City of Palo Alto (ID # 3248)

Finance Committee Staff Report

Report Type: Action Items **Meeting Date: 12/18/2012**

Summary Title: Fiscal Years 2013 to 2023 Long Range Financial Forecast

Title: Review of Fiscal Years 2013 to 2023 Long Range Financial Forecast

From: City Manager

Lead Department: Administrative Services

Recommendation

Staff recommends that the Finance Committee review and comment on the attached draft forecast of revenues and expenses and forward it to the full Council for review and input

Executive Summary

The City's General Fund Long Range Financial Forecast (LRFF) illustrates the City's financial future based on a variety of assumptions. It is a fiscal portrait of the next ten years painted at one point in time. (See Attachment A.)

The LRFF shows better "bottom line" results than in last year's presentation. This is due to employee benefit concessions, budget reductions, and higher revenues. The City must continue, however, to find additional structural savings as benefit costs are increasing at a higher rate than revenue increases. Although healthy revenue increases ranging between 1 to 4 percent are projected over the next 10 years, expense forecasts begin to exceed revenues in Fiscal Year 2021. In addition, funding for General Fund infrastructure improvements, a key City priority, continues to be a challenge. To maintain prudent fiscal stewardship, the City must continue to explore its benefit structure, alternative forms of service delivery, and more efficient operations.

We are also including a summary of the California Public Employees' Pension Reform Act of 2013 (PEPRA) that was enacted in fall of 2012. (See Attachment B.)

Background

Attached to this report is the City's updated General Fund LRFF for Fiscal Years 2013 through 2023. The LRFF identifies key issues that affect the City's future financial condition and will guide the upcoming Fiscal Year 2014 annual budget process.

Discussion

This report serves as a forecast and is not a plan or commitment. It is contingent upon a number of assumptions which are outlined in the report and serves as a view of the future at one point in time. The goal is to identify key issues that must be addressed in the near term to improve the City's long-term outlook. Below is a summary of the Base Model contained in the attached report.

Table 1:
Base Model
Fiscal Years 2013 to 2023

	Projected 2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Revenues	154,593	156,817	163,384	168,722	174,176	179,664	185,790	192,232	197,624	203,540	210,614
Total Expenditures	153,401	156,246	161,190	165,620	171,671	177,965	185,547	191,412	198,602	206,122	213,992
Net Surplus (Gap)	1,191	571	2,194	3,102	2,506	1,699	243	820	(978)	(2,582)	(3,379)
Budget Stabilization Reserve Projection	29,313	29,884	32,079	35,180	37,686	39,385	39,628	40,448	39,470	36,888	33,510
Minimum Reserve - 18.5%	28,379	28,905	29,820	30,640	31,759	32,924	34,326	35,411	36,741	38,133	39,589
Amount Exceeding/(Below) Minimum	934	979	2,259	4,541	5,927	6,462	5,302	5,037	2,729	(1,244)	(6,079)

Attachments:

- Attachment A: Long Range Financial Forecast Fiscal Years 2013 to 2023 (PDF)
- Attachment B: AB340 Pension Reform Summary (DOCX)

Attachment A

CITY OF PALO ALTO

LONG RANGE FINANCIAL FORECAST

Fiscal Years 2013 to 2023

Finance Committee Draft—December 18, 2012

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EXECUTIVE SUMMARY

This forecast summarizes the General Fund outlook for Fiscal Years (FY) 2014 through 2023. Rather than a prediction or commitment, a forecast is a financial snapshot based on a number of assumptions. This Long Range Financial Forecast (LRFF) is a tool to allow staff and Council members to see the longer-term results of choices made up to date, and identify issues that must be addressed in the near term in order to improve the City's long-term outlook.

The national and state economies continue to show improvement. At the national level, growth in the next one to two years ranges between 2-3 percent, with potential growth of over 3 percent in 2014. With California being one of the top ten labor markets in the country, a 1.5 percent unemployment rate decrease between September 2011 and 2012, a strong export market, and concentrated interest of venture capital investors in Silicon Valley, the state has cause for optimism. Locally, job growth is steady and the housing market increasingly robust. A few recent challenges for the City, such as providing adequate parking downtown and at California Avenue, reflect the noticeable increase in economic activity.

FY 2011 and 2012 ended with net positive results. FY 2011 ended with a $3.2 million General Fund surplus, and FY 2012 financial results included a $4.5 million surplus. Therefore, staff recommended a transfer or $7.6 million from the General Fund to the Infrastructure Reserve to support of the Council's Infrastructure priority.

The LRFF Base Model shows a continuing positive trend. FY 2013 is projected to end with a $1.2 million surplus. In the LRFF Base Model, the combined Net Surpluses for FY 2014 to 2023 (ten years) are $4.2 million. The Base Model can be found on page 20 of this report. Below is a summary.

BASE MODEL SUMMARY

	Projected 2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Revenues	154,593	156,817	163,384	168,722	174,176	179,664	185,790	192,232	197,624	203,540	210,614
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Amount Exceeding/(Below) Minimum	934	979	2,259	4,541	5,927	6,462	5,302	5,037	2,729	(1,244)	(6,079)

The Base Model includes two assumptions indicated by Council: (1) 10 percent annual medical cost increases from FY 2014 on and (2) 3-percent annual pension rate increases beginning FY 2017. The PERS actuarial report received November, 2012 provides the base rates used in FY 2014 to 2016. PERS rates used in this forecast can be found on page 17 of this report.

EXECUTIVE SUMMARY

The Base Model also includes savings from the recent agreements with the Palo Alto Police Officers' Association (PAPOA), the Service Employees International Union (SEIU) and the Management/Professional group. The savings from these three agreements add to $2.7 million in FY 2013.

Additional assumptions incorporated into the Base Model are detailed beginning on page 6.

In addition to the Base Model, two alternate scenarios are included. One allocates additional funding to the Capital Fund, creating additional expenditures of $36.8 million and bringing the cumulative surplus of $4.2 million down to a combined deficit of $32.6 million. The other assumes 4.5% annual PERS rate increases from 2017-2023, rather than the Base Model's assumed 3% increases. This scenario changes the combined bottom line from a $4.2 million surplus to $22.5 million deficit from FY 2014-2023—a total negative change of $26.7 million. Both scenarios can be found beginning on page 24 of this report.

The following pages of this report provide a summary of national, state, and local economic outlook; the updated Base Model, the assumptions used, and a brief discussion of major categories; two alternative scenarios for pension cost and increased funding to infrastructure; and a summary of employee concessions to date.

ECONOMIC OUTLOOK

Economic growth – on national, state, and local levels - has finally begun to look more robust in the past year. The following indicators contribute to the impression that the economy is on a more stable footing:

National

- Predictions for growth in next 1-2 years range from 2-3% (Beacon Economics) to potentially above 3% for 2014 (Anderson School of Business Forecast).
- Home values are now 2% to 3% above where they were last year at this time. See Housing Summary Table on page 4 for details on national, state and local housing market progress.
- In September, the national unemployment rate fell to 7.8%, its lowest level since January 2009, followed by a 0.1% increase in October. So far in 2012, overall job growth has averaged 143,000 a month, compared with 153,000 in 2011.[1] The small increase in October is attributed to the increasing re-entry of workers into the work force.
- Lower labor costs helped push corporate profits to a record 10.6 percent of US GDP in the first three months of 2012.[2]

HOUSING MARKET SUMMARY	
USA	• Home values are now 2% to 3% above where they were last year at this time.[3]
CALIFORNIA	• Since hitting bottom in April 2009, the median price of a home is up more than 24%. • Beacon Economics expects home prices to grow at roughly 7% in 2012 at about 5% in 2013 before settling out in the mid-3% range in 2016-2017.[4] • Sales of existing, single family detached homes were up 15.3 percent from a year earlier (July to July). Pace of existing home sales during first seven months of 2012 was up 7 percent from the same months of 2011.[5]
SF BAY AREA	• Single-family home prices climbed 16 percent in the Bay Area between September 2011 and September 2012. • Bay Area home values increased 8.2 percent between the 3rd quarter of 2011 and that of 2012, but are still down 29.5 percent from their peak in 2006.[6] • Silicon Valley home prices are close to an all-time high. In the 3rd quarter of 2012, Los Altos, Palo Alto, and Burlingame reached home prices just several percentage points away from peak levels in 2008.[7]

ECONOMIC OUTLOOK

State

- California remains one of the top ten labor markets in the country. The state accounted for half of all the jobs created nationwide in May and all of the job growth in the US in June.[8]
- The state unemployment rate declined to 10.6% in August and 10.2% in September, down from 11.7% in September 2011. Moreover, state job growth was broad-based. Every sector besides Farm, Manufacturing and Government, posted job growth over the last 12 months. Construction has led the charge adding 6% to its payrolls.[9]
- UCLA Anderson Forecast predicted unemployment levels of 9.8% in 2012 and 8.5% in 2014[10] ; Beaconomics forecasts job growth of 2% through 2012 and 2013, increasing to 2.5% to 3.0% per year from 2015 to 2017. Taxable sales rose 9.2% on a year-over-year basis in Q1 2012, and are forecasted to grow an average of 7% over the next year, reaching their pre-recession peak by the end of 2012.[11]
- Venture capital investments continue to be concentrated in Silicon Valley and California vs. rest of nation.[12]
- See Housing Market Summary, page 4 for info on the state housing market.

Local

- The Bay Area has been the strongest regional economy in California. Two of its three major urban centers, the South Bay and the SF-San Mateo-Marin region, in recent months have posted the fastest rate of annual employment growth in the entire country.[13]
- Total nonfarm employment in the San Jose area increased for each of the last 10 months and has now added back 83% of all nonfarm jobs lost in the South Bay since March 2008. The technology industry has led the way.[14]
- Caltrain Annual Passenger Counts show a 15.7% increase in ridership to Palo Alto between February 2011 and February 2012.[15]
- Home prices in Silicon Valley are at an all-time high. (See Housing Table on page ___ for details.)
- Palo Alto is seeing a noticeable increase in commercial activity, as evidenced by the opening of several new retail stores, and a renewed dearth of parking capacity, with Council and staff now weighing a range of solutions
- The last two years have been a period of steady growth in revenues for local hotels, and five hotels are in the pipeline, including:
    - Hilton Garden Inn: 175 Rooms. Expected opening: 2014
    - Hilton Homewood Suites: 138 Rooms, Expected opening, 2014
    - Casa Olga: 86 rooms. Approved July 23, 2012. Renovations are currently under construction. Expected opening, summer 2013.
    - Mings (1700 Embarcadero): 147 Rooms. Council approval requires that building permits must be obtained and construction commence must start by April 2014.
    - Westin annex (711 El Camino Real) (Clement): 23 room expansion. Preliminary architectural review occurred in May 2012. No formal application has been received.

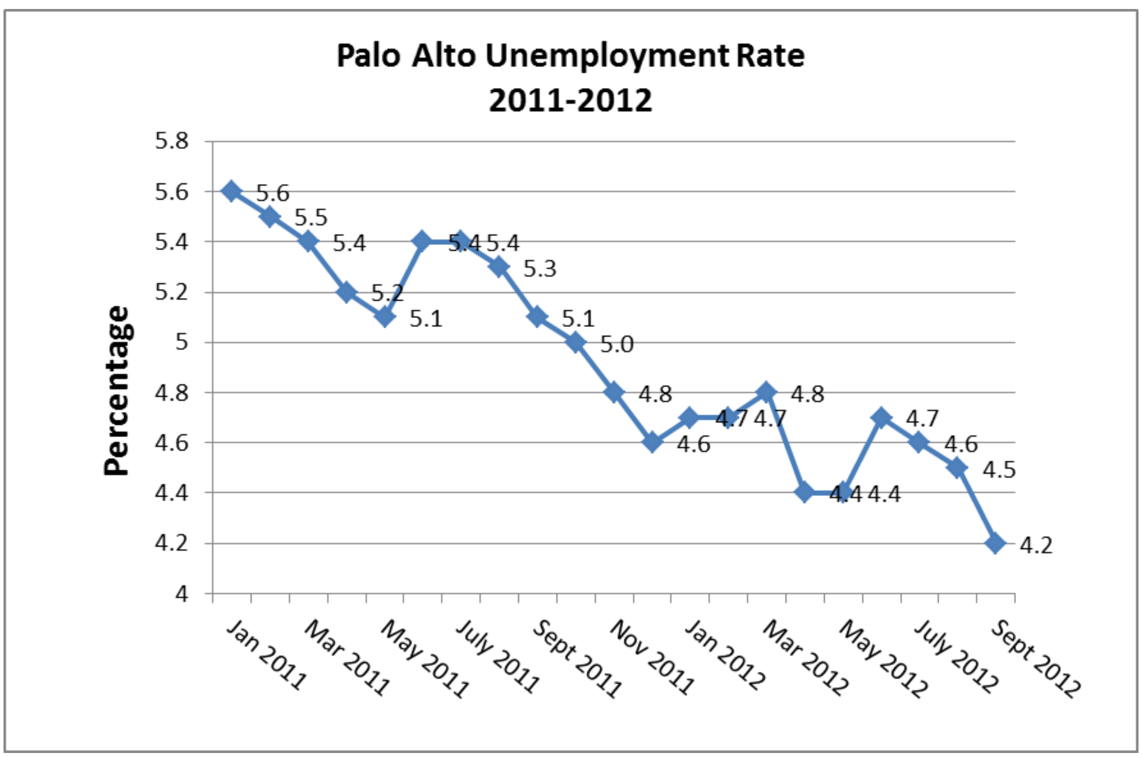
IMPACT OF ECONOMIC OUTLOOK ON ASSUMPTIONS USED IN MODEL

As a result of the factors discussed above, the Forecast includes relatively healthy growth in sales, property, transient occupancy and documentary tax revenues. The following chapter discusses each revenue source in detail.

Unemployment Rates, 2011-2012

	Sept. 2011	***Sept. 2012 (prelim.)***
Palo Alto Civilian Unemployment Rate	*5.1%*	*4.2%*
Santa Clara County Unemployment Rate	*9.6%*	*7.9%*
CA Unemployment Rate	*11.5%*	*9.7%*
US Unemployment Rate	*8.8%*	*7.6%*

Source: EDD Labor Market Information Division, October 19, 2012



UPDATED MODEL

ASSUMPTIONS INCLUDED IN THE MODEL

The following describes factors assumed in the Base Model. Some descriptions refer to the Compound Annual Growth Rate, or CAGR, which is the average rate of growth over a period of time for a revenue or expense category. The Base Model uses the CAGR over FYs 2008 to 2012, as noted in the discussions of each revenue and expense category, as a guideline for future rates of increase.

The FY 2013 revenues and expenditures include a number of one-time expenditures and savings. For forecasting purposes, beginning FY 2014, the Base Model does not include these one-time items. During the annual budget process, staff will have the opportunity to review the impacts of operational changes and determine whether positions can be permanently eliminated and whether one-time cost saving items can be sustained on an ongoing basis.

Specifically, the Base Model removes from the FY 2014 base budget the following:

- $1.1 million salary and benefits net increase due to the release of previously frozen positions and budget reductions (increasing FY 2014 expenditures)
- $0.2 million in one-time, non-salary costs, including $80,000 for a Police Service Study; $50,500 for Comprehensive Plan funding; and $70,000 for an organizational study of the Planning and Community Environment department. (decreasing FY 2014 expenditures)
- The payback of a $4.9 million loan to the Technology Fund. The last payment of $1.2 million on this loan was completed in FY 2013. (decreasing FY 2014 expenditures)

In addition to these items, the FY 2014 projected budget assumes a one-time net decrease in revenues of $1.4 million for the Golf Course Reconfiguration project. The entire ten-year period includes an assumed $1 million in additional operational expenses attributable to the Library renovations.

Recent agreements with the Palo Alto Police Officers' Association (PAPOA), the Police Management Association (PMA), Service Employees International Union (SEIU), and the Management/Professional group – resulting in a combined savings of $1.9 million in FY 2013 – are included in the Base Model.

Revenue increases ranging from 1 to 4 percent are projected over the next 10 years. Although this is a good sign of improved city resources, looming pension and retiree medical obligations and infrastructure needs exceed available resources. The most recent valuation report from CalPERS increases the FY 2014 City contribution by 1.6 percent and 3.4 percent for the City's Miscellaneous and Safety groups, respectively, and results in $1.8 million in additional General Fund expense for FY 2014 compared to FY 2013. Furthermore, the General Fund's retiree medical obligation is $9.1 million in the coming FY and is expected to grow 3.25 percent annually.

As recommended by the Infrastructure Blue Ribbon Commission (IBRC) report (December, 2011), and approved by Council beginning in FY 2013, the Base Model incorporates an additional $2.2 million in capital operating and maintenance funding ("keep-up"). Although the Base Model reflects a balanced budget for the next seven fiscal years, the IBRC report recommended that an additional $4.2 million be contributed annually towards the City's infrastructure "catch-up" needs. In addition to funding these "catch-up" needs, the IBRC report also recommends other project and construction needs totaling approximately $210 million. These needs, including a new Public Safety Building and rebuilding the Municipal Service Center, are not included in the Base Model or either of the alternate scenarios. The Council started discussions on how to address these new or replacement needs.

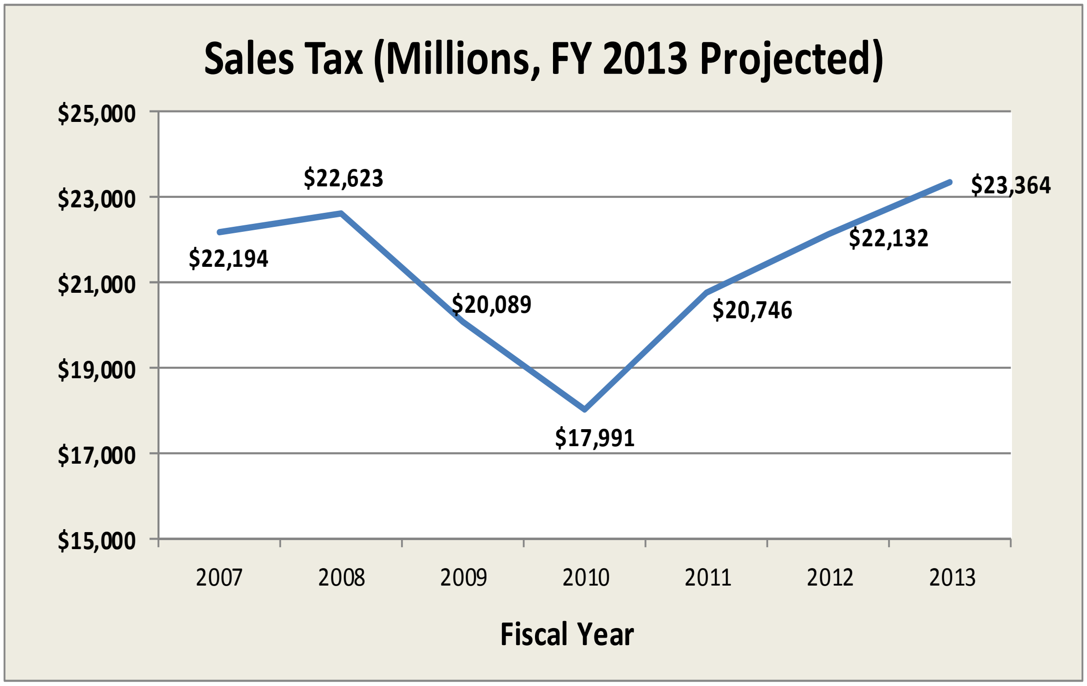
Lastly, the LRFF contains two alternate scenarios that address pension costs in addition to the Base Model and the financial outlook of providing additional funding to the City's capital Fund. These concerns and can be found beginning on page 24 of this report.

REVENUES

Tax revenues in Palo Alto have improved markedly since the beginning of the Great Recession and are expected to continue their upward trend in the near future.

Sales Tax

This economically sensitive revenue source is bouncing back from its recession low of $18.0 million in FY 2010. Receipts rose to $20.7 million in FY 2011 and to $22.1 million in FY 2012. Staff is currently projecting sales tax revenues of $23.4 million in FY 2013, nearly $0.8 million above the adopted budget. Receipts in the first quarter of FY 2013 which are 6.7 percent above the prior year's first quarter support this forecast. Robust economic segments include electronic equipment, apparel stores, restaurants, and service stations. Weak performers include furniture/appliance and business services. Staff's forecast is in line with that of the City's sales tax consultant Muni-Services, with annual growth rates in the 3.5% to 4.4% range over the next ten years. Staff estimates that sales tax revenue will rise to $24.3 million in FY 2014, a 4.1 percent or $1.0 million increase, above estimated FY 2013 year end revenue.



Property Tax

Unlike many California jurisdictions, Palo Alto's property taxes did not take a material "hit" as a consequence of the Great Recession. Revenues have remained relatively stable as shown below:

Fiscal Year	Property Tax Revenues
2009	$25.4 million
2010	$26.0 million
2011	$25.7 million
2012	$26.5 million

For the past several years, staff has primarily relied on County estimates to develop its property tax budget. The County has regular meetings to inform cities and school districts on assessment roll growth and events that can impact revenues (e.g. appeals from commercial and residential properties). Based on recent County data, it is likely that receipts will exceed the FY 2013 adopted budget of $27.3 million by some $0.5 million.

As stated in the previous chapter, housing values in Silicon Valley are rising at a faster rate than the rest of California and the country. According to a November "Intero Real Estate Services" update, "While the rest of the country has been recovering…the Bay Area housing market has exploded over the last 18 to 24 months. Most listings are selling with multiple offers and considerably over list price." This prognosis for the Palo Alto real estate market will likely translate into higher documentary transfer and property taxes. For FY 2014, property tax revenue is projected at $28.9 million, a $1.1 million or 4 percent increase above the current fiscal year estimate of $27.8 million.

Transient Occupancy Tax (TOT)
Since declining to $6.9 million in FY 2010 due to the Great Recession, TOT revenues have steadily risen. In FY 2011 receipts totaled $8.1 million and in FY 2012 they moved to $9.7 million. Staff now estimates they will increase to $10.4 million in FY 2013 and to $11.0 million in FY 2014. Average occupancy and daily rates, respectively, have surged from 66 percent and $139 per day in FY 2010 to an average of 85 percent and $174 in the first quarter of FY 2013. With increased business activity and visitors to Palo Alto, staff will adjust the FY 2013 budget upward by approximately $0.8 million, and the out years of the Forecast include annual growth rates of 5.7 percent in 2014 declining to 5 percent in 2015 and 4.0-4.5 percent in the remaining years. Note that the Base Model Forecast does not include revenue from hotels expected to open in FY2014.

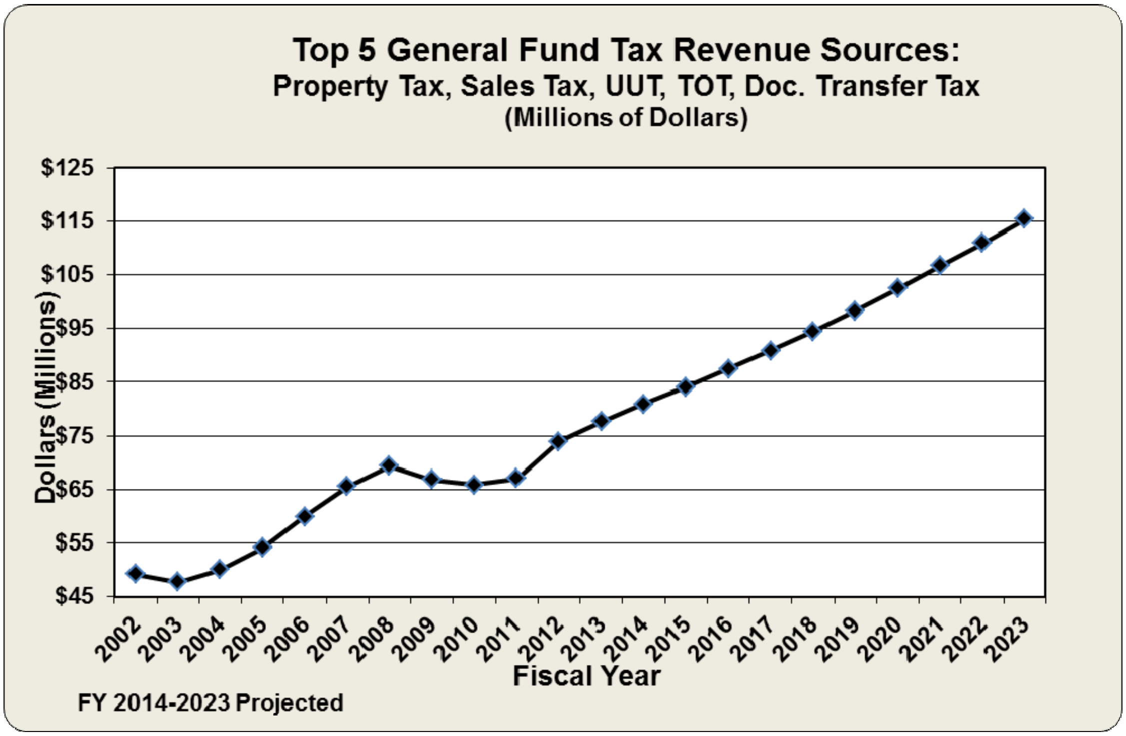
Documentary Transfer Tax (DTT)
This revenue source is based on the number and value of commercial and residential property sales. In the last decade, revenues have averaged $4.8 million per year. During the recession period, DTT revenues fell to $3.1 million in FY 2009 and to $3.7 million in FY 2010. Results for FY 2011 and 2012 were $5.2 million and $4.8 million, respectively. With revenue stabilizing in the last two FYs and the rising value of commercial and residential transactions in the first quarter of FY 2013, staff is projecting receipts in FY 2013 of $5.2 million, or about $122,000 higher than Budget. FY 2014 revenue is estimated to be $5.5 million, a 6.6 percent or $0.3 million increase above the FY 2013 year end projection.

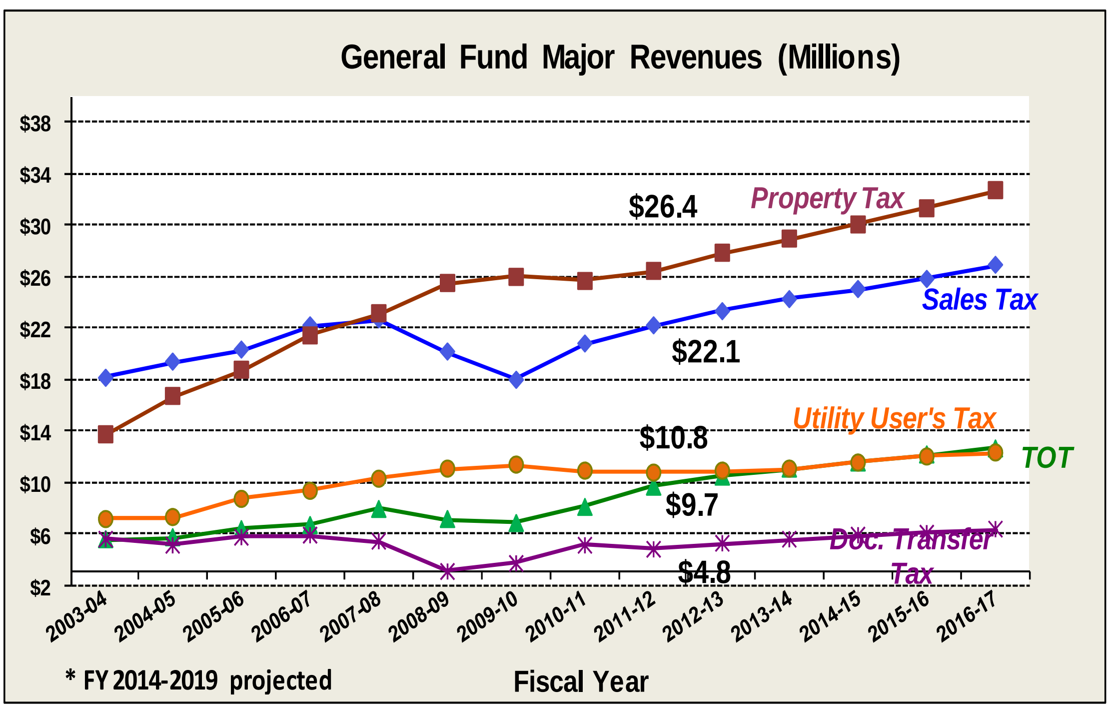
Utility Users Tax (UUT)
FY 2013 UUT revenues are expected to be the same as actual FY 2012 revenues, or $10.8 million. The utility-generated UUT estimates assume the rate increases in electric, water, and gas that are shown in the table below. Note that the assumed increases through FY 2016 come from Utility department rate projections. The remaining years' increases are based on the CAGR for the preceding 5 years. Telephone-generated revenues continue their downward decline, due to decreased landline usage.

UTILITY RATE INCREASE ASSUMPTIONS USED IN UUT PROJECTION

FISCAL YEAR	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Electric	*0%*	*4%*	*6%*	*5%*	*4%*	*4%*	*4%*	*4%*	*4%*	*4%*
Water	*15%*	*9%*	*3%*	*2%*	*4.3%*	*4.3%*	*4.3%*	*4.3%*	*4.3%*	*4.3%*
Gas	*4%*	*5%*	*4%*	*4%*	*0.8%*	*0.8%*	*0.8%*	*0.8%*	*0.8%*	*0.8%*

Other Taxes & Fines
The large part of this category is comprised of Parking Violation revenue, which staff is estimating to be $1.5 million in FY 2014. Other revenue items such as traffic violations, administrative citations, and library fines and fees have continued to grow over the past five years. Another component of this revenue category is the Vehicle-in-Lieu Fee (VLF). In FY 2012, the state legislature suspended its allocations to local agencies in order balance the State budget. Until the legislature takes action to restore it, staff is not projecting any VLF receipts in this forecast. Staff expects that FY 2014 revenue will end at the same level as FY 2013, which is $2.1 million.


Top 5 General Fund Tax Revenue Sources:
Property Tax, Sales Tax, UUT, TOT, Doc. Transfer Tax
(Millions of Dollars)
Dollars (Millions)
$125
$115
$105
$95
$85
$75
$65
$55
$45
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
2023
Fiscal Year
FY 2014-2023 Projected


General Fund Major Revenues (Millions)
$38
$34
$30
$26
$22
$18
$14
$10
$6
$2
$26.4
Property Tax
Sales Tax
$22.1
Utility User's Tax
$10.8
TOT
$9.7
Doc. Transfer Tax
$4.8
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
2011-12
2012-13
2013-14
2014-15
2015-16
2016-17
* FY 2014-2019 projected
Fiscal Year

Charges for Services
Total revenues in this category are projected to be $2.9 million lower in FY 2014. Most of this reduction is attributable to the loss of $2.2 million in Golf Course revenue while the course closes for reconfiguration. Additionally, the FY 2013 adopted budget assumed revenue increases related to the Development Center expansion and cost of service study implementation, totaling $0.9 million. These anticipated revenue enhancements were not assumed in the FY 2014 Base Model. Staff plans to present Council with results of the cost of services study in January/February 2013.

Based on the National Golf Foundation estimate presented to Council, completion of the golf course reconfiguration will bring in $0.3 million additional revenues beyond the $2.2 million lost in FY 2014. This is included in Base Model. For the Charges for Services category, the forecast also assumes a 3.5 percent growth rate for the overall Charges for Services category from FY2015 through FY 2023.

Stanford Fire and Dispatch Services
The City currently is under agreement with Stanford University to provide Fire Response and Dispatch services. Stanford is charged 30.3 percent of the Fire Department's net cost and 16 percent of the Police Department's Communication and Dispatch Division. With the exception of pension, healthcare, and retiree medical obligation cost increases, the FY 2014 base does not assume any significant changes for the Fire Department and Police Communication and Dispatch Services budgets. Stanford fire and dispatch revenue is estimated to increase by $0.2 million in FY 2014 due to pension, healthcare, and retiree medical cost increases. The Base Model assumes that revenue from this agreement will increase 3.5 percent annually.

Currently, the City is in negotiations with Stanford for the Fire Services component of the contract. The FY 2013 budget includes a total of $8.2 million of revenue from Stanford for Fire and Dispatch Services. In the best scenario, the final determination of a new reimbursement agreement could result in $1.4 million in additional revenue; in the worst scenario the agreement could be terminated entirely. The agreement requires the University to give 12 months' notice of termination. Assuming that negotiations are concluded in FY 2014, a modest increase of 3.5% has been built into the outer years to account for staffing and other department costs.

Permits and Licenses
Revenue from permits and licenses rose significantly in FY 2011 and 2012 due primarily to increased activity at the Development Center. Budgeted revenue in FY 2013 decreased in FY 2013 because the city implemented a citywide Technology Enhancement Fee and these revenues, which had previously been charged only to some development permits, were moved from the General Fund to the Technology Fund. This revenue category is projected to decrease slightly due to two factors. Internal street cut fees, which are based on Utilities activities, are reduced $.11 million to reflect planned project activities. Additionally, based on historic activity, the Forecast is decreased approximately 2 percent per year to reflect an assumed slowdown in permit activity through FY 2018, followed by a 3.5 percent annual growth in subsequent years.

UPDATED MODEL

Return on Investment
General Fund interest earnings have declined 82 percent from FY 2009 to projected FY 2013 levels, as higher-yielding maturing investments are re-invested in a historically low interest rate environment. The Federal Open Market Committee remains committed to keeping interest rates at exceptionally low levels through mid-2015 to stimulate the economy and boost job growth. This action would continue to keep downward pressure on the City's portfolio yield in FY 2014. The interest earnings are projected to gradually increase by 1.3 percent in FY 2015 growing to 3.0 percent in FY 2023. It is expected that FY 2013 revenue will be below the adopted budget by $0.2 million, totaling $0.8 million. In FY 2014, return on investment revenue is estimated to remain level at $0.8 million.

Rental Income
The largest source of rental income is the City's Enterprise Funds and the Cubberley Community Center. The rent from the Enterprise Funds declined $2.5 million with the closure of landfill, the Middlefield Well site, and the former Los Altos Treatment Plant (LATP) site in FY 2013. FY2014 rental income also reflects partial closure of restaurant and pro-shop facilities during the Golf Course Re-Configuration Project. For this forecast period, a 2.5 percent growth was assumed for all rental properties – tied to the projected increase in the CPI, which drives Enterprise Fund facility rental fees - except for the Refuse Fund rent which remains fixed until FY 2021.

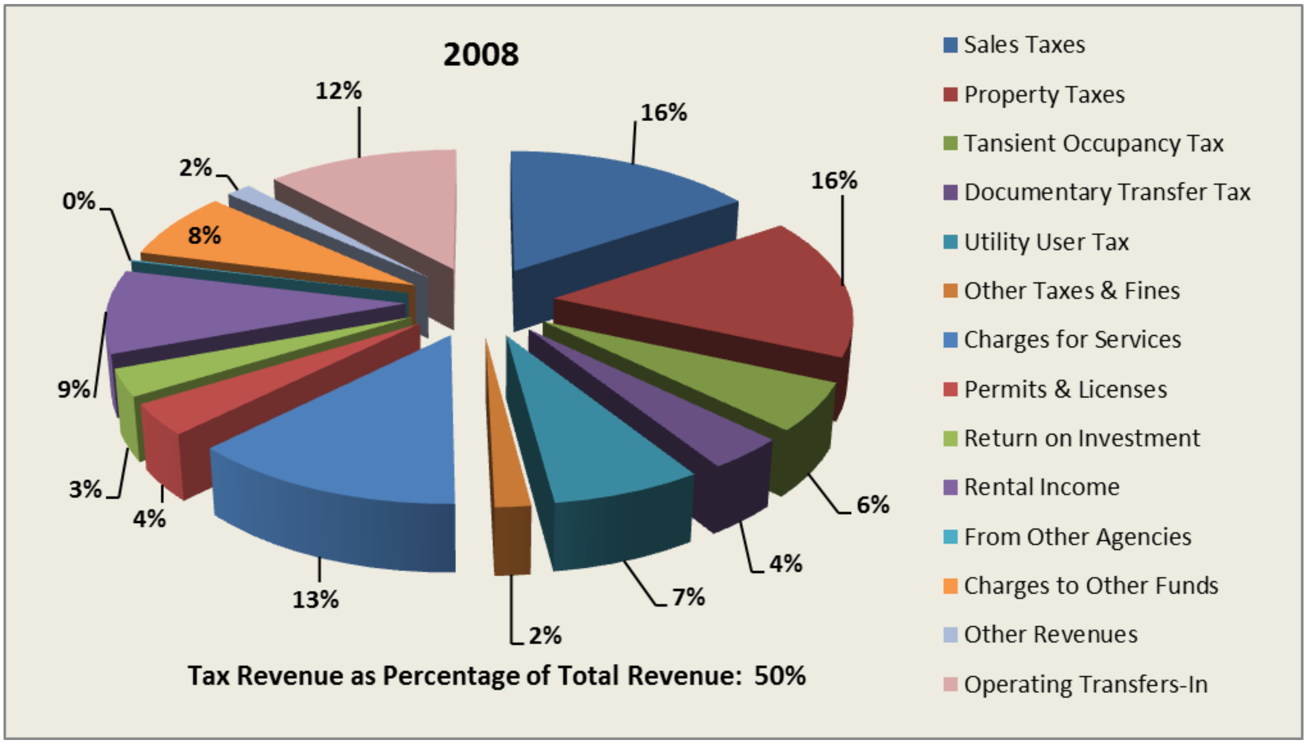
The City is conducting an assessment of all General Fund properties which might impact the rental income from Enterprise Funds during FY 2014 and beyond.

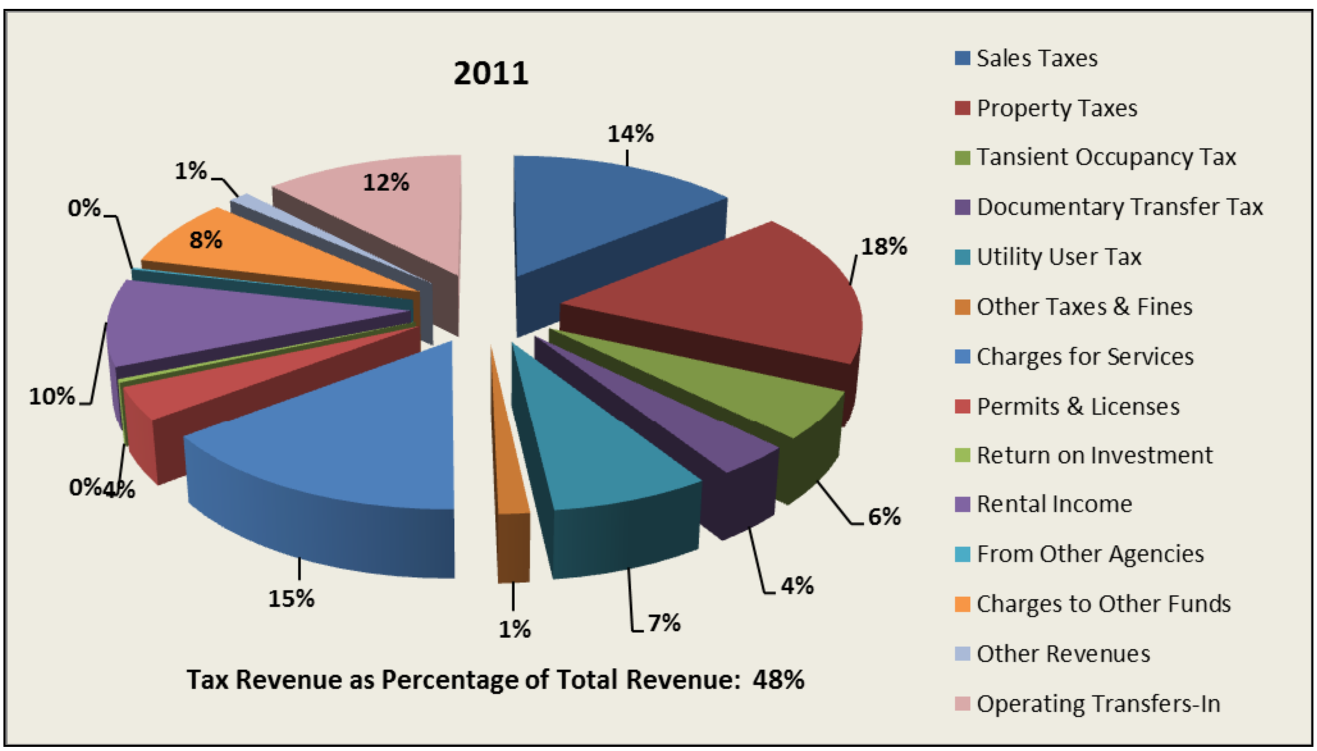
From Other Agencies
Revenue from Other Agencies includes income from Community Services Outreach theatre programs, Palo Alto Unified School District (PAUSD) reimbursements, State of California grants for Police, Libraries and Community Services, and donations from Friends groups. Many of these are less than predictable. For example, state grants are reduced when the state experiences budget difficulties. Revenues over the past 4 years have ranged from $0.08 million to $0.3 million. The Forecast assumes a zero growth rate from FY 2014 onwards.

Charges to Other Funds
Eighty-six percent of this category is General Fund administrative cost plan allocation charges to the Enterprise Funds. For FY 2013, the projected amount is equal to the budgeted amount of $10.9 million. In FY 2014 onward, forecasted increases are around 2 percent.

Other Revenues
Major revenue sources in this category are Animal Services charges to Los Altos and Los Altos Hills, reimbursements from PAUSD for its share of Cubberley and athletic field maintenance, donations from non-profits for City libraries, and revenues which do not belong to other categories. In FY 2013, Other Revenues are projected at $1.2 million – the same level as in the Adopted Budget. Projected FY 2014 revenues of $1.9 million include a $0.7 million donation from various non-profits to libraries plus a 2 percent increase. The Base Model assumes one-time library donations of $0.6 million. In FY 2015 onwards, the base model assumes a 2 percent annual increase for all Other Revenues.

COMPARISON OF REVENUE SOURCES FY 2008 vs. FY 2011





Operating Transfers In

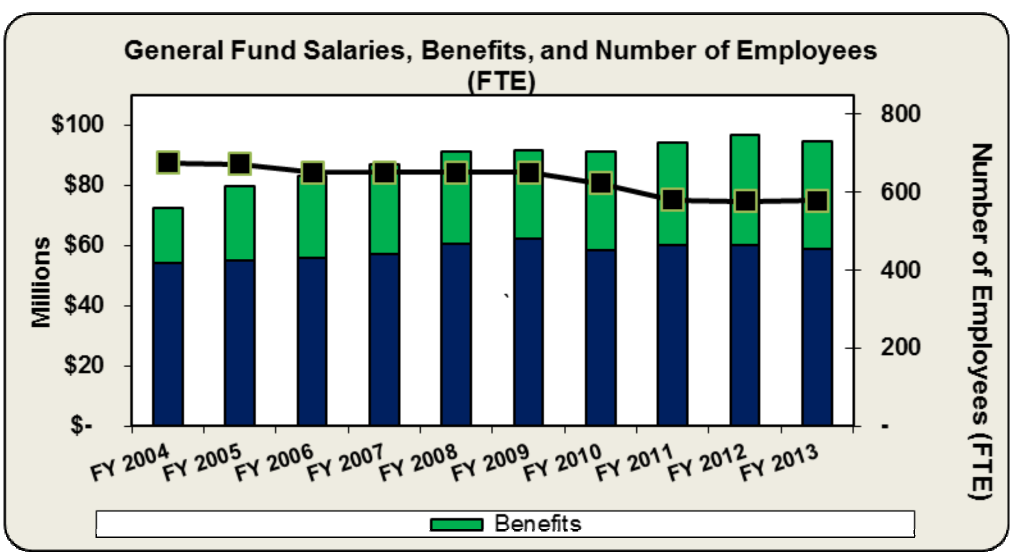
Operating Transfers include the equity transfer from the Electric and Gas Funds, as well as transfers from the University Ave Parking Permit Fund and the California Ave Parking Permit Fund. The equity transfers are based upon a rate of return on the asset base of the Electric and Gas Funds, and increase roughly 2 to 3 percent per year. For FY 2013-2016, equity transfers from Electric Fund and Gas Fund are based on Utilities Five-Year Financial Plan (presented to Council in April 2012), which are estimates and subject to change.

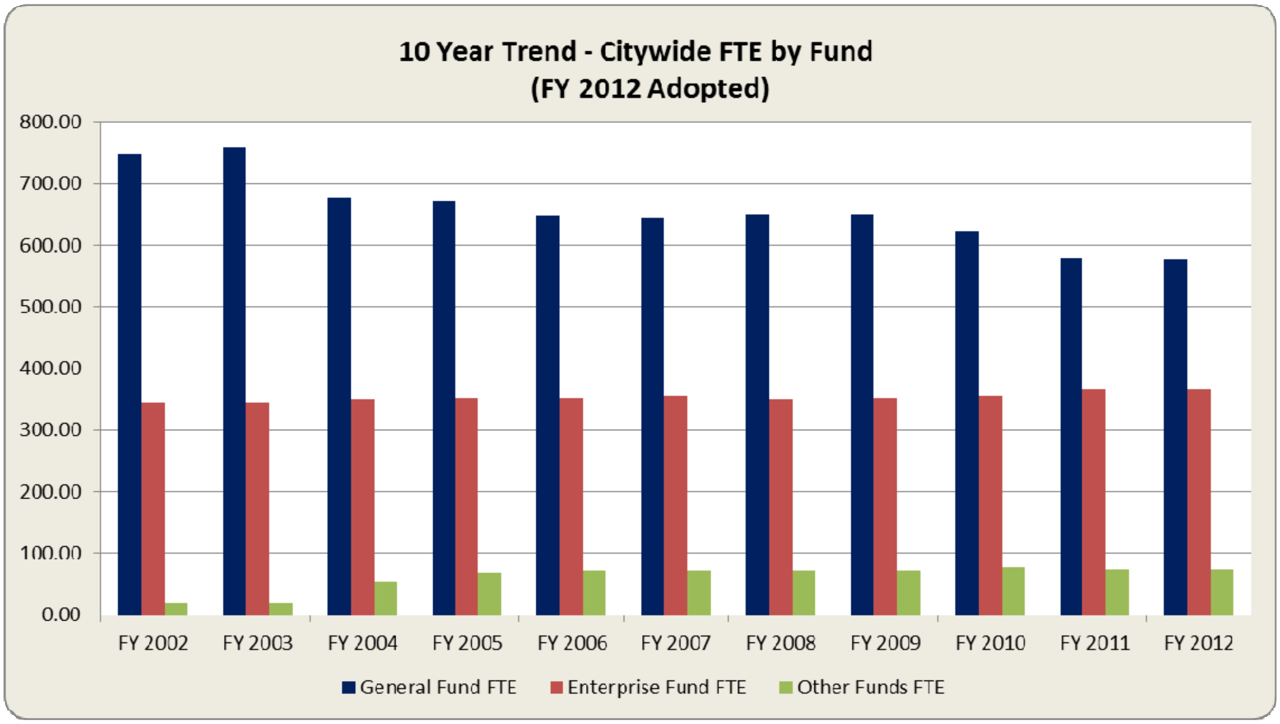
EXPENSES

Salary & Benefits

<u>Salary</u>

- A 2 percent salary increase for SEIU and Management/Professional is assumed in FY 2014. Beginning FY 2015 and through FY 2023, a 2 percent salary increase is assumed for all labor groups. It is important to note that these increase are for forecasting purposes and do not represent a commitment.
- $1.1 million in salary and benefits related to position freezes is added back to the FY 2014 projected base. This includes funding for five Library Department staff (related to the Mitchell Park Community Center and Library Project), seven positions in the Police Department, one Plan Check Engineer, one Program Assistant in the Fire Department, and one three-quarter time Program Assistant in the Community Services Department. In addition, the FY 2014 projected base assumes three position reductions in the City's Animal Services operations.

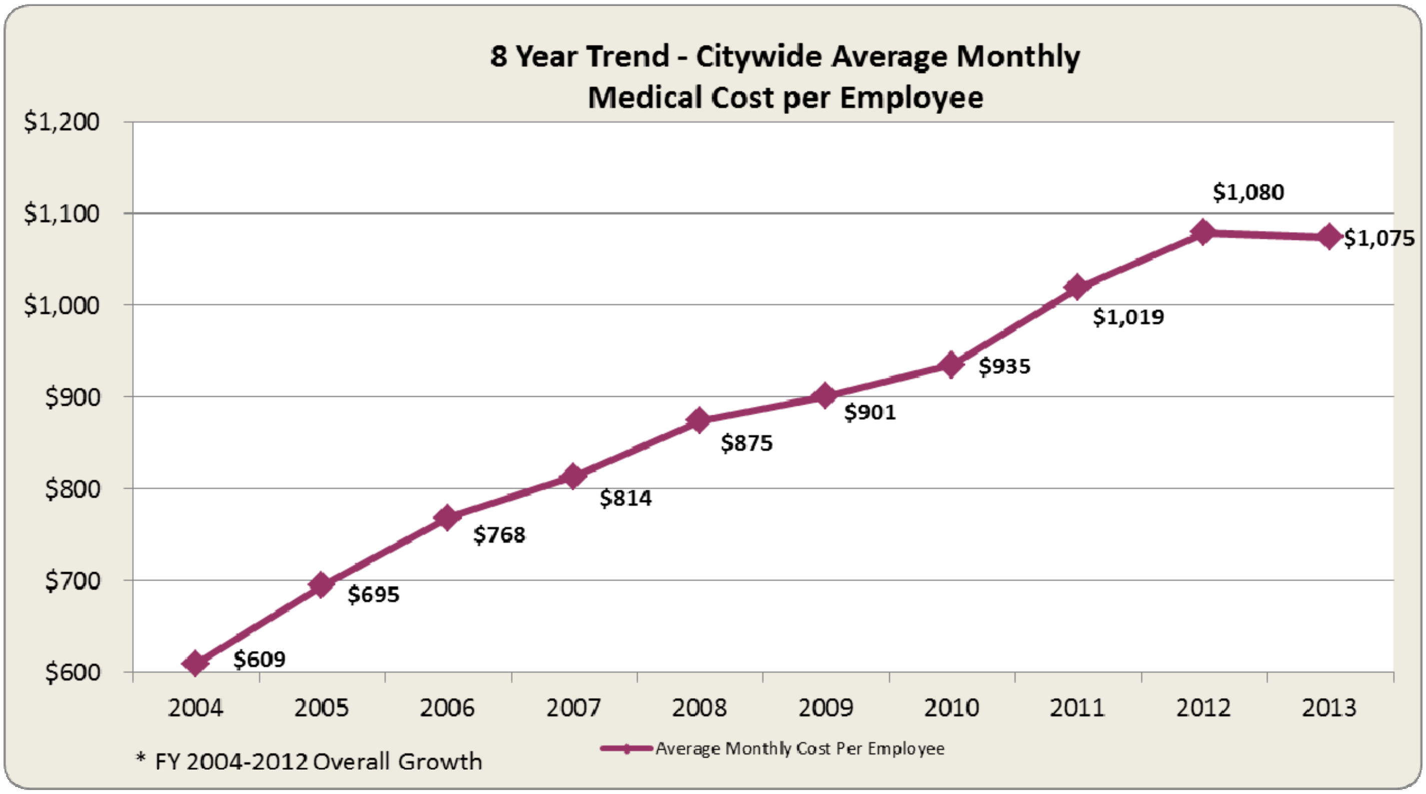


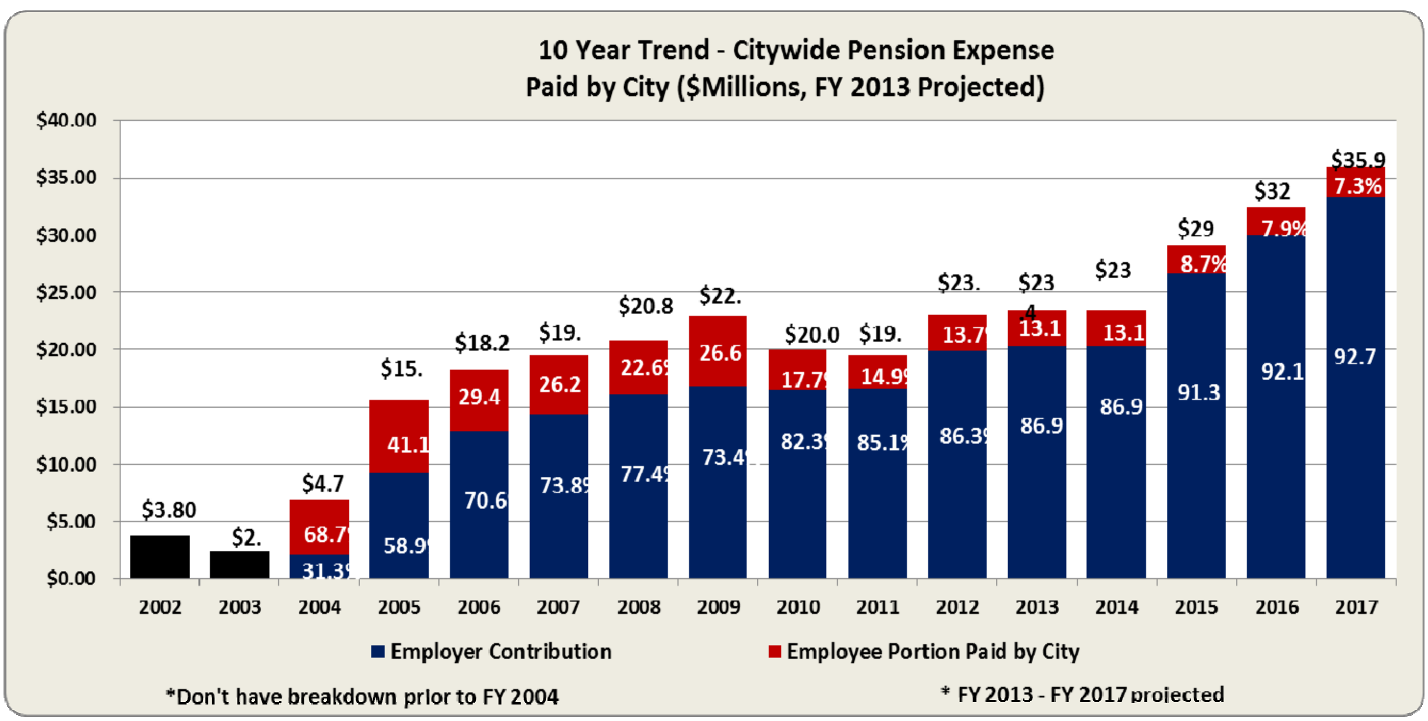


Benefits

- The Base Model includes CalPERS' estimated rates for FYs 2014, 2015, and 2016. The most recent rates were received in November 2012.
- Per Council direction, the Base Model assumes a 3 percent per year increase in pension costs from FY 2017-2023. Following the Base Model, an alternate scenario assuming a 4.5 percent per year increase beginning in FY 2017 is presented on page 25. Second-tier retirement savings, estimated by Bartel & Associates, are included in the Base Model beginning FY 2015.
- Starting in January 2013, pension reform requires new members of CalPERS be enrolled into a new pension plan that offers lower pension benefits. CalPERS is calculating the actual cost for Palo Alto, so an estimate is not available at this time. It is clear that the savings of the pension reform is in the outer years since it impacts only new members to the pension system. Staff will provide updated cost savings once CalPERS provides expected costs.
- Retiree Annual Required Contributions (ARC) are based on the January 1, 2011 actuarial study for FY 2012, 2013, and 2014, as amended by the Council Direction of April 16, 2012. In setting the ARC, the actuary assumes it will increase each year by 3.25 percent, the presumed annual increase in payroll.
- The forecast assumes a 10 percent annual increase in medical costs and a 4 percent annual increase in dental and vision costs. This assumption results in a $0.76 million increase between projected FY 2013 and 2014 costs. Over the next ten fiscal years (2014 through 2023), these healthcare cost will increase from $9.5 million to $20.8 million, or 218 percent.

UPDATED MODEL





Employer CalPERS Rates

	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY2012	FY 2013	FY 2014	FY2015	FY2016
Miscellaneous	11.4%	17.4%	17.0%	17.1%	17.6%	21.7%	23.0%	24.6%	26.4%	26.9%
Safety	24.2%	23.6%	24.5%	23.9%	24.7%	30.1%	31.1%	33.4%	35.9%	36.6%

* FY 2008 Miscellaneous rate reflects plan change from 2% @ 55 to 2.7 % @ 55
** FY 2014, 2015, and 2016 rates are based on PERS actuarial valuation received November 2012.

Contract Services

FY 2013 Projected Contract Services include $80 thousand of one-time contracts, such as the Police Organization study, and $0.5 million in assumed savings from the re-organization of Palo Alto Animal Services. The FY 2014 base removes these one-time FY 2013 expenses and projected savings. The forecast assumes that the project will be completed and return to normal operations at the end of FY 2014. In addition, the FY 2014 Base Model also assumes a one-time $0.6 million increase for use of library donations from the library foundation. Total expense for this category totals $11.1 million, a $0.4 million increase over the FY 2013 adopted budget. In FY 2015 and beyond, contract expenses are projected to remain relatively stable, with a 3.0 percent annual growth rate throughout the forecast period.

Supplies & Materials

The base model assumes the same level of $3.2 million for this category in for FY 2013 and 2014. In FY 2015, Community Services will see a small increase of approximately $31,000 for Supplies & Materials at the Palo Alto Golf Course. This is based on the National Golf Foundation estimates to maintain the newly redesigned golf course. Costs will remain relatively constant looking forward to outer years, with a consistent yearly increase based on the 3.0 percent annual increase.

In November 2012, Council was presented with the results of the contracts audit conducted by the City Manager's Office. Staff has examined the audit findings and determined that under a new, revised contract, the City would save an additional $40 thousand (citywide) in office supplies. Staff estimates that approximately $24 thousand of this savings would occur in the General Fund. Staff expects to have the new contract in place in early 2013.

General Expense

The majority of General Expense includes categories like travel and meetings, telephone and non-city utilities, contingency accounts, and debt service payments for the newly signed Golf Course Lease/Purchase Agreement. Projected FY 2013 expenses of $4.6 million reflect annual debt service which was originally budgeted as a transfer to Debt Service Fund. In FY 2014, there is a 2 percent decrease, and from FY 2014 onwards, annual increases of 3.0 percent are assumed.

Cubberley Lease

This category represents lease payments to PAUSD for the Cubberley facility. The Forecast assumes that the lease contract with PAUSD will continue beyond 2014 — not as a recommendation, but just for financial impact purposes. FY 2014 onward payments are based on projected 3 percent annual CPI increases. This assumed 3 percent increase yields $7.3 million in Cubberley lease expense in FY 2014.

Rents and Leases

Expansion of the Development Center increased this expense category by $0.2 million in FY 2013. Rent and lease expense for FY 2014 is estimated to remain flat at $1.1 million. Rents and Leases expense growth will remain fairly steady, with 3 percent annual increases assumed.

Facilities & Equipment

An additional $0.2 million was added to Facilities & Equipment during FY 2013 due to one-time increase for the Development Center upgrade expansion. Facilities and equipment expense for FY 2014 is $0.5 million. The base model assumes a 3 percent annual increase.

Allocated Charges

Allocated charges represents expense allocations to the City's enterprise and internal services funds for services and products they provide to General Fund departments for items such as utilities usage, liability insurance, technology costs, and vehicle replacement costs. The last year of the General Fund loan repayment to the Technology Fund was in FY 2013; the FY 2014 base model is reduced by this amount to total $15.8 million. Beyond FY 2014, the base model assumes a modest an annual growth rate of 2 percent in Allocated Charges.

Operating Transfers Out

Operating Transfers Out includes transfers for Debt Service, Tech Fund, and the Airport Fund. Transfers out is reduced by $0.4 million due to the refinancing of the Golf Course debt. The Golf Course debt will be paid down by FY 2018. Funding for the Airport Fund from the General Fund continues through FY 2014 and the FY 2013 projected base model assumes an additional $0.2 million will be transferred to the Airport Fund. The base model assumes that the Airport Fund will be self-sustaining in FY 2015.

Transfer to Infrastructure

In FY 2013, adopted and projected transfers to capital project fund remain at $13.2 million. In FY 2014, they are projected to grow to $13.5 million. Transfers to the Capital Projects Fund are based on several components described below:

1. The "annual base transfer" of $3.6 million and a "dedicated year-end surplus" of $1.0 million remain constant.
2. The transfer for specific projects receiving General Fund reimbursements varies year-by-year with the 5-

year CIP Budgets. The average annual rate of increase is 2.7 percent in the 10-year forecast.

3. As a result of Council's "$3 million challenge" begun in 2007, Council committed to spend an additional $3 million on infrastructure, growing by 7 percent per year. This amount has grown to $4.9 million in FY 2014 and is reflected in the Base Model.
4. Beginning in FY 2013, an additional $2.2 million per year is added to fund the annual maintenance of existing infrastructure or "keep-up" needs as defined by the (IBRC) Infrastructure Blue Ribbon Commission Report.
5. An additional $4.2 million per year will be required to fund deferred maintenance or "catch-up" needs as defined by the IBRC Report. This additional contribution is not included in the Base Model.
6. In FY 2012, the General Fund closed with a $4.4 million surplus. A one-time, additional $7.6 million was transferred from the General Fund to the Capital Fund.

FACTORS NOT INCLUDED IN THE BASE MODEL

- The allocated cost of various IT Department's new initiatives such as migration to cloud based technologies, purchase of new equipment and related maintenance/support costs.
- The IBRC's recommended $4.2 million per year increase in infrastructure expenditure – see alternate scenario following the base model to see impacts.
- Possible TOT revenues from five hotels expected to open in the next two years (see page 4 for details).

GENERAL FUND LONG RANG
BASE MO
FY 2013-2

	Adopted 2013	Projected 2013	2014	2015	2016
Revenues					
Sales Taxes	22,545	23,364	24,323	25,010	25,896
Property Taxes	27,306	27,783	28,898	30,073	31,341
Transient Occupancy Tax	9,591	10,439	11,035	11,592	12,114
Documentary Transfer Tax	5,078	5,200	5,541	5,808	6,073
Utility User Tax	10,731	10,825	11,054	11,568	12,005
Other Taxes & Fines	2,058	2,058	2,058	2,078	2,099
Subtotal: Taxes	**77,309**	**79,669**	**82,909**	**86,130**	**89,529**
Charges for Services	15,461	15,461	12,587	15,204	15,729
Stanford Fire and Dispatch Services	8,221	8,221	8,391	8,685	8,989
Permits & Licenses	6,614	6,614	6,587	6,431	6,302
Return on Investment	959	774	769	779	793
Rental Income	12,640	12,640	12,923	13,246	13,577
From Other Agencies	157	157	157	157	158
Charges to Other Funds	10,875	10,874	11,062	11,283	11,509
Other Revenues	1,187	1,187	1,888	1,319	1,345
Total Revenues Before Transfers	**56,114**	**55,928**	**54,364**	**57,106**	**58,402**
Operating Transfers-In	18,995	18,995	19,543	20,148	20,791
Total Source of Funds	**152,418**	**154,593**	**156,817**	**163,384**	**168,722**
Expenditures					
Salaries	57,214	58,940	60,899	62,139	63,327
Benefits	37,071	35,426	37,598	40,056	41,800
Subtotal: Salaries and Benefits	**94,285**	**94,366**	**98,496**	**102,196**	**105,127**
Contract Services	10,733	10,698	11,092	11,518	11,777
Supplies & Materials	3,220	3,219	3,246	3,491	3,595
General Expense	4,019	4,568	4,475	4,606	4,716
Cubberley Lease	7,133	7,133	7,347	7,567	7,794
Rents & Leases	1,184	1,184	1,207	1,243	1,281
Facilities & Equipment	518	746	521	549	574
Allocated Charges	16,932	16,933	15,758	15,848	16,165
Total Expenditures Before Transfers	43,739	44,481	43,646	44,823	45,901
Operating Transfers Out	1,605	1,376	639	329	329
Transfer to Infrastructure	13,178	13,178	13,465	13,843	14,263
Total Use of Funds	**152,807**	**153,401**	**156,246**	**161,190**	**165,620**
Net Surplus/(Gap)	**(389)**	**1,191**	**571**	**2,194**	**3,102**

E FINANCIAL FORECAST
DEL
2023

2017	2018	2019	2020	2021	2022	2023
26,907	27,970	29,148	30,416	31,754	33,100	34,466
32,679	34,123	35,699	37,383	39,011	40,642	42,267
12,643	13,181	13,724	14,277	14,869	15,504	16,204
6,343	6,585	6,803	7,066	7,371	7,705	8,137
12,296	12,629	12,966	13,298	13,624	13,940	14,271
2,120	2,141	2,163	2,184	2,206	2,228	2,251
92,988	**96,629**	**100,503**	**104,624**	**108,836**	**113,120**	**117,595**
16,266	16,632	17,010	17,401	17,803	18,220	18,650
9,303	9,629	9,966	10,315	10,676	11,049	11,436
6,177	6,043	6,255	6,474	6,733	7,069	7,423
809	828	848	869	891	914	942
13,917	14,265	14,621	14,987	14,119	13,568	13,907
158	159	160	161	161	162	163
11,739	11,974	12,213	12,458	12,707	12,961	13,220
1,372	1,400	1,428	1,456	1,485	1,515	1,545
59,742	**60,930**	**62,501**	**64,119**	**64,575**	**65,459**	**67,287**
21,446	22,106	22,786	23,489	24,213	24,961	25,731
174,176	**179,664**	**185,790**	**192,232**	**197,624**	**203,540**	**210,614**
64,540	65,776	67,037	68,323	69,635	70,973	72,338
45,080	48,535	52,192	56,042	60,123	64,437	69,002
109,620	**114,311**	**119,229**	**124,365**	**129,758**	**135,410**	**141,341**
12,054	12,326	12,605	12,894	13,190	13,496	13,809
3,703	3,814	3,929	4,047	4,168	4,293	4,422
4,829	4,945	5,065	5,189	5,316	5,447	5,582
8,028	8,269	8,517	8,773	9,036	9,307	9,586
1,319	1,359	1,400	1,442	1,485	1,529	1,575
591	609	627	646	665	685	705
16,488	16,818	17,154	17,497	17,847	18,204	18,568
47,012	48,139	49,297	50,486	51,707	52,961	54,248
329	329	329	329	329	329	329
14,710	15,186	16,693	16,233	16,809	17,422	18,075
171,671	**177,965**	**185,547**	**191,412**	**198,602**	**206,122**	**213,992**
2,506	**1,699**	**243**	**820**	**(978)**	**(2,582)**	**(3,379)**

GENERAL FUND LONG RANGE
BASE MODEL PERECENT

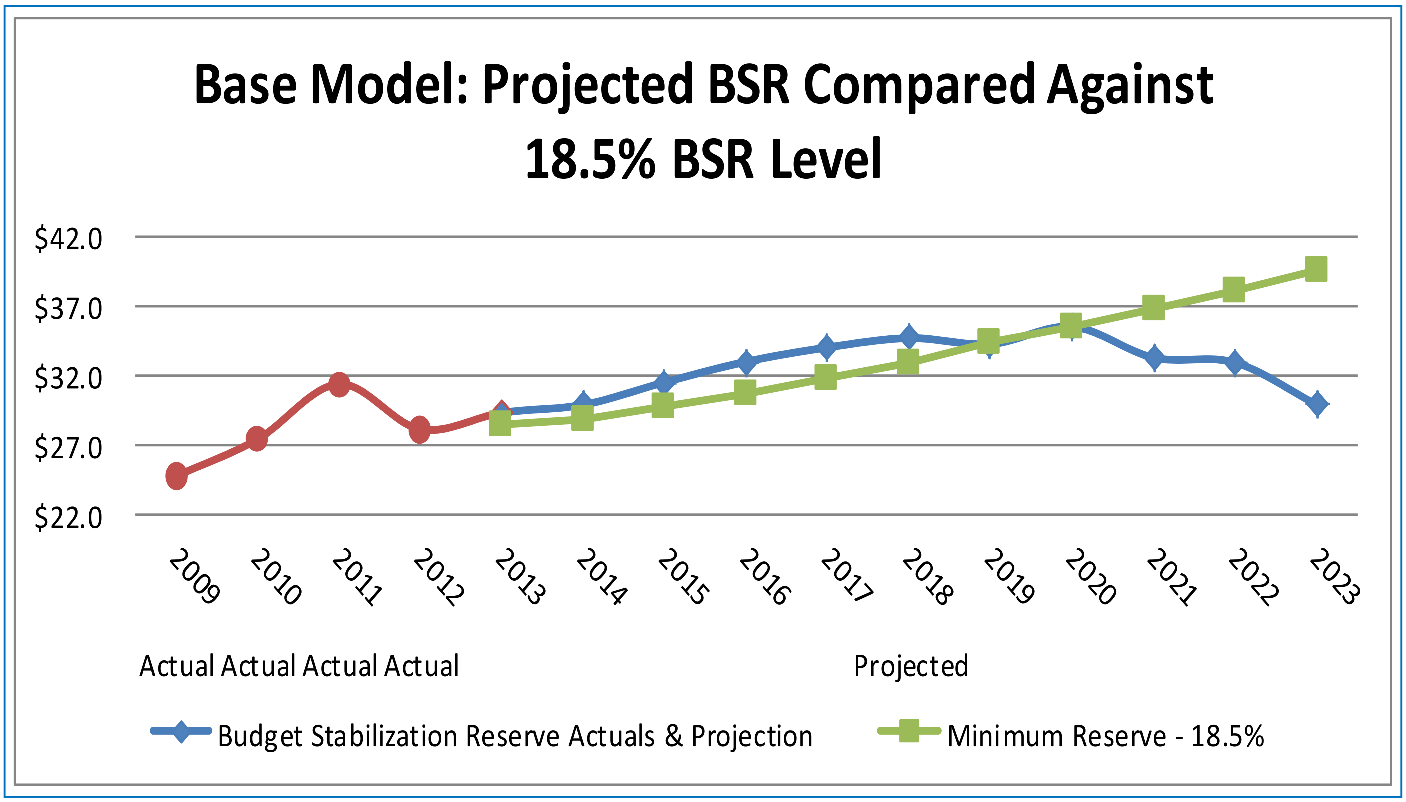
	Adopted 2013	Projected 2013	2014	2015	2016
Revenues					
Sales Taxes	1.86%	3.63%	4.10%	2.82%	3.
Property Taxes	3.07%	1.75%	4.01%	4.07%	4.
Transient Occupancy Tax	-0.75%	8.85%	5.71%	5.05%	4.
Documentary Transfer Tax	5.32%	2.40%	6.57%	4.82%	4.
Utility User Tax	-0.95%	0.88%	2.12%	4.65%	3.
Other Taxes & Fines	1.22%	-0.01%	0.00%	1.00%	1.
Subtotal: Taxes	**1.75%**	**3.05%**	**4.07%**	**3.88%**	**3.**
Charges for Services	0.61%	0.00%	-18.59%	20.79%	3.
Stanford Fire and Dispatch Services	-9.48%	0.00%	2.07%	3.50%	3.
Permits & Licenses	-8.48%	0.00%	-0.41%	-2.36%	-2.
Return on Investment	-5.29%	-19.33%	-0.57%	1.31%	1.
Rental Income	-11.57%	0.00%	2.24%	2.50%	2.
From Other Agencies	94.45%	0.00%	0.00%	0.25%	0.
Charges to Other Funds	-6.56%	-0.01%	1.73%	2.00%	2.
Other Revenues	-52.15%	0.03%	59.00%	-30.14%	2.
Total Revenues Before Transfers	**-8.28%**	**-0.33%**	**-2.80%**	**5.04%**	**2.**
Operating Transfers-In	-16.26%	0.00%	2.88%	3.10%	3.
Total Source of Funds	**-4.64%**	**1.43%**	**1.44%**	**4.19%**	**3.**
Expenditures					
Salaries	-4.60%	3.02%	3.32%	2.04%	1.
Benefits	0.86%	-4.44%	6.13%	6.54%	4.
Subtotal: Salaries and Benefits	**-2.53%**	**0.09%**	**4.38%**	**3.76%**	**2.**
Contract Services	3.22%	-0.32%	3.68%	3.84%	2.
Supplies & Materials	3.52%	-0.03%	0.84%	7.54%	3.
General Expense	15.23%	13.65%	-2.03%	2.94%	2.
Cubberley Lease	3.03%	0.00%	3.00%	3.00%	3.
Rents & Leases	17.95%	0.02%	1.94%	3.00%	3.
Facilities & Equipment	62.50%	43.97%	-30.15%	5.37%	4.
Allocated Charges	-5.91%	0.01%	-6.94%	0.57%	2.
Total Expenditures Before Transfers		1.16%	1.70%	-1.88%	2.
Operating Transfers Out	-54.04%	-14.25%	-53.60%	-48.54%	0.
Transfer to Infrastructure	-29.32%	0.00%	2.18%	2.81%	3.
Total Use of Funds	**-5.74%**	**0.39%**	**1.85%**	**3.16%**	**2.**
Net Surplus/(Gap)	**-82.81%**	**-406.22%**	**-52.05%**	**284.14%**	**41.**

FINANCIAL FORECAST
TAGE CHANGES

	2017	2018	2019	2020	2021	2022	2023
.54%	3.90%	3.95%	4.21%	4.35%	4.40%	4.24%	4.13%
.22%	4.27%	4.42%	4.62%	4.72%	4.35%	4.18%	4.00%
.50%	4.37%	4.25%	4.12%	4.03%	4.15%	4.27%	4.51%
.57%	4.44%	3.82%	3.32%	3.87%	4.32%	4.54%	5.60%
.78%	2.42%	2.71%	2.67%	2.56%	2.45%	2.32%	2.37%
.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%
.95%	**3.86%**	**3.92%**	**4.01%**	**4.10%**	**4.03%**	**3.94%**	**3.96%**
.45%	3.42%	2.25%	2.27%	2.29%	2.31%	2.34%	2.36%
.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
.01%	-1.99%	-2.16%	3.50%	3.50%	4.00%	5.00%	5.00%
.76%	2.01%	2.38%	2.41%	2.46%	2.51%	2.66%	3.01%
.50%	2.50%	2.50%	2.50%	2.50%	-5.79%	-3.90%	2.50%
.30%	0.35%	0.40%	0.45%	0.50%	0.55%	0.60%	0.65%
.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
.27%	**2.29%**	**1.99%**	**2.58%**	**2.59%**	**0.71%**	**1.37%**	**2.79%**
.19%	3.15%	3.07%	3.08%	3.08%	3.09%	3.09%	3.09%
.27%	**3.23%**	**3.15%**	**3.41%**	**3.47%**	**2.80%**	**2.99%**	**3.48%**
.91%	1.91%	1.92%	1.92%	1.92%	1.92%	1.92%	1.92%
.35%	7.85%	7.66%	7.53%	7.38%	7.28%	7.18%	7.09%
.87%	**4.27%**	**4.28%**	**4.30%**	**4.31%**	**4.34%**	**4.36%**	**4.38%**
.24%	2.35%	2.26%	2.27%	2.29%	2.30%	2.32%	2.32%
.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
.38%	2.40%	2.41%	2.42%	2.44%	2.45%	2.46%	2.48%
.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
.50%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
.70%	2.41%	2.42%	2.40%	2.40%	2.41%	2.42%	2.43%
.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
.03%	3.13%	3.24%	9.92%	-2.76%	3.55%	3.65%	3.75%
.75%	**3.65%**	**3.67%**	**4.26%**	**3.16%**	**3.76%**	**3.79%**	**3.82%**
.36%	**-19.21%**	**-32.19%**	**-85.70%**	**237.55%**	**-219.28%**	**163.96%**	**30.86%**

RESERVES

FY 2012 ended with a Budget Stabilization Reserve (BSR) totaling $28.1 million. Although the Base Model forecasts surpluses in FYs 2014 to 2020, beginning in FY 2019, total expense begins to drop below the 18.5 percent level. By FY 2023, it is forecasted that the BSR will be $9.7 million, or 14 percent of total expenditures. The graph below illustrates how the BSR projection compares to the 18.5 percent minimum reserve level.



Alternate Scenario 1

The Base Model assumes an annual 3 percent pension increase each year from FY 2017 to 2023. The following scenario assumes an annual 4.5 percent increase beginning in FY 2017. The 4.5 percent annual increase is based on preliminary discussions of PERS removing their smoothing of gains and losses, and the changed demographics of retirees. Assuming an increased pension contribution increases the cumulative deficit from $9.761 million to $54.618 million, or 459 percent, in FY 2016 through 2023. This scenario needs to be updated to account for the pension reform changes. CalPERS has not provided a cost impact as of yet, so this impact will be updated later in the process.

Alternate Scenario 1—4.15% annual PERS increase starting FY 2017

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Source of Funds	**156,817**	**163,384**	**168,722**	**174,176**	**179,664**	**185,790**	**192,232**	**197,624**	**203,540**	**210,614**
Salaries	60,899	62,139	63,327	64,540	65,776	67,037	68,323	69,635	70,973	72,338
Benefits	37,598	40,056	41,800	45,961	50,332	54,941	59,780	64,890	70,272	75,946
Subtotal: Salaries and Benefits	**98,496**	**102,196**	**105,127**	**110,501**	**116,108**	**121,978**	**128,104**	**134,525**	**141,245**	**148,284**
Total Use of Funds	**156,246**	**161,190**	**165,620**	**172,551**	**179,762**	**188,297**	**195,151**	**203,369**	**211,957**	**220,935**
Net Surplus/(Gap)	**571**	**2,194**	**3,102**	**1,625**	**(98)**	**(2,506)**	**(2,919)**	**(5,745)**	**(8,417)**	**(10,322)**

Alternate Scenario 2

The following scenario assumes that beginning FY 2014, General Fund funds an additional, ongoing $4.2 million to the Capital Fund. Assuming an increased capital contribution increases the cumulative deficit for FYs 2015 through 2023 from $7.269 million to $44.068 million.

Alternate Scenario 2—Additional $4.2 million Annual Contribution to Infrastructure Fund

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Source of Funds	**156,817**	**163,384**	**168,722**	**174,176**	**179,664**	**185,790**	**192,232**	**197,624**	**203,540**	**210,614**
Total Expenditures Before Transfers	43,646	44,823	45,901	47,012	48,139	49,297	50,486	51,707	52,961	54,248
Operating Transfers Out	639	329	329	329	329	329	329	329	329	329
Transfer to Infrastructure	13,464	18,043	18,463	18,910	19,386	19,893	20,433	21,009	21,622	22,275
Total Use of Funds	**156,245**	**165,389**	**169,820**	**175,871**	**182,165**	**188,748**	**195,613**	**202,802**	**210,322**	**218,192**
Net Surplus/(Gap)	**572**	**(2,005)**	**(1,098)**	**(1,694)**	**(2,501)**	**(2,957)**	**(3,380)**	**(5,178)**	**(6,782)**	**(7,579)**

CHALLENGES & CONCLUSIONS

CHALLENGES: PENSION REFORM

The California Public Employees' Pension Reform Act of 2013 (PEPRA) was enacted fall 2012 and has generated increased attention and questions from CalPERS retirement system members and employers. The new law includes a suite of changes to current retirement formulas, new members, employer/member contributions, and working after retirement. PEPRA also establishes a cap on the amount of compensation that can be used to calculate the retirement benefit for all new CalPERS members. At this time, the dollar impact to the City of this new legislation is unknown. Staff will provide Council with updates as more information and data emerge.

CONCLUSIONS

The LRFF shows better "bottom line" results than in last year's presentation. This is due to employee benefit concessions, budget reductions, and higher revenues. The City must continue, however, to find additional structural savings as benefit costs are increasing at a faster rate than revenues.

Since FY 2010, the City has realized $16.7 million in savings from structural changes, the fruit of staff "thinking different." The Cost of Service study is nearly complete and will allow the Council to thoroughly review the price of doing business and make decisions on what services can be provided and/or how they can be provided.

In addition to employee benefit obligations, the City's infrastructure needs – capital operation and maintenance, project "catch-up", and other projects that were identified in the IBRC report – are commitments that should be addressed and planned for via this forecast. The Base Model and Alternate Scenario #2 show two levels of investment in the City's infrastructure and their impact on the bottom line.

To maintain prudent fiscal stewardship, the City must continue to explore its benefit structure, alternative forms of service delivery, and more efficient operations. Although successful efforts have been made, staff recognizes that it must continue to review alternatives in service delivery and the cost of such services to address key issues outlined in this report to realize a sustainable, long-term, financial plan.

APPENDIX

APPENDIX 1 – CONCESSIONS TO DATE

Since 2009, Council and staff completed the negotiation of agreements with labor groups to eliminate more than $8.5 million in salary and benefit expense. The City is working with the Police Management Association (PMA) to negotiate cost savings.

The following is a list of current labor contracts and agreements:

<u>SEIU (current contract)</u>
Estimated Savings: $0.55 million per year, or 0.76 percent of total compensation

- Created a second tier to our retirement structure (2 percent at 60) for new employees hired or after July 17, 2010.
- Shifted full cost of employee PERS contribution to employee.
- Implemented the 90/10 medical cost sharing plan.
- Decrease alternative medical cash-out benefit to a flat $284 per month, effective October 1, 2012.
- 1.65 percent cost of living increase effective first day of pay period including July 1, 2012
- Reduced floating holidays by three days. An additional floating holiday will be eliminated after June 30, 2013.

<u>Management and Professional (current agreement)</u>
Estimated Savings: $0.51 million per year, or 1.5 percent of total compensation

- Eliminated the Variable Management Compensation plan as of FY 2009.
- Shifted full cost of employee PERS contribution to employee.
- Implemented the 90/10 medical cost sharing plan.
- Decrease alternative medical cash-out benefit to a flat $284 per month, effective October 1, 2012.
- Three percent salary increase to partially offset pension contribution costs
- Changes to the group's professional development plan, including eliminating use of professional development funds to purchase electronic technology and gym memberships and reducing the annual amount per employee from $1,500 to $500. Gym members can be reimbursed through management excess benefit.
- Eliminated car allowances for newly hired Department Directors.

<u>International Association of Fire Fighters (current contract)</u>
Estimated Savings: $1.6 million per year, or 6.8 percent of total compensation

- Created a second tier to our retirement structure (3 percent at 55) for new employees.
- Shifted full cost of employee PERS contribution to employee.
- Eliminated minimum staffing requirements.

- Implemented the 90/10 medical cost sharing plan.
- Cost-of-living freeze for FYs 2012-2014.
- Eliminated tuition reimbursement program.

Fire Chiefs' Association (current agreement)
Estimated Savings: $91 thousand per year, or 9.8 percent of total compensation

- Created a second tier to our retirement structure (3 percent at 55) for new employees.
- Shifted full cost of employee PERS contribution to employee. In March 2013, the city paid employee retirement contribution "resets" to 5.1 percent.
- Eliminated the Variable Management Compensation plan.
- 1.33 percent salary reduction.
- Eliminated three holidays.
- Implemented the 90/10 medical cost sharing plan.

Palo Alto Police Officers' Association (current contract):
Estimated Savings: $1.4 million per year, or 7.7 percent of total compensation

- Created a second tier to our retirement structure (3 percent at 55) for new employees.
- Shifted full cost of employee PERS contribution to employee.
- Eliminated tuition and training benefit.
- 1.33 percent salary reduction.
- Eliminated three holidays.
- Implemented the 90/10 medical cost sharing plan.

Prior to 2009, between 2004 and 2006, the City implemented for all bargaining units:

- 20-year vesting period to qualify for lifelong City-paid health coverage
- Highest cost health care plan option eliminated, saving almost $10,000 per year for each employee moved away from this option.

The aforementioned concessions and staffing reductions have been tough decisions that were not taken lightly. Like the City, our employees face rising household costs and diminished asset values. Furthermore, the impact of the position eliminations is that our employees are stretched thin, and our ability to take on new projects is reduced.

ENDNOTES

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Americans with Disabilities Act Statement

***In compliance with
Americans with Disabilities Act (ADA) of 1990,
this document may be provided
in other accessible formats.***

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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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CalPERS PENSION BENEFITS:
STATE LAW, PENSION REFORM & IMPACTS ON PALO ALTO

	State Law Mandates for Local Agencies Offering CalPERS Pensions	Palo Alto Benefits
Pension Formulas and Retirement Age	**State Law as of 12/31/2012** CalPERS offers employers a menu of pre-defined basic and enhanced benefit formulas for Miscellaneous (Non-Safety) and Safety (Police & Fire). In general, employers contract with CalPERS for one of the formulas after bargaining with employee organizations. The benefit factor is a percentage of pay to which members are entitled for each year of service. It is determined at the member's age at retirement and one of the following retirement formulas that the employer has contracted for. Misc: 2% at 55, 2% at 60. 2.5% at 55, 2.7% at 55, 3% at 60 Safety: 2% at 50. 2% at 55, 2.5% at 55, 3% at 50, 3% at 55 In 1999, the California Legislature amended the pension law to allow the state to offer enhanced pension formulas: 3% at age 50 for Safety and 2.7% at age 55 for Miscellaneous. In XXXX, the Legislature authorized cities and other local government agencies to adopt the same enhanced benefit formulas. The California Courts have held that a pension formula "vests" at the time is promised, which generally means the promise is binding and cannot be reduced during the employees service or retirement, subject to certain limited exceptions. For this reason, reduced formulas are applied only to newly hired employees.	**Palo Alto Pension Benefits as of 12/31/2012** Palo Alto last moved to enhance benefit formulas in 2002 for Police and Fire and in January 2007 for Miscellaneous employees. Beginning in July 2010, the City has been negotiating lower more sustainable benefits for newly hired employees. Currently, Palo Alto's pension formulas are: Miscellaneous (Non-Safety) Employees • Tier 1, hired before July 16, 2010: 2.7% at 55 • Tier 2, hired on or after July 17, 2010: 2% at 60 Police & Fire • Tier 1 Fire, hired before June 8, 2012: 3% at 50 • Tier 1 Police, hired before December 2012 (estimated): 3% at 50 • Tier 2 Fire, hired on or after June 8, 2012: 3% at 55 Tier 2 Police, estimated to change in December 2012: 3% at 55

	PEPRA Effective January 1, 2013, all newly hired employees must be enrolled in the following pension plans: • Miscellaneous Employees: 2% at 62 • Police & Fire: PEPRA includes three formulas – 2% at 57, 2.5% at 57, and 2.7% at 57 – and mandates that the employer use the formula closest to status quo. After January 1, 2013, an employer could bargain to use a lower formula, but may not impose a lower formula in the absence of an agreement. Note: Employees who move from one CalPERS or reciprocal employer to another after Jan. 1, 2013, are not considered new employees, unless there is a break in service of more than six months. PEPRA requires that employees who move from one public employer to another be enrolled in the new employer's formula that would have applied on December 31, 2012.	**PEPRA's Impact on Palo Alto** PEPRA will add a 3rd pension tier for both Miscellaneous and Safety, applicable to employees hired on or after Jan. 1, 2013 (except that employees previously employed by another CalPERS or reciprocal employer will move into Tier 2): • Miscellaneous Tier 3: 2% at 62 (earliest eligibility 50 years @1.426% - 2.5% @ 67 years of age) • Safety Tier 3: 2.7% at 57 (earliest eligibility 50 years @2% - 2.7% @ 57 years of age)

	State Law Mandates for Local Agencies Offering CalPERS Pensions	Palo Alto Benefits
Calculation of Final Compensation: Single Highest Year or Average of Three Consecutive Highest Years	**State Law as of 12/31/2012** The CalPERS basic pension benefit is calculated using the average of the three highest consecutive earning years. CalPERS allowed employers to select an enhanced benefit of basing pension on the single highest earning year.	**Palo Alto Pension Benefits as of 12/31/2012** Palo Alto moved to single highest year in 1983 for Miscellaneous and 1981 for Fire and Police. Beginning in 2011 for Public Safety, the City began negotiating a return to three-year final averaging as part of its effort to adopt more sustainable pensions for new employees. Currently, Palo Alto plans are as follows: Miscellaneous (Non-Safety) – • All Miscellaneous: single highest year • In August 2013, which is the earliest permissible date under current CalPERS law, Palo Alto will request permission to change to three-year final averaging for employees newly hired in Palo Alto from another CalPERS agency. (By August 2013, new employees without prior public service will automatically be enrolled in the new PEPRA tier, which has three-year final averaging). It is unclear at this time whether CalPERS will allow this change to Tier 2 due to limiting language in PEPRA. Safety (Police & Fire) – • Fire, hired before June 7, 2012: single highest year • Police, hired before December 6, 2012 (estimated): single highest year • Fire, hired on or after June 8, 2011: average of three highest years

		• Police, hired on or after Dec. 7, 2012: average of three highest years
	PEPRA Effective January 1, 2013, pensions must be calculated using the average of the three highest consecutive years. This change applies only to new employees hired on or after Jan. 1, 2013, except that employee with prior public service will be enrolled in the local plan in effect on December 31, 2012.	**PEPRA's Impact on Palo Alto** For all employees hired on or after Jan. 1, 2013, pensions will be based on the average of three highest consecutive years, except that Miscellaneous employees hired from another CalPERS or reciprocal employer may remain eligible for single highest year, subject to further consultation with CalPERS.

	State Law Mandates for Local Agencies Offering CalPERS Pensions	Palo Alto Benefits
Base Retirement Allowance on Regular Pay	**State Law as of 12/31/2012** State law defines compensation as that which is payment for the member's services performed during normal working hours or for time during which the member is excused from work because of holidays, sick, disability, and other leaves, vacation (taken, not cashed out). State law also defines special compensation. Special compensation is outside of base pay but still included in pensionable earnings. Examples are bilingual pay or fire inspector certification pay.	**Palo Alto Pension Benefits as of 12/31/2012** Memoranda of Agreement may contain provisions for special compensation for employees to receive payment for special skills, knowledge, abilities, work assignment, workdays or hours, or other work conditions as permissible under PERL.
	PEPRA For employees hired on or after January 1, 2013, pension must be calculated on normal monthly base pay. Excludes other payments such as vacation, sick leave, overtime and other special pay categories. In the past, agencies were able to contract for sick leave credit and have this count as special compensation, no longer will be an option. This did not apply to Palo Alto as City did not permit this. New members will not be eligible to have their uniform compensation be part of pension calculation.	**PEPRA's Impact on Palo Alto** May exclude Public Safety uniform allowance from being considered special compensation as well as other special assignment pay, will be subject to further consultation with CalPERS.

	State Law Mandates for Local Agencies Offering CalPERS Pensions	Palo Alto Benefits
Cap on Pensionable Compensation	**State Law as of 12/31/2012** CalPERS limits safety pensions at either 80% or 90% of final compensation. Miscellaneous employees are not subject to these limits, although generally are covered by lower formulas and in most cases are unlikely to reach 80% or 90% of final compensation. Otherwise, CalPERS pensions apply to all compensation up to the federal limit in Internal Revenue Code section 401(a)(17), currently $250,000.	**Palo Alto Pension Benefits as of 12/31/2012** The limits in state and federal law apply to Palo Alto retirees.
	PEPRA For employees hired on or after January 1, 2013, PEPRA caps the amount of compensation that can be used to calculate a retirement benefit at: • $ $113,700for employers participating in social security • $136,440for employers not participating in social security. The cap is adjusted annually based on the Consumer Price Index for All Urban Consumers or otherwise by the Legislature. Employers are barred from adopting any supplementary defined benefit plan. Employers may contribute to a defined contribution plan, subject to certain limitations.	**PEPRA's Impact on Palo Alto** Palo Alto does not participate in social security. New employees hired on or after Jan. 1, 2013, except those with prior CalPERS or reciprocal service, will be subject to $135,120 cap on pensionable income. At this time, Palo Alto does not have a program in place to make deferred compensation contributions on behalf of all employees, only as provided for in employment agreements with Council Appointed Officers However, employees can make voluntary contributions to deferred compensation plans made available.

	State Law Mandates for Local Agencies Offering CalPERS Pensions	Palo Alto Benefits
Cost Sharing: Employee Contributions to Pension Costs	**State Law of 12/31/2012** CalPERS establishes a fixed mandatory employee contribution: • Misc. Basic Plans (Tier 2) – 7% • Misc. Enhanced Plans (Tier 1) – 8% • Safety All Plans – 9% Employers may agree to "pick up" part or all of the employee contribution. In addition to the employee contribution, which does not change from year to year, CalPERS determines annually an amount that the employer must pay to fund the benefits owed to retirees and current employees. CalPERS' actuaries determine the employer contribution by adding the employee contributions to the system's investment returns and subtracting those sums from the total amount required to fund the system. Funds collected from employees and employers fund two types of liabilities: • the "normal cost" of pension benefits, which is the amount that must be set aside this year to pay for the pension obligations earned by active employees this year, incorporating CalPERS' rate of return and employee demographic assumptions, and • any "unfunded liabilities," which are funding gaps generated by shortfalls in the projected rate of return on investment, changes in employee demographic assumptions (such as employees living longer), etc.	**Palo Alto Pension Benefits as of 12/31/2012** Palo Alto began "picking up" the employee contribution in 1981 for Fire and Police and in 1983 for Miscellaneous employees. In 2007, the City began to bargain for employees to resume paying the employee contribution for Miscellaneous employees. Currently: • SEIU, IAFF, Battalion Chiefs, POA and Managers/Professionals pay full employee contribution of 7%, 8% or 9%, depending on the employee's benefit formula. • PMA pays 0%. • UMPAPA pays 2%. In addition to the employee contribution, as of June 30, 2011, CalPERS actuaries calculated Palo Alto's pension liabilities as follows (expressed as a percent of payroll): Miscellaneous • Normal cost 10.360% • Unfunded liabilities 14.240% • Total = 24.600% Safety • Normal cost 18.658% • Unfunded liabilities 14.786% • Total = 33.444%
	PEPRA	**PEPRA's Impact on Palo Alto**

	The cost-sharing provisions of PEPRA are complex and not clearly drafted. CalPERS is working to clarify the implementation of the new law. Clean-up legislation, implementing regulations or litigation may be required in order to clarify the meaning of several of the provisions. ***New employees – sharing the "normal cost."*** PEPRA states that employees hired on or after Jan. 1, 2013, must pay "at least" 50% of the normal cost of their pension or the current contribution rate of similarly situated employees, whichever is greater. CalPERS has not yet notified local agencies of the specific amount that new hires must pay. ***Current employees – sharing the "normal cost."*** After Jan. 1, 2018, PEPRA authorizes employers to bargain for current employees to pay 50% of the normal cost so long as the employee contribution does not exceed 8% for Misc and 12% for Police & Fire. ***The employer contribution.*** PEPRA also authorizes employers and employees to agree to share the employer contribution, but prohibits employers from imposing cost-sharing of the employer share in the absence of an agreement with labor.	Palo Alto is at or close to the goal set in PEPRA for employee cost sharing. Except for Police Managers and UMPAPA, all Palo Alto employees already pay their full employee PERS contribution (7%, 8% or 9%). PEPRA allows employers to negotiate an additional increment, not to exceed 8% for Miscellaneous and 12% for Safety, as labor contracts are open. Before 2018, any such additional contribution would require labor's agreement. After that date, the standard negotiation and impasse procedures would apply. For new employees, Palo Alto is awaiting CalPERS actuarial determination of the amount that Tier 3 employees should be charged after January 1, 2013, for their employee contribution. Under PEPRA, the City could seek to negotiate additional employee contributions towards the employer portion. Any such negotiations would require agreement and would not be subject to impasse procedures. Finally, PEPRA will impact Palo Alto as the City seeks to recruit or retain employees, by creating a more level playing field with other cities that until now have continued to pay some or all of the employee contribution.

OTHER PENSION REFORM CHANGES

Restrictions on Hiring Retirees	PEPRA requires new retirees to sit out for at least 180 days before returning to work as a retiree. The local agency's governing body may make exceptions for critically needed positions. The 180-day rule does not apply to police or fire retirees.
Forfeit Pension on Felony Conviction	PEPRA requires a pension be forfeited upon a felony conviction related to the performance of official duties. It appears that this requirement only applies to pension benefits earned after the date of the felony. PEPRA states the rule applies to both new and current employees, although CalPERS has stated it believes the rule may violate the vested rights of current employees.
Eliminate Airtime	CalPERS allows employees to purchase service credit for years in excess of those actually worked, known as "air time." Effective January 1, 2013, PEPRA bans the practice of allowing the purchase of "air time." PEPRA applies the ban to both new and current employees. CalPERS has stated that it believes the application of this rule to current employees may violate vested rights.
Prohibit Retroactive Benefit Increases	CalPERS requires benefit increases to apply to all service earned by current employees, including service already earned in prior years. Effective January 1, 2013, PEPRA requires that any enhancements to formulas or benefits must occur prospectively and not retrospectively.
Prohibit Pension Holidays	CalPERS calculates the annual contribution for all employers. Participating employers must pay the full amount of the annual required contribution as determined by CalPERS. In some past years, when high returns on investments led to funded status well over 100%, CalPERS granted employers a "pension holiday," meaning employers were not required to contribute to CalPERS for that year. Effective January 1, 2013, PEPRA prohibits pension holidays, except if (a) the plan is more than 120% funded; (b) excess earnings could result in disqualification of tax deferred status; and (c) the CalPERS board finds that additional contributions would conflict with its fiduciary duty.
Other changes	PEPRA makes other changes, including requiring local elected members first elected after January 1, 2013, to receive pensions based on the highest average compensation earned as an elected member; instructing CalPERS to develop regulations to adjust costs between employers where excessive compensation is paid by a successor agency; increasing Disability Retirements for certain public safety employees; and requiring equal health benefits vesting rules for non-represented and represented employee groups.