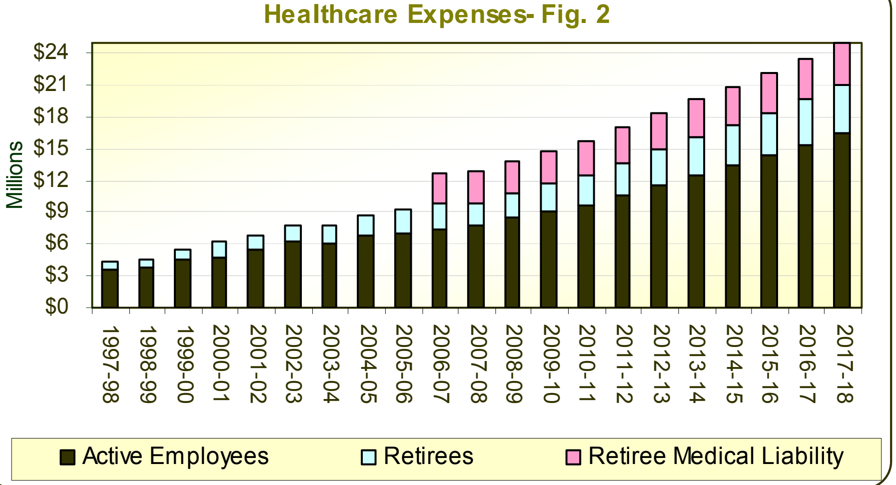
For the one-year period ended June 30, 2007, CalPERS investments earned a 19.1 percent return. This marked the fourth consecutive year of double-digit returns. Also, pension expenses are expected to continue to level out in subsequent years.

Management/Professional and SEIU employees are now contributing 2 percent of their salary to their PERS retirement plan, as a consequence of receiving the 2.7 percent at 55 package. With this change, as with the containment of costs on medical plans, the concept is emerging that retiree benefit and medical costs can no longer be fully borne by the City and need to be shared with employees.

Healthcare and Retiree Medical Costs

The City of Palo Alto was one of the few remaining jurisdictions that fully funded employee health insurance premiums and retiree medical costs. As mentioned earlier, that long-held practice was amended last year when the City placed a limit on its contribution to medical premiums for both active and retired employees.

Healthcare Expenses- Fig. 2



Healthcare

In the past five years, healthcare expenses have nearly doubled. Medical premiums are expected to increase from $12.8 million in 2007-08 to $16.9 million in 2011-12.

Retiree Medical

As a result of GASB 45, the City recently underwent an actuarial study which valued its retiree medical liability at $82.6 million, (assuming the establishment of an irrevocable trust and a 7.75 percent discount rate.) The City has already funded a Retiree Health Benefit reserve valued at $30.7 million. Having this reserve places the City at an advantage compared to most jurisdictions. After transferring $30 million to the trust fund, the unfunded portion of the liability will be reduced to $52.6 million. The 2007-08 General Fund budget includes $2.9 million, which is its portion of the annual required contribution.

In its attempts to limit healthcare costs for both current and retired employees, the City has accomplished the following:

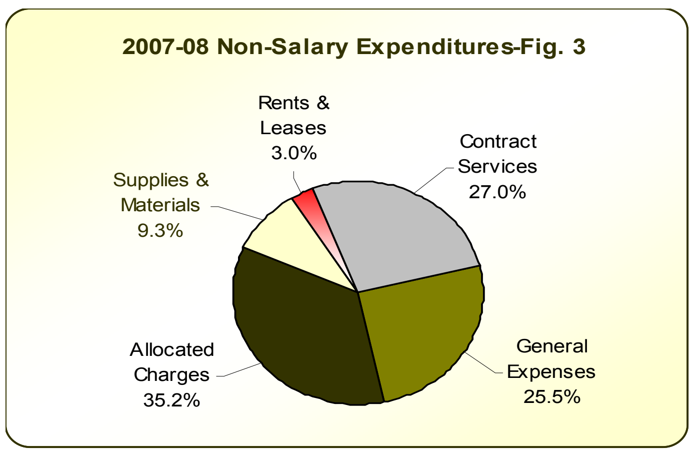
- Placed a limit on the employer's contribution to medical premiums for both active and future retirees, eliminating the most expensive health plan the PERS system offers, and reversing its long-held practice of funding 100 percent of every available PERS healthcare plan for employees and retirees
- Raised the full vesting requirement for retiree medical eligibility from 5 to 20 years for new employees

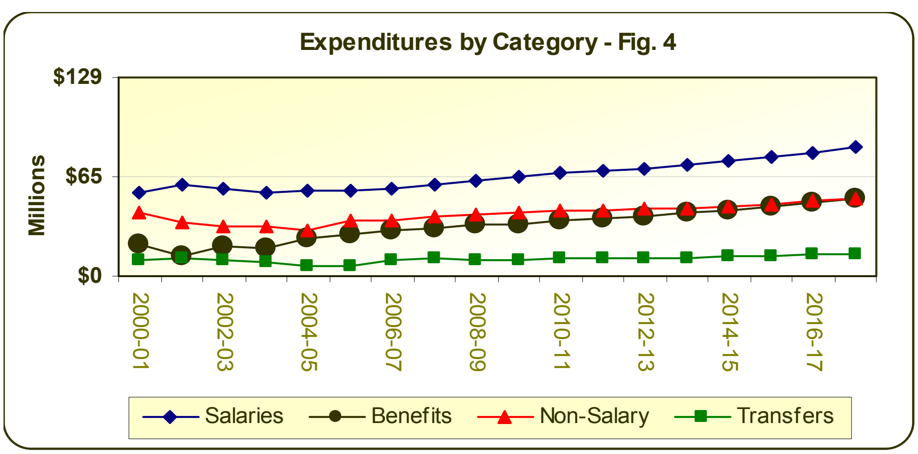
Going forward, the City will continue to explore strategies to reduce healthcare and retiree medical costs.

Non-salary Expenditures

Non-salary expenditures represent 28 percent of the 2007-08 General Fund budget. These expenditures include allocated charges, supplies and materials, rents and leases, contract services, and general expense. Consistent with last year's LRFF, this forecast assumes no program growth beyond general cost inflation over the next ten years. Figure 3 shows the breakdown of non-salary expenditures.

General expense includes the lease payment of $6.3 million to the Palo Alto Unified School District (PAUSD) for the "Covenant Not to Develop" surplus school facilities. This contract requires CPI adjustments to the annual lease payment, with a projected annual growth rate for the next ten years of 3.0 percent or a minimum of $189,000 annually.





Expenditure Trends by Category and Function

Figure 4 depicts the projected trend lines for salaries, benefits, non-salary expenses, and transfers:

Please note the following:

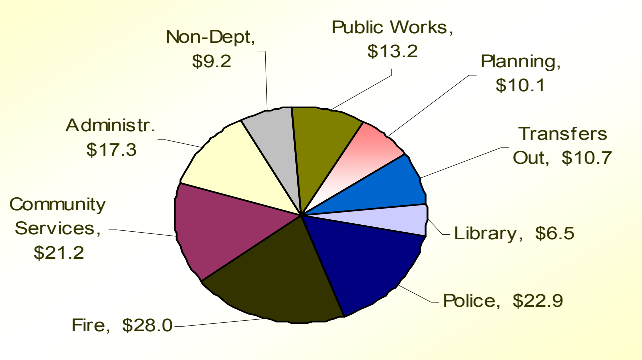
- Salaries, while trending upward, remain at about 44 percent of total expenditures from 2007-08 through 2017-18
- Benefits increase from 22 to 26 percent of total expenditures from 2007-08 to 2017-18, primarily due to the inclusion of the retiree medical liability starting in 2007-08
- Total expenditures increase an average of 3.7 percent per year from 2007-08 through 2017-18
- Non-salary expense and transfers represent about one-third of General Fund expenditures

Figure 5 displays the budget by functional area:

The largest functional areas of the budget are Police, Fire and Community Services. They comprise 16 percent, 20 percent and 15 percent of total expenditures in 2007-08, respectively.

The Administrative functional areas includes Administrative Services, the City Attorney, City Auditor, City Clerk, City Council, City Manager, and Human Resources. These functions represent 12 percent of total expenditures. Forty-four percent of the services that the administrative departments provide is expense is reimbursed by the Enterprise Funds.

2007-08 Expenditures by Functional Area - Fig. 5



RISKS

The City continues to face fiscal challenges and opportunities which create upside potential and downside risks in the Forecast. Some of these challenges and prospects are immediate and others can be viewed as longer term parts of the City's sustainable budget effort.

Downside Risks

The primary downside risks on the revenue side are the housing market, energy prices, and credit crisis. Sales, Property and TOT revenues will move downward it these areas worsen. Slow to moderate growth rates are reflected in the Forecast through 2009-10 or before an expected recession. Starting in 2012-13, all revenue sources are anticipated to resume more normal growth patterns.

The following are some additional downside risks related to **revenues** forecasted in the model.

Economic Base

The City is moving proactively to maintain and grow its economic base. Mayoral efforts to retain and grow automobile dealers and other key revenue generators, recent discussions to expand the Stanford Shopping Center, and the effort to build a new hotel in the Shopping Center, have all been part of a heightened awareness and action plan to secure the City's economic base. (Further details appear below in "Upside Potential") These efforts are vital given the following threats to City businesses:

- Big-box stores such as Best Buy, Home Depot, Costco, REI, and supermarkets in Mountain View and East Palo Alto that draw sales and sales taxes away from Palo Alto
- Nearby cities' efforts to attract automobile dealerships. For example, plans have emerged in Menlo Park (in conjunction with General Motors) to develop an automobile mall on Willow Road and Highway 101. Given the lack of suitable space in Palo Alto, this could lead to the departure of key local dealerships. The City has already lost three auto dealerships in the past five years: Ford, Nissan, and Porsche
- Retail competition from regional shopping centers such as Valley Fair and Santana Row
- The emergence of high-end hotels in Los Altos, Menlo Park and East Palo Alto, generating increased competition for Palo Alto hotels and for TOT dollars
- The transformation of Stanford Research Park from firms producing taxable sales to those providing non-taxable research, administration, and business services
- Opposition to business development within the City

The Forecast incorporates the most recent loss of automobile dealerships and hotels; however, should any of these trends become more significant, the City's revenues will decline accordingly.

Telephone UUT Threat

Voice-Over-Internet Protocols (VOIP) technology will impact telephone UUT revenues as it penetrates homes and businesses. Based on a recent Federal Communications Commission ruling, the City will no longer have the authority to tax VOIP service; thus the $2 million telephone UUT revenue source may erode over time. In addition, since the telecommunications industry was successful in relocating local franchise authority to the State level, it is possible they will attempt to do the same for UUT. A State UUT could result in further diminution of the City's telephone UUT revenues.

The following are some additional downside risks on the **expenditure** side.

Healthcare

Over the past five years, healthcare cost for the City have risen from a low of 3.4 percent to a high of 12.7 percent per year. The Forecast assumes an average growth rate of 7.7 percent per year. It is quite possible that healthcare costs will escalate beyond that rate of growth.

Increased Salary Pressures

If prevailing labor market differentials surface as comparisons are made with benchmark cities, more complex labor negotiations may ensue in the next 2-3 years. Budget-balancing requirements will be weighed against the need to match regional wage standards. This may drive salaries and benefits expenditures above the Forecast.

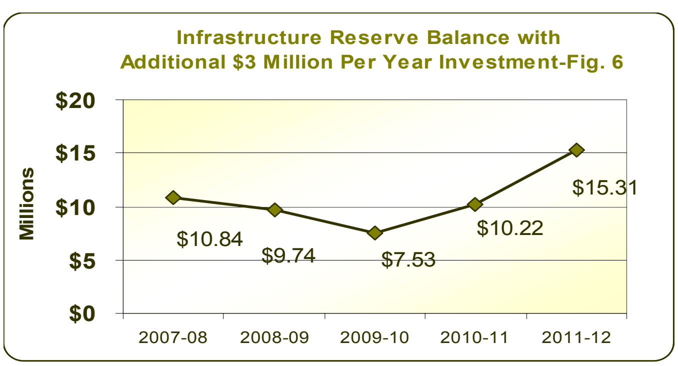
New Projects and Priorities

If the City identifies new projects or priorities that are not included in this Forecast, new revenue sources and/or expenditure cuts would have to be identified to fund them. Capital and other costs not funded through debt financing would require alternative resources. For example, should new library and public safety facilities be constructed, additional maintenance expenditure will be required. In addition, furniture, fixtures and equipment that cannot be covered through specific types of debt structures must be funded using new or existing resources.

Moreover, as the City utilizes new or existing resources to fund expanded facilities or programs, it reduces its flexibility to cover increasing expenses in other programs. Adhering to Sustainable Budget tenets will require a mechanism for prioritizing project and program needs.

Infrastructure Reserve Funding

One of Council's top priorities is to restore and maintain the City's General Fund infrastructure. An Infrastructure Reserve (IR) was created to ensure future project funding. When the Infrastructure Management Plan (IMP) was initiated in 1998, it was estimated that the City needed to spend $10 million annually to eliminate the infrastructure backlog and to maintain existing infrastructure in future years. However, that $10 million per year has not been sufficient to cover the growth in infrastructure project costs, which have been impacted by inflation, changes in scope, and steep increases in the cost of construction materials. A consultant has been hired by the City to update the Buildings and Facilities



portion of the IMP. The financial impact of this update will not be known until Winter 2008. The Capital Improvement Program Plan for the ensuing year will incorporate the new data from the update.

In April 2006, the City Council directed staff to review options to increase IMP funding by $3 million per year through a combination of expenditure reductions and revenue enhancements. The LRFF assumes that the transfer of $3 million per year will increase by an inflation factor of seven percent per year.

State Budget Difficulties

The State of California is expected to have a deficit ranging from $10 to $12 billion in 2008-09. Although the passage of Proposition 1A includes protections from State raids on local jurisdiction resources, there is a provision that in emergency situations these controls can be sidestepped. The State's ability to borrow its way out of the looming budget dilemma is limited, and local governments should be prepared for potential take-aways.

UPSIDE POTENTIAL

Possible developments that would positively impact the City's bottom line include:

Successful Economic Development Efforts

In the past few years, the City has engaged in several efforts to encourage business development. As a result of the Mayor's Committees on Retail and Business Attraction, several key strategies have been implemented:

- The City will be partnering with the Simon Group in efforts to expand the Stanford

Shopping Center and maintain its competitive position in the marketplace

- Staff has reviewed zoning requirements in several business districts and implemented changes to the zoning code that address challenges to high-volume sales tax generators such as auto dealers
- The City worked with auto dealerships to identify potential land near Highway 101 to provide greater visibility and space
- Other zoning changes have protected commercial zones from housing development

In addition, the Business Improvement District (BID) has been a catalyst for businesses in the City's downtown. Events such as Dine Downtown have successfully increased sales to local restaurants. The pilot program "Destination Palo Alto" has engaged a variety of partners (the City, Chamber of Commerce, BID, Stanford, commercial areas, and neighborhood associations) in promoting visitor and visitor-related economic activity and revenues. Attraction of the "2008 Amgen Tour de California" is a prime example of the effort to bring high-profile events to the City.

Business outreach efforts continue, focusing on valued businesses and top sales tax generators. City staff and elected officials have conducted business outreach visits to companies such as Communications and Power Industries, Inc., Varian, and VM Ware. These visits help the City assess its strengths, weaknesses, and challenges; they will continue to inform decisions regarding business development efforts by the City.

To the extent that these efforts counteract the negative competitive pressures facing the City's business community, City revenues may exceed those forecasted.

Talent Crisis

The City of Palo Alto, like most other government agencies, is facing an approaching "baby boomer" retirement wave. Currently, 38 percent of staff is eligible for retirement, and the figure will increase to 56 percent within five years. This wave of retirements will create an opportunity for restructuring, reviewing how services are delivered, and reducing staff. This opportunity, however, must be weighed against the challenges of managing the loss of expertise and institutional knowledge in the organization and the response to the service needs of the community.

With retirements looming, Palo Alto faces a related challenge: the effort to hire new workers. Local governments find it difficult to recruit as fewer potential entry level employees are attracted to the public sector. Dr. Stuart Greenfield of the Center for State and Local Government Excellence recently published a study that helps explain this relative disinterest. For example, local government workers earn 7 percent less than comparable private sector workers; salaries in local government jobs increased less than in the private sector between 1997-2005 (3.3 percent compared to 3.8 percent); public sector workers are better educated yet they earn 25 percent less than those in the private sector with comparable degrees; and while the public sector has a greater percentage of knowledge workers, those workers earn 25 percent less than similar workers in the private sector. It is important to point out that strong public sector benefit packages can compensate, in part, for lower comparable earnings.

To address the recruitment challenge, Palo Alto is working to attract potential employees through the summer internship and management fellows program. In addition, the City will continue to promote itself as a great place to work providing employees with challenge and opportunity, attractive salary and benefit packages, and a focus on work/life balance.

LOOKING BACKWARD AND FORWARD

In summary, this forecast shows that the City has righted its financial course over the past several years through expense and position reductions and revenue enhancements. In addition, the City can point to major accomplishments such as increased infrastructure spending and funding of its retiree medical liability. Few jurisdictions can lay claim to these achievements given the financial pressures cities face. This City, however, continues to have a plethora of existing and new infrastructure needs, enhanced program requests, and new demands such as in the area of climate protection. The myriad of expenditure pressures on General Fund resources has prompted a discussion of developing a "Sustainable Budget" whereby sources and uses of available funds are in equilibrium over time. This concept and goal has been explored in CMR:387:07 which was presented to the Council's Finance Committee in October, 2007. Highlights of this report are summarized below.

SUSTAINABLE BUDGET

The idea of a "sustainable" budget emerged from the financial disruptions of the "dot-com" bust and the concern that the City cannot continue to support the variety and level of current services over the long-term. This concern is compounded by emerging new program and facility needs that must compete with existing services for resources.

A "sustainable budget" is a plan to keep spending within one's means over the long-term. Another definition of this type of budget is an expenditure plan that meets the needs of the present without compromising the ability to provide services to future generations.

As the above "Risks" section states, the goal of budget sustainability is not as simple as it appears, since dynamic forces such as economic cycles, changing demographic and social needs, rising medical and energy costs, new facility needs, and other factors impact the best of budget strategies. Tough questions must be raised and addressed to provide the flexibility necessary to achieve a balanced budget over time. These include, for example:

- What are the City's basic program and spending priorities now and in the future? Balancing a rich and wide level of services with expanding infrastructure, for example, will present a difficult trade-off
- How long can current expenditure patterns continue and what costs can be reduced or eliminated to achieve a balanced budget?
- Can current services and service levels be provided in a more efficient and cost-effective manner?
- What revenue sources can be counted upon now and in the future, and which are likely to decline?
- To what extent are the City and community able and willing to maintain and grow revenue resources when needed?

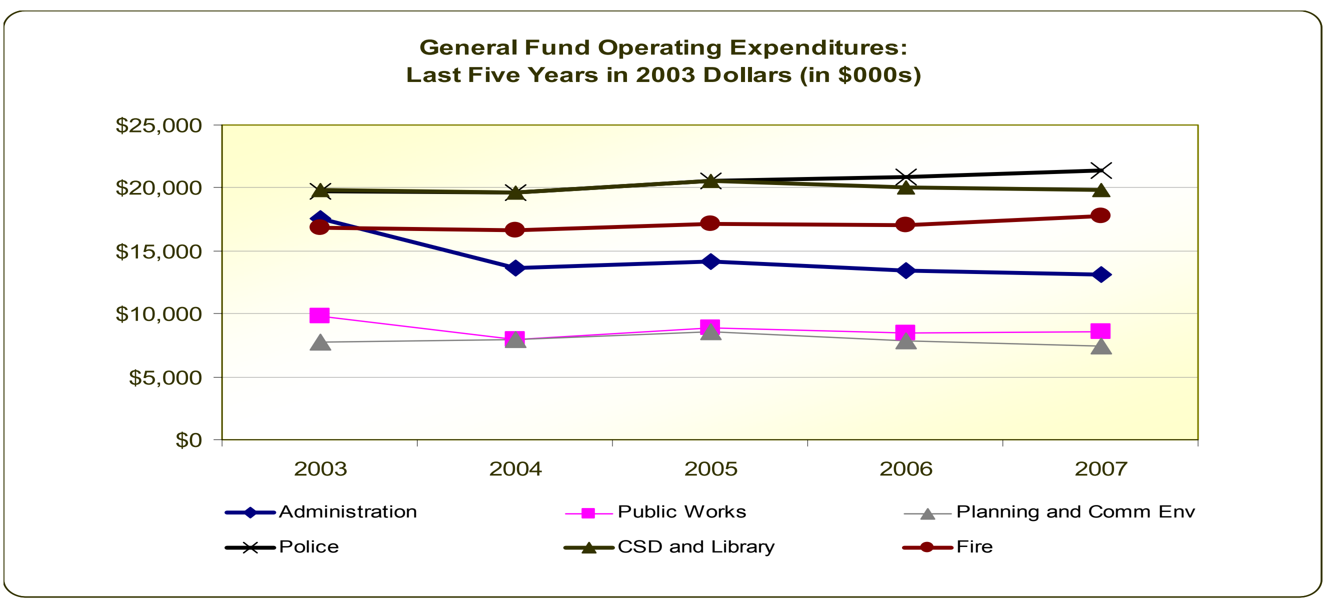
A critical component of developing a sustainable budget is that the City raise and respond to the above questions on an ongoing basis, preferably annually. This implies that as new expectations, initiatives, and programs arise, they are grounded in the reality of available resources and competing priorities. Maintaining such a budget takes considerable discipline. By being proactive in finding answers to the difficult questions raised above, the City can avoid the painful, abrupt and potentially near-sighted solutions that are typically necessary to solve budget shortfalls.

As stated in this report, the City has capably addressed a number of structural and long-term funding issues such as infrastructure replacement, the loss of revenues during the "dot-com" downturn, and the retiree medical liability. It has solved these problems primarily by reducing General Fund costs. As the City grapples with the rising cost trends cited in this report, the option of reallocating resources has become more problematical.

An analysis of expenditure growth by department (see table below) shows that budgeted resources for administrative departments have dropped in real dollar terms over the past five years while those providing community and public safety services have either remained constant or increased. As a proportion of the City's budget, the public safety and community service functions have grown from 58.3 percent of the total in 1997 to 61.5 percent in 2007. These numbers make sense in light of the reductions made in the administrative departments, but they indicate that if the City is to sustain its budget, difficult decisions may be necessary in areas that the public and Council see as "basic" services. This is especially important as the City endeavors to fund a new public safety building and library/community center facilities.
In addition to the capital costs expected to be debt financed, there will be incremental equipment, maintenance, and operating costs associated with these new facilities.

To maintain a sustainable budget, the City has taken several actions including:

- Reallocating of resources - e.g., recent $3 million shift of operating resources to infrastructure spending



- Increasing revenues or resources - e.g., recent 2 percent increase in TOT rate
- Reducing or shifting benefit expense – e.g., recent capping of medical premium costs and having employees pay a share of retirement plan contribution
- Increasing use of debt versus pay-as-you-go funding for capital projects so as to spread costs and benefits over time

As with most budget decisions, the City will have to make hard choices as it develops a sustainable budget. To facilitate the decision-making process, the following complex questions (in addition to those raised earlier) need further analysis, discussion, and action:

- What is the optimal balance between infrastructure and operating expenses that will sustain the delivery of services?
- Should the City incur more debt for capital projects so as to spread the cost burden of improvements over current and future users? The City has generally used a conservative, pay-as-you go approach for capital projects.
- How can the City control expenditures growing at greater than inflation rates yet preserve core services?
- What opportunities does the City have to maintain and expand revenue sources when necessary?
- To what extent is the community willing to balance its desire for services and the revenues that support them with its desire to restrict business growth and its associated traffic impacts?
- What degree of risk is the City willing to incur as it seeks to control expenses?
- Can a meaningful dialogue be initiated with City employees and unions on sharing medical premium expenses?
- What framework will the City use to evaluate and fund new programs versus ongoing services?

As the Finance Committee indicated in October, 2007, these questions must be vetted by the community and Council. They will require considerable discussion and consensus since they involve real, competing interests. The City's practice is to conservatively and judiciously manage its resources. With the development of a sustainable budget it will continue this practice into the future.

CONCLUSION

In conclusion, this years' LRFF incorporates many significant changes and challenges. As the financial forecast's bottom line shows, the City is in a sound financial position. The budget continues to be balanced despite rising benefit costs, enhanced infrastructure funding, and a significant retiree medical liability. Although deficits are shown in 2010-11 due to a projected recession and the decline in Refuse Rent, the City is expected to see reasonable surpluses in the second half of the ten year forecast.

In addition, this year's LRFF includes a brief, but informative information chapter on the status of the Enterprise Utility Funds. This next section represents the first, small step toward a more comprehensive citywide Long Range Financial Forecast.

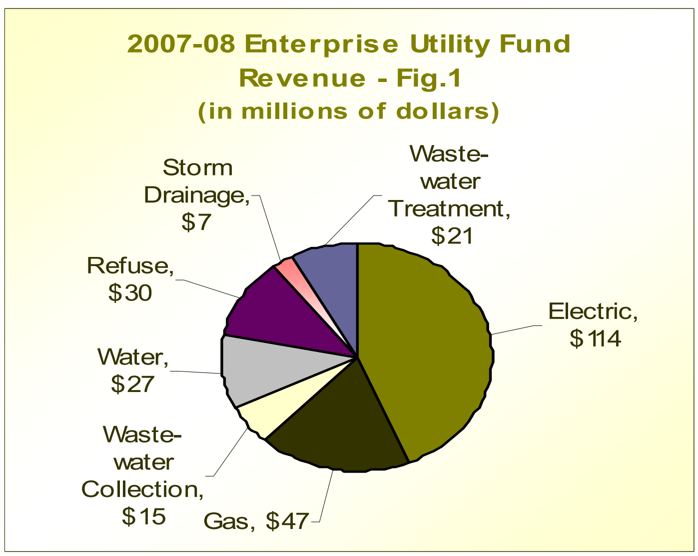
ENTERPRISE FUNDS

ENTERPRISE UTILITY FUNDS

Although the Long Range Financial Forecast's main focus is the General Fund, the financial outcomes of the Enterprise Utility Funds affect the City as a whole. The addition of information on the Utility Funds represents the first step toward a comprehensive, citywide Long Range Financial Forecast.

The City of Palo Alto has provided utility service to its citizens and businesses for over 100 years and is the only city in California to offer a full array of utility services. The Enterprise Utility Funds are comprised of the Electric, Gas, Refuse, Storm Drainage, Wastewater Collection, Wastewater Treatment and Water Funds. Each of these Funds is managed independently, and a summary of the Funds is presented below.

It is important to note that the basic principal of the Enterprise Utility Funds is that customers pay the full cost of the services they receive.



REVENUES

Revenues for the Enterprise Utility Funds are primarily generated through rates charged to customers and are designed to cover the full cost of delivering services. Those costs include the cost of commodities, replacement and maintenance of capital infrastructure, debt service coverage and operation expense. Overall utility rates increased 8.9 percent in the 2007-08 adopted budget, and additional increases were included in the proposed 2008-09 budget.

The total combined revenue for the Enterprise Utility Funds in the 2007-08 budget is $261 million. Figure 1 shows revenue by Fund.

EXPENSES

As noted on the previous page, expenses for the Enterprise Utility Funds are driven by commodity, capital infrastructure, debt service and operational costs.

The total combined expense for the Enterprise Utility Funds in the 2007-08 adopted budget is $283 million. Figure 2 shows expense by Fund. Figure 3 shows combined expense by category.

EXPENSE DRIVERS

Commodity Costs

Fluctuating commodity and electric and gas transmission costs continue to be a challenge for the Electric, Gas and Water Funds, since commodity purchases represent the largest expense in dollars and percentage for these three Funds.

In 2007-08, total budgeted commodity expense is $118 million or 41% of total Enterprise Utility Fund expense.

Commodity pricing can be driven by weather, supply availability, changes in demand and regulatory policies. Increases in commodity expenses may cause customer rate increases. To mitigate marketplace volatility and dramatic customer rate changes, staff uses a three-year laddered purchasing strategy for electric and gas supplies.

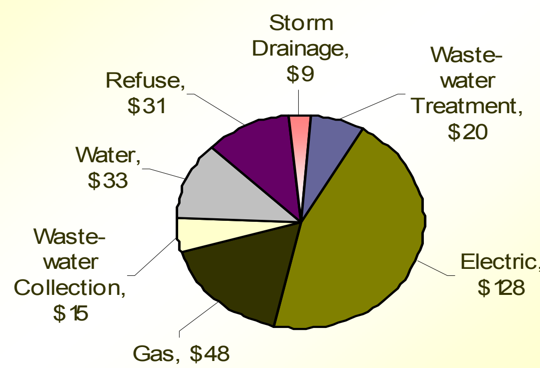
Capital Infrastructure

The investment in capital infrastructure is a major priority for the Enterprise Utility Funds. Replacing, maintaining and upgrading plant and technology ensures continuing, reliable service delivery. Costs incurred for capital infrastructure can drive changes to customer rates.

The major investments that were included in the 2007-08 budget are the following:

- The replacement, rebuilding and conversion of underground electric systems- $10.5 million
- The replacement and upgrade of gas mains- $6.9 million
- The rehabilitation of wastewater collection systems- $3.4 million
- Water main replacement, reliability upgrades, and emergency water supply- $11.1 million
- The construction of a new storm water pump station and citywide storm drainage system repairs- $5.5 million

2007-08 Enterprise Utility Fund Expense - Fig. 2
(in millions of dollars)



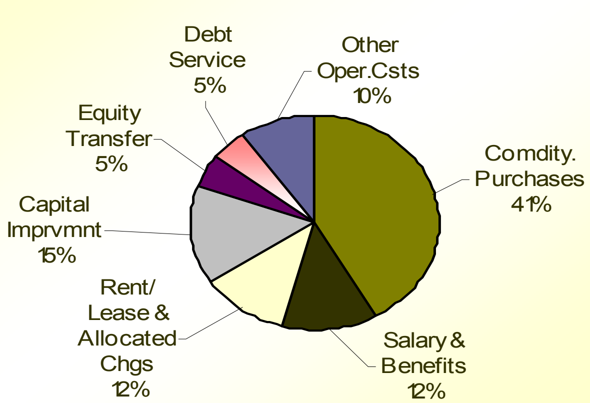
- Design costs for improvements to the disinfection facility at the wastewater treatment plant- $1.3 million

Multi-year projects included in the 2008-09 proposed budget are the replacement of a reclaimed water pipeline to the City of Mountain View ($26 million), the construction of the ultraviolet disinfection facility at the wastewater treatment plant ($26 million), and the Emergency Water Supply Project with an estimated four-year cost of $40 million. Revenues from an anticipated $35 million bond issuance will help fund the Emergency Water Supply project. State of California loans and grant funding may assist with the disinfection facility and reclaimed water pipeline projects along with $16.1 million in reimbursements from the City of Mountain View and wastewater treatment plant partners.

Operational Costs

Operationally, the Enterprise Utility Funds face similar types of cost drivers as the General Fund. After commodity expense, salary and benefits, allocated charges, rent and the equity transfers are the significant operational costs for the Enterprise Utility Funds.

2007-08 Enterprise Utility Fund Expense by Category - Fig. 3



Salary and benefits expense represents 12 percent of total budgeted expense for all Enterprise Utility Funds in 2007-08. Included in this figure are negotiated salary increases and the rising cost of health care and retiree medical benefits.

Allocated charges and rent represent 12 percent of total budgeted expense for all Enterprise Utility Funds. The utility funds reimburse the General Fund for administrative services such as attorney and payroll services, and they pay market-based rents for the use of General Fund land. Increases in General Fund expenditure are allocated based on various measures to the utility funds, and rent is adjusted annually after an independent appraisal.

The equity transfer to the General Fund from the Electric, Gas and Water Funds, represents 5% of the expense for the Enterprise Utility Funds.

Increases in operational costs may drive increases in customer rates. Many of the cost pressures described in the Expenditure Drivers section of the General Fund LRFF, also apply to the Enterprise Utility Funds.

Reserves

In addition to commodity purchasing strategies, Utility Fund reserve balances are also used to mitigate the effect on customer rates on commodity market price swings and operational cost increases. These mitigations are typically used on a one-time basis, since ongoing higher costs must eventually be borne through the rate structure. Additionally, Enterprise Utility Fund reserves provide cash for the emergency equipment replacement, and planned capital expenditures.

The total combined reserves for the Enterprise Utility Funds per the 2006-07 Comprehensive Annual Financial Report (CAFR) are $233 million. Figure 4 shows the reserves by Fund.

Risks

The Enterprise Utility Funds, like the General Fund, face significant fiscal challenges and opportunities that will impact future financial outcomes.

DOWNSIDE RISKS

Commodity Markets

Volatile markets for commodity and transmission costs will continue to present significant challenges for the Enterprise Utility Funds. Wholesale electric supply costs have increased 71 percent since 2003 and 58 percent since 2004. Water supply costs have increased almost 30 percent since 2005-06.

Currently, staff is able to mitigate the market volatility for gas and electric purchases with its three-year laddered purchasing strategy. However, if a supplier defaults or staff is unable to negotiate long-term contracts, energy supplies will need to be purchased at the then-current market price.

Weather-Related Concerns

Approximately 50 percent of the City's electric supply comes from hydroelectric projects. The availability of hydroelectric supply is dependent on the weather, and thus the cost to purchase electric commodities may increase dramatically in a dry year. The City tries to maintain sufficient cash reserves to buy energy from the market during periods of drought and replenishes the cash reserves during wet periods when production is high and purchase costs are lower. This use of reserves to balance the hydroelectric supply uncertainty enables the City to provide relatively stable rates to customers.

Regulatory Concerns

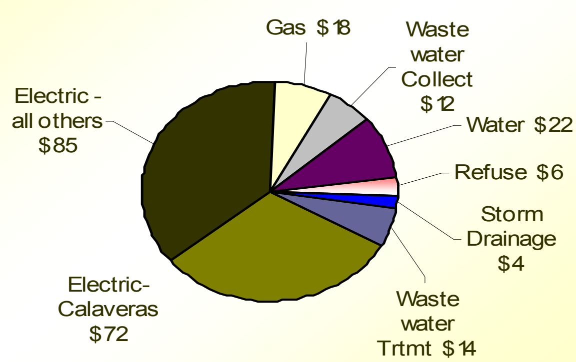
Regulatory concerns include proposed changes to the electric industry structure by the Federal Energy Regulatory Commission (FERC) and the California Independent System Operator (ISO) as well as several State of California legislative bills. If passed, the new regulations and laws would increase transmission, local capacity and reporting costs.

Funding for Capital Improvement

In recent years the cost of construction materials has risen sharply, outpacing the general rate of inflation. As the costs of material and labor rise, planned projects are being re-evaluated, delayed or scaled down.

The Storm Drainage Fund has been particularly impacted by these concerns. In 2005, property owners voted to approve a fee increase to fund specific storm drain improvement projects. Per the terms of the approved ballot measure, annual Council-approved rate increases cannot exceed the local rate of general inflation (which is significantly lower than the rate of increase in construction costs) or 6 percent, whichever is less. Due to the rapid increases in construction

2006-07 Enterprise Utility Fund Reserves - Fig. 4 (in millions of dollars)



costs, the Storm Drain Fund will be unlikely to complete all of these projects without additional funding from the General Fund. Staff is working closely with the Storm Drain Oversight Committee to develop strategies and recommendations on which projects to implement with the available funds.

The Wastewater Treatment Fund has also been adversely impacted by the rise in construction and labor costs. The $26 million reclaimed water pipeline project with the City of Mountain View has been delayed due to construction bids coming in over budget. Revenue from State grants and the Treatment plant partners will offset a portion of the increase; however, Palo Alto's portion of the cost will increase as well.

Water, Gas and Electric Fund capital improvement projects are also subject to the rising cost of construction labor and materials. The increased costs for new projects as well as on-going upgrades for replacement and reliability will have an effect on changes to customer rates.

Talent Replacement Gaps

The Enterprise Utility Funds, like the General Fund, face skill shortages in a variety of technical areas. Examples include; difficulty recruiting electrical line personnel and project engineers for the wastewater treatment plant.

Upside Potentials

The Enterprise Utility Funds have several programs and processes in place that may positively impact their financial outcomes.

Renewable Resources

The Enterprise Utility Funds are committed to the implementation of renewable energy programs. Recently the Environmental Protection Agency (EPA) designated Palo Alto as the first Green Community in California. Palo Alto's renewable portfolio standard has set a goal of purchasing 20 percent of the electric commodity supply from renewable sources by 2008 and 33 percent by 2015.

The inclusion of "green" electricity produced by landfill gas and wind power will diversify the electric commodity portfolio and allow for greater purchasing flexibility. The current renewable energy contracts are long-term, fixed price contracts with a 10 to 20 year commitment. These contracts will provide relatively low-cost and stable electric supplies if market prices continue to rise in the future.

Customer Energy Efficiency Programs

The Enterprise Utility Funds offer their customers a wide array of energy and water efficiency programs. Efficiency rebates, energy and water usage analysis and efficiency education allow customers to implement measures that will save them money and reduce the demand to purchase commodity resources.

CONCLUSION

In conclusion, this section on the Enterprise Utility Funds is designed to inform the City Council and the public of major challenges facing the Utilities. It is these factors that will drive rate changes and are important to understand.

APPENDIX A

DEFINITIONS OF REVENUES AND EXPENDITURES CATEGORIES

REVENUES:

Sales Tax
is a tax collected from customers by retailers on sales of tangible personal property and services. In fiscal year 2007-2008 it represents 18 percent of total General Fund revenues.

Property Tax
is a tax that the owners of real and personal property pay, equal to one percent of the assessed value of the property. Of the one percent, the City receives 9 percent, or .09 percent of the assessed property value. Note that the bulk of Vehicle License Fees are now remitted to the City via property tax payments from the County.

Utility Users Tax (UUT)
is a tax based on the usage of telephone, electric, water and gas utilities. The tax rate is 5 percent of the usage, with discounted rates on utility usage, available for very large users.

Transient Occupancy Tax (TOT)
is a tax levied on short-term (30 days or less) rental of lodging. The current TOT rate is 12 percent of the price of the rental.

Documentary Transfer Tax
is a tax levied on real property bought or sold in the City at the rate of $3.30 per $1,000 of value. Revenues can vary significantly from year to year since they are sensitive to the volume and value of property sales, and due to one-time transactions such as the Stanford Shopping Center lease.

Other Taxes, Fines, & Penalties

consists of remaining Vehicle License Fees paid directly by the State, parking violations, library fines, administrative citations, and other fines and penalties. Parking violations is the largest component in this category with projected revenues in fiscal year 2007-08 of $1.95 million.

Service Fees & Permits

are generated from golf course fees and class registration and admission fees in the Community Services Department; permits and plan check and zoning fees in the Planning and Community Environment Department; and paramedic service fees in the Fire Department. Plan check fees are the most significant in this area, projected to be $2.3 million in fiscal year 2007-08.

Joint Service Agreements

primarily comprise the Stanford University contract for fire and communication services, which funds 30 percent of the Fire Department's budget-approximately $7 million.

Reimbursements

refer to payments received by the General Fund (GF) for services rendered to the Enterprise Funds, such as accounting, payroll, purchasing, human resources, and legal advice.

Transfers

between Funds are a common way of moving resources for both general operations and capital projects. The main component of this source of funding is the equity transfer from the Enterprise Funds ($15.7 million), which represents a return on the City's original capital investment in the Utility Department's operations .

Other Revenues

are primarily comprised of the rent received for land and facilities used by the Utilities and Public Works Enterprise Funds. They comprise 12 percent of the total sources of GF revenue in fiscal year 2007-08.

EXPENDITURES

Salaries & Benefits

consist of salaries (regular, temporary, and overtime) and benefits (healthcare, retirement and others). Salaries and Benefits account for approximately 64 percent of fiscal year 2007-08 total expenditures.

Non-Salary Expenditures

include contract services, supplies, general expenses, rents and leases, and allocated charges. They represent 28 percent of the GF budget in fiscal year 2007-08.

Contract Services

include contracts for Children's Theatre, golf professional services, park maintenance, class instructors, traffic studies, outside legal counsel, auditing, and financial services. In fiscal year 2007-08, contract services represent 8 percent of the GF budgeted expenditures.

Supplies & Materials

include office supplies, recreational and housekeeping supplies, City employees' uniforms, construction and planting materials, and library circulation. Supplies and materials expense represents 9 percent of non-salary expenses in fiscal year 2007-08.

General Expense

is mainly comprised of the annual Cubberley lease payment to Palo Alto Unified School District (PAUSD) in the amount of $6.3 million. General expense is 25 percent of total non-salary expense in fiscal year 2007-08.

Rents, Leases & Equipment

consist mainly of land and facility rentals, other rents, and leases. It comprises only 3 percent of total non-salary expense in fiscal year 2007-08.

Allocated Expenses

include printing and mailing, vehicle replacement, technology, and benefits costs incurred by internal service funds, which are allocated to various departments based on a prescribed usage methodology.

Transfers to Other Funds

are transfers between Funds as reimbursement for services, overhead expenses, or other payments. The LRFF includes four main transfer categories: Infrastructure Management Plan (IMP) capital projects, non-IMP capital projects, debt service, and other transfers.

Debt Service

Is the interest and principal payments made to bond holders on the outstanding debt principal balance. The City of Palo Alto's total current outstanding debt principal is $9 million, one of the lowest debt levels of any city in the Bay Area.

Infrastructure Projects

are a subset of the Infrastructure Management Plan, also known as "CityWorks." It began in fiscal year 1999-00 as a 10-year, $100 million plan designed to eliminate the City's backlog of infrastructure rehabilitation projects.

Other Capital Projects

include projects for traffic calming, public art, and other miscellaneous projects. They are estimated to increase by an average annual rate of 3 percent over the next ten years.

APPENDIX B

BASIC FORECAST METHODOLOGY

Revenue Projection Methodology

Consistent with past forecasts, the compound annual rate of growth (CAGR) over the past ten years for economically sensitive revenues is the assumed rate of growth for the next ten years. In utilizing this CAGR methodology for the past ten years, the significant revenue gains during 1999 through 2001 and the steep losses from 2001 through 2003 are balanced. One shortcoming of this methodology is that it does not account for structural changes in revenue receipts, such as the departure or arrival of a major revenue-generating business. When this occurs, staff modifies the base revenues prior to developing projections.

This forecast assumes that the City will channel all revenue windfalls into reserves or one-time capital improvements. This assumption ensures that the City will not commit its resources to new or ongoing operating programs or labor commitments in flush times, only to see them cut or under-funded when revenues return to normal levels.

The forecast assumes an economic downturn in approximately three years, or in fiscal year 2010-11. Although projecting a recession is more guesswork than science, it is known that, historically, California has experienced a recession once each decade. Because of this cyclical phenomenon, anticipating a two-year downturn within the next ten years is recommended for prudent planning and fiscal management. Due to the downturn, decreased surpluses begin in 2010-11, a deficit of $2.3 million is projected for fiscal year 2011-12, and a deficit of $1.7 million is projected for fiscal year 2012-13. At this time, staff believes that corrective action is not required. Should a recession fail to materialize, the City will be in a better position than projected.

Expenditure Projection Methodology

Similar to revenue projections, expenditure projections are based on a combination of historical trends, assumptions about future growth rates, and other judgments calls. Salary projections are based primarily on existing labor agreements. For timelines beyond existing contracts, salary growth is projected using a weighted average of historical trends and regional labor cost increases.

Due to GASB 45, we have budgeted for retiree medical based on our most recent actuarial study and assumptions. Since healthcare and pension costs have risen so rapidly over the past several years, we expect these rates to moderate over the next ten years. The City will continue to explore methods of controlling the growth of these expenses, but such controls are not assumed in the plan..

Operating transfers are primarily generated in relation to capital projects. The five-year capital improvement plan is the basis for the first half of the LRFF's capital transfer projections. The last 5 years are estimated based on historical spending patterns.

APPENDIX C

LEGISLATIVE ANALYST OFFICE'S AND OTHER ECONOMIC FORECASTS

The following table summarizes the California Legislative Analyst Office's economic projections, as published in its February 21, 2007 report entitled "2007-08 Budget: Perspectives and Issues".

The Legislative Analyst's Office also compared its projections with other expert projections available at the time of publication. The table at the right summarizes projections made by the UCLA Business Forecast Project in December 2006, the 2007-08 Governors' Budget Forecast, and the consensus forecasts published in the Blue Chip Economic Indicators in January and February 2007. To varying degrees, all of the projections call for slowing growth with a partial rebound in 2008, with the UCLA Business Forecast Project anticipating a slightly more significant slowdown than did the other California forecasters.

LAO February Report	2007 (estimated)	2008 (forecast)	2009 (forecast)
National Figures:			
Real GDP	2.5%	3.1%	3.4%
Unemployment	4.9%	4.9%	4.6%
Job Growth	1.2%	1.4%	1.6%
Personal Income	5.3%	5.5%	6.1%
CA Figures:			
Unemployment	4.9%	4.8%	4.6%
Job Growth	1.4%	1.7%	1.8%
Personal Income	5.6%	5.7%	6.2%

Comparisons of Recent Economic Forecasts a

(% Changes)	Forecast		
	2006	2007	2008
United States Real GDP:			
UCLA December	3.2	2	3.1
DOF January	3.3	2.4	2.9
Blue Chip Consensus b January	3.3	2.4	3
LAO February	3.4	2.5	3.1
California Payroll Jobs:			
UCLA December	1.5	0.5	1
DOF January	1.8	1.2	1.6
Blue Chip Consensus c February	1.5	1.1	1.2
LAO February	1.9	1.4	1.7
California Personal Income:			
UCLA December	7.2	4.3	4.6
DOF January	6.6	5.7	5.4
Blue Chip Consensus c February	5.8	5.3	5.6
LAO February	6.1	5.6	5.7
California Taxable Sales:			
UCLA December	6.2	4.2	4.7
DOF January	4.5	3.1	5.4
Blue Chip Consensus c February	5.3	4.4	5
LAO February	4.8	3.5	5.2

a Acronyms used apply to Legislative Analyst's Office (LAO); University of California, Los Angeles (UCLA); and Department of Finance (DOF).

b Average forecast of about 50 national firms surveyed in January by *Blue Chip Economic Indicators* .

c Average forecast of organizations surveyed in February by *Western Blue Chip Economic Forecast* .

[1] LAO 2006-07 Budget: Perspectives and Issues, 2/21/07, page 34

[2] LAO "Perspectives on the Economy and Demographics" 2/21/07, page 28

APPENDIX D

HISTORICAL TRENDS

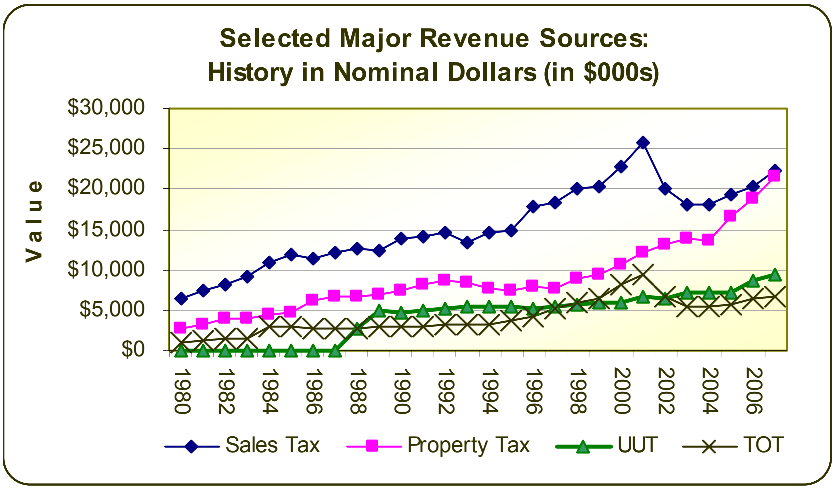
Historical trends help portray the context in which the City operates and are carefully considered in preparing this forecast. Please note that the total revenue and expenditure figures in this section may differ from those of other financial documents published by the City due to differences in reporting formats.

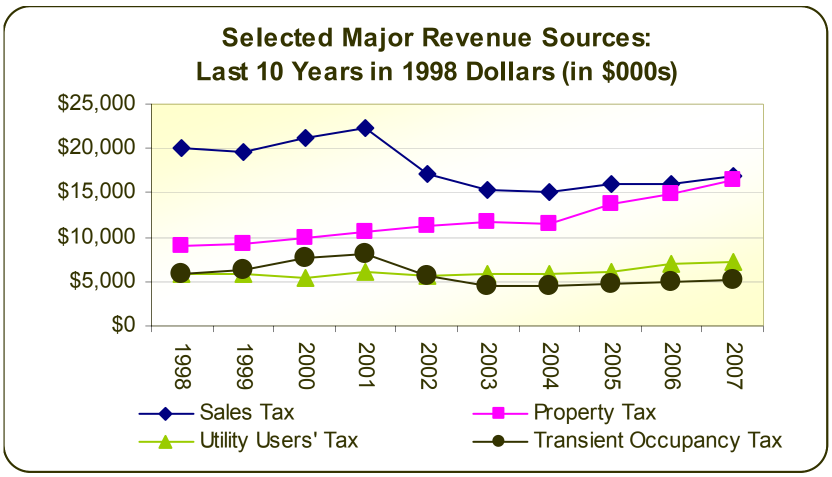
GENERAL FUND REVENUE SOURCES

These charts show the major sources of General Fund revenues, first in nominal dollars (not adjusted for inflation) and then in constant dollars (adjusted for inflation). Both illustrate that sales tax revenue reached a high in 2001 and has since declined markedly, while property tax revenue has increased steadily over the past ten years. Utility users tax revenue has remained relatively stable, and transient occupancy tax revenue has followed the swings of the economy during the past ten years.

The second chart shows that, in real dollars, sales tax revenue is lower now than in 1998, while property tax is higher. UUT and TOT have remained relatively unchanged since 1998.

Selected Major Sources: Average Annual Growth Rate				
	Property Tax	Sales Tax	UUT	TOT
From 2005 to 2007	9.5%	3.5%	9.5%	4.8%
From 2002 to 2007	7.7%	-0.2%	5.3%	-1.9%
From 1998 to 2007	7.1%	-1.8%	2.4%	-1.4%

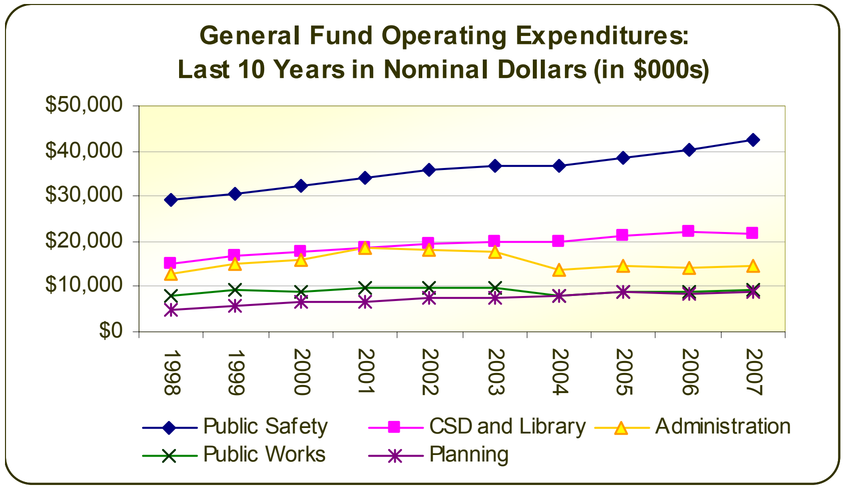


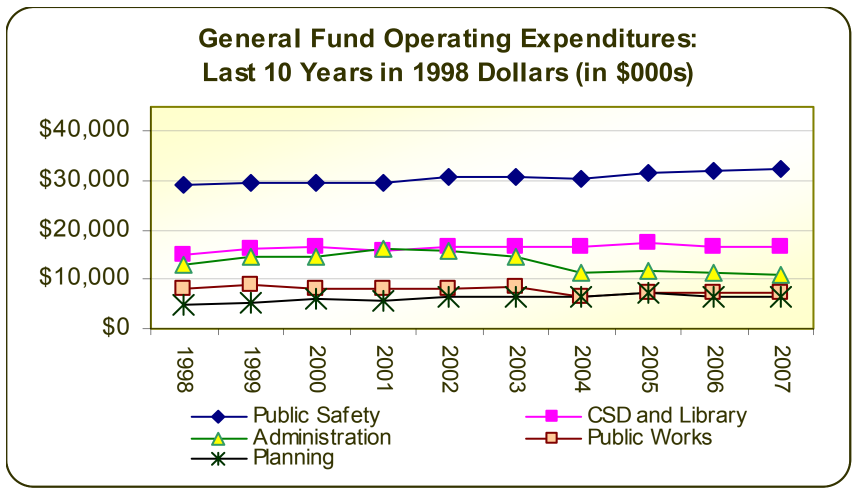


Note: Administration is comprised of City Council, City Manager, City Attorney, City Auditor, Administrative Services, and Human Resources. Chart does not show separation of Library from Community Services beginning in 2005.

General Fund Operating Expenditures

General Fund operating expenditures are also shown in both nominal dollars (not adjusted for inflation) and constant dollars (adjusted for inflation). The largest percentage of total expenditures has been devoted to public safety. Also, expenditures for administration peaked in 2001 and have since decreased significantly.





General Fund Operating Expenditures: Average Annual Growth Rate

	Public Safety	CSD and Library	Admin	Public Works	Planning
From 2005 to 2007	1.1%	-1.9%	-3.9%	0.0%	-4.2%
From 2002 to 2007	1.2%	0.0%	-6.7%	-2.5%	0.9%
From 1998 to 2007	1.2%	1.2%	-1.8%	-1.4%	3.5%

Why Look at Past Trends?
Understanding where we've been helps us understand where we're headed.

CONSUMER PRICE INDEX TRENDS

Tables for U.S. and Bay Area CPI indices are presented below.

U.S. Consumer Price Index

Fiscal Year	Amount	Percent Change
1997	160.3	
1998	163.0	1.7%
1999	166.2	2.0%
2000	172.4	3.7%
2001	178.0	3.2%
2002	179.9	1.1%
2003	183.7	2.1%
2004	189.7	3.3%
2005	194.5	2.5%
2006	202.9	4.3%
2007	208.4	2.7%

Bay Area Consumer Price Index

Fiscal Year	Amount	Percent Change
1997	160.0	
1998	165.5	3.4%
1999	171.8	3.8%
2000	179.1	4.2%
2001	190.9	6.6%
2002	193.2	1.2%
2003	196.3	1.6%
2004	199.0	1.4%
2005	201.2	1.1%
2006	209.1	3.9%
2007	216.1	3.3%

Source: U.S. Department of Labor
Bureau of Labor Statistics
June of each year

Average Annual Growth Rate	
Last 2 Years	3.5%
Last 5 years	3.0%
Last 10 Years	2.7%

Average Annual Growth Rate	
Last 2 Years	3.6%
Last 5 years	2.3%
Last 10 Years	3.1%

Bureau of Labor Statistics

June of each year

City Housing Units and Population Trends

Tables for Palo Alto Housing Units and Population trends are presented here.

City of Palo Alto Housing Units

Fiscal Year	Amount	Percent Change
1997	25,625	
1998	25,701	0.3%
1999	25,708	0.0%
2000	25,732	0.1%
2001	26,048	1.2%
2002	26,841	3.0%
2003	26,934	0.3%
2004	27,019	0.3%
2005	27,522	1.9%
2006	27,767	0.9%
2007	27,763	0.0%

City of Palo Alto Population

Fiscal Year	Amount	Percent Change
1997	57,800	
1998	57,900	0.2%
1999	58,300	0.7%
2000	58,500	0.3%
2001	60,200	2.9%
2002	60,500	0.5%
2003	60,465	-0.1%
2004	60,246	-0.4%
2005	61,674	2.4%
2006	62,148	0.8%
2007	62,615	0.8%

Average Annual Growth Rate	
Last 2 Years	0.4%
Last 5 years	0.7%
Last 10 Years	0.8%

Average Annual Growth Rate	
Last 2 Years	0.8%
Last 5 years	0.7%
Last 10 Years	0.8%

State of California, Department of Finance
Demographic Research Unit

What do these charts show?
Population, housing and inflation trends for the last 10 years. These are considered in making revenue and expenditure forecasts.

Americans with Disabilities Act Statement

In compliance with
Americans with Disabilities Act (ADA) of 1990,
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For information contact:

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Acknowledgements

Staff thanks City Manager, Frank Benest, Director of Administrative Services, Carl Yeats, and Assistant Director of Administrative Services, Lalo Perez for their careful review and support in preparing this document. In addition, thanks to Debra Remley for her conscientious administrative support.

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The City of Palo Alto is located in northern Santa Clara County, approximately 35 miles south of the City of San Francisco and 12 miles north of the City of San Jose. Spanish explorers named the area for the tall, twin-trunked redwood tree they camped beneath in 1769. Palo Alto incorporated in 1894 and the State of California granted its first charter in 1909.

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