



City Council Staff Report

From: City Manager

Report Type: ACTION ITEMS

Lead Department: Administrative Services

Meeting Date: January 22, 2024

Report #:2311-2226

TITLE

Review and Accept the FY 2025 - FY 2034 Long Range Financial Forecast (LRFF) and FY 2025 Budget Development Guidelines as Recommended by the Finance Committee, CEQA Status – Not a Project

RECOMMENDATION

The Finance Committee and Staff recommend the City Council accept the General Fund Long Range Financial Forecast (LRFF) for Fiscal Year 2025-2034 (Attachment I) and the FY 2025 annual Budget Development Guidelines (Attachment II) and direct staff to use this forecast as the starting point for the initiation of the FY 2025 budget process.

EXECUTIVE SUMMARY

The FY 2025 - 2034 Long Range Financial Forecast (LRFF) was reviewed with the Finance Committee on December 5, 2023 (Attachment I) along with the annual Budget Development Guidelines (Attachment II) and were unanimously approved by the Committee. Base Case Long Range General Fund forecast projects a shortfall of \$6.0 million in FY 2025, followed by shortfalls ranging from \$5.4 million in FY 2026 down to \$0.5 million in FY 2029. These amounts are consistent with previous projections used as part of the two-year budget balancing strategy when adopting the FY 2024 Budget and a reserve was adopted by Council to provide funding for the FY 2025 projected gap. This report summarizes the key discussion points with the Finance Committee and includes additional information requested by the Finance Committee to provide context and/or additional data points of reference to the City Council.

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

BACKGROUND/ANALYSIS

The LRFF is a preliminary ten-year forecast based on the most current information available, actual revenues for FY 2023, and projected results through FY 2024 at the point in time of release (December 2023). General Fund expenditures are based on current City Council approved service levels (Base Case) compared to projected revenues over the next ten years. This Forecast allows staff and City Council to look at both the short-term and long-term financial status of current service levels in the General Fund to inform daily policy decisions and evaluate long-term goals and ongoing challenges. The Committee and staff recommend use of the Base Case for the FY 2025 Budget planning.

- Base Case Long Range General Fund forecast projects a shortfall of \$6.0 million in FY 2025, followed by shortfalls ranging from \$5.4 million in FY 2026 down to \$0.5 million in FY 2029. FY 2030 has a surplus of \$6.6 million which continues to grow through FY 2034. This forecast maintains current service levels approved in FY 2024 and should be used for planning purposes to assist in gauging effects of major policy interventions against a likely “status quo” version of the future. These amounts are consistent with previous projections used as part of the two-year budget balancing strategy when adopting the FY 2024 Budget.
- Alternate forecast scenario that reflects a 1% loss in economically sensitive revenue. Compared to the Base Case, this scenario reduces revenues by \$2.1 million in FY 2025 and maintains and increases the projected shortfalls over the next ten years, ranging from \$8.1 million in FY 2025 to \$3.0 million in FY 2029. FY 2030 begins a surplus of \$3.9 million which continues to grow through FY 2034.
- Alternate forecast that reflects a 1% compensation adjustment (1%) in FY 2026. Compared to the Base Case, this scenario increases expenses by \$1.2 million in FY 2026 and maintains and increases projected shortfalls over the next ten years, ranging from \$6.7 million in FY 2026 to \$1.9 million in FY 2029. FY 2030 begins a surplus of \$5.2 million which continues to grow through FY 2034.

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

The economy continues to demonstrate resiliency to a formal recession and this forecast reflects a continued level of stagnation offset by inflation. Risks remain due to world conflicts and potential local economy impacts. Several persistent issues across the City are improving but continue to impact the ability to provide fully authorized service levels. These include staff turnover, recruitment and retention, and supply chain issues and inflation that continue to increase costs across all aspects of the City. All of these factors lead to heightened intensity of financial forecasting and the budget development process. These forecast figures present staff

with the challenge of prioritizing the growing needs of the City with the fiscal sustainability of these needs.

Consistent with the projections in the FY 2024 Adopted Budget, this LRFF reflects deficits in the near term with revenues falling below expenses. As previously recommended, the shortfall in FY 2025 will be addressed by the Uncertainty Reserve that was proactively set aside during the prior year for this purpose. Also, this LRFF assumes support from both local ballot Measures K (Business Tax) and L (Gas Utility Fund Equity Transfer) that were approved by the voters in November 2022.

Based on this forecast, ensuring ongoing financial stability will require continued prioritization of spending and utilization of one-time surplus funding or the Uncertainty Reserve to address short-term deficits in the next few years. More detailed guidelines and policies to inform the development of the FY 2025 budget are discussed in Attachment II.

As directed by the City Council, staff will include recommendations for addition of key resources and appropriation of funds as part of the FY 2024 Midyear process, including a review of objectives deferred in the development of the FY 2024 Adopted Budget. The Mid-Year Review report is scheduled for Council review in February 2024.

Finance Committee Review

As part of the Finance Committee's review of the LRFF, several requests were made to provide context and/or additional data points of reference. Staff has compiled a summary of these items below and details in Attachment III.

Vacancy Analysis

The current vacancy rate is approximately 13.5% in the General Fund, excluding public safety. This preliminary vacancy rate is point in time and does not consider actions currently in progress for recruitments, promotions, and other staffing shifts. To better align with the status of vacancies, this forecast increases the vacancy estimate from previously assumed rate of 3% to 5% in all years. This results in additional savings of approximately \$2 million annually, or a projected \$5 million in total vacancy savings each year. This additional funding fully forecasts the vacancy savings the City has seen in recent years of \$1.7 million as shown in Table 1.

Table 1 provides a historical summary of budget to actuals variance in the Salary and Benefits category for General Fund departments. The budget includes the budgeted vacancy factor assumption, therefore this savings is what has been achieved beyond planned levels. The table includes the annual vacancy rate and the percentage difference from budgeted funding levels. As shown below, the vacancy savings from the previous year have varied from -\$1.7 million to +\$1.7 million over the last five years from the budgeted vacancy assumption, reflecting a variance of less than 1.5% as compared to the budgeted.

TABLE 1: Historical General Fund Vacancy Savings (\$'s in Millions)

	2019	2020**	2021**	2022	2023
Total General Fund Vacancy Savings	\$1.3M	\$1.3M	-\$1.7M	\$1.6M	\$1.7M
Annual Vacancy Rate	12%	12%	15%	12%	13%
General Fund Adjusted Budget*	\$123.3M	\$134.7M	124.1M	\$134.3M	\$148.4M
Variance to Budget	1.1%	1.0%	-1.4%	1.2%	1.2%

* The annual budget reflects *salaries and benefits net of the forecasted vacancy factor each year*.

** FY 2020 and FY 2021 are anomaly years as they were significantly impacted by adjustments made due to the COVID-19 pandemic where a number of factors are impacting these rates including but not limited to a hiring freeze as well as eventual position reductions citywide.

Economic Recovery Advisory Report

During the LRFF review, the Finance Committee raised questions regarding the processes to develop LRFF assumptions and variability in actual results. As a follow up to this discussion, this report includes references to an audit completed by the Office of the City Auditor (OCA) in April 2022 to review the City's long-term financial planning models and inputs (CMR 13915¹). The OCA results indicated that the City's was able to forecast revenues at no more than a 9% difference from original estimates over a five-year period, from FY 2016 to FY 2020. Further, the results indicated that the City has a robust process for forecasting and uses reliable information for assumptions. Overall, the OCA determined that the City's long-term financial planning models and inputs align with the OCA's considerations and best practices.

Historical Grant Funding and Funding from Other Agencies

From FY 2019 through FY 2023, various federal, state, local, and other agencies allocated funds for programs and initiatives across the General Fund and the Capital Improvement Fund. The City's practice is to recommend allocation of these funds after formal agreements are in place with the granting agency or jurisdiction. In addition, since these funds are designated for specific needs, staff strives to use these funding sources first in order to maximize resources.

Operating - General Fund

	2019	2020	2021	2022	2023
Funding by Fiscal Year (in Millions)	\$0.8	\$0.8	\$1.1	\$8.8	\$12.1

Notable funding includes but is not limited to, the Federal Transportation Agency (FTA) contributed to transportation-related projects along with the Santa Clara County Measure B

¹ City Council, April 11, 2022; Staff Report # 13915,

<https://portal.laserfiche.com/Portal/DocView.aspx?id=59425&repo=r-704298fc&searchid=4fe0b40a-9941-44aa-8e0d-6479fb037f48>

Transportation Improvement Program, and Stanford University supporting the PA Link program, Federal Health and Human Services (HHS) funding was appropriated for mental health services, COVID-19 relief through CARES and American Rescue Plan Act (ARPA) funds, fire fighter staffing funding via Staffing for Adequate Fire and Emergency Response (SAFER), and investments in safety equipment through the Santa Clara County Office of Emergency Services (SCC OES).

Capital Improvement Fund

External revenues supporting capital improvement projects fall into three broad categories: local/regional grants (including Measure B), state grants, and federal grants. The table below summarizes the amounts, sources, and uses of these revenues by fiscal year from FY 2019-FY 2023. The amounts in each fiscal year, which total \$50.5 million, do not include reappropriations.

	2019	2020	2021	2022	2023
Funding by Fiscal Year (in Millions)	\$12.4	\$4.3	\$12.6	\$4.0	\$17.0

Turning to currently budgeted revenues in the Capital Improvement Fund, the table below shows how Measure K, the City of Palo Alto's business tax, and Measure B, a Santa Clara sales tax that benefits transportation projects, are currently planned to be allocated across capital improvement projects based on the 2024-2028 Capital Improvement Plan (CIP). These allocations may change during the FY 2025 budget and 2025-2029 CIP development cycle.

	2024	2025	2026	2027	2028
Measure K - City of Palo Alto Business Tax	\$0.75	\$1.5	\$3.0	\$3.0	\$3.0
PL-24000 - Meadow Dr./ Charleston Rd. Rail Grade Separation and Safety Improvements	\$0.43	\$0.75	\$2.0	\$2.0	\$2.0
PL-24001 - Churchill Avenue Rail Grade Separation and Safety Improvements	\$0.32	\$0.75	\$1.0	\$1.0	\$1.0
Measure B - Santa Clara County Sales Tax	\$10.5	\$7.8	\$27.3	\$27.3	\$20.3
PL-05030 - Traffic Signal and Intelligent Transportation Systems	\$0.6	\$0.3	\$0.3	\$0.3	\$0.3
PL-12000 - Transportation and Parking Improvements	\$0.5	-	-	-	-
PL-17001 - Railroad Grade Separation and Safety Improvements	\$1.9	\$1.0	\$2.0	\$2.0	\$1.0
PL-24000 - Meadow Dr./Charleston Rd. Rail Grade Separation and Safety Improvements	\$4.5	\$4.5	\$15.0	\$15.0	\$15.0
PL-24001 - Churchill Avenue Rail Grade Separation and Safety Improvements	\$3.0	\$2.0	\$10.0	\$10.0	\$4.0

Human Services Resource Allocation Process (HSRAP)

As part of the LRFF, staff provided additional details to facilitate the City Council's review of a referral to consider pegging HSRAP budget allocations to a benchmark, such as a percentage of General Fund budgeted expenditures. Staff confirmed that funding levels in prior years were not tied to a percentage of the General Fund budgeted expenditures. As part of the LRFF review, the Finance Committee elected to continue the discussion on this referral in February 2024 with any recommended changes forwarded to the City Council for consideration as part of the FY 2025 budget process. The status of the referral has been updated from 'complete' to 'in progress', as indicated in the status update completed on December 5, 2023 (CMR 2307-1794²).

FISCAL/RESOURCE IMPACT

Financial implications from this report and input from the City Council will be considered in the City Manager's development of the Fiscal Year 2025 budget. Upcoming milestones related to the City's fiscal standing and the FY 2025 Budget Process include:

- February (Council) – FY 2024 Mid-Year Budget Review and Second Quarter Financial Report
- March/April (Finance Committee and Utilities Advisory Commission or UAC) – Five Year Utility Financial Plans and FY 2025 Utility Rate Recommendations
- May (Council) – FY 2025 Proposed Operating and Capital Budgets Published
- May (Finance Committee) – FY 2025 Proposed Budget Hearings, including Utility Rates, Municipal Fees, and Five-Year Capital Improvement Plan
- June (Finance Committee) – FY 2024 Third Quarter Financial Report
- June (Council) – Adoption of the FY 2025 Operating and Capital Budgets, Utility Rates, and Municipal Fees.

STAKEHOLDER ENGAGEMENT

The preliminary forecast for FY 2025 represents the beginning of the fiscal year 2025 budget development process. As in previous years, City Council discussion of the LRFF will provide guidance to staff in the budget development process. It is anticipated that conversations with City Council and the community will occur through public budget hearings in Spring 2024, according to the standard budget adoption process.

ENVIRONMENTAL REVIEW

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

² Finance Committee, December 5, 2023; Staff Report # 2307-1794,
<https://portal.laserfiche.com/Portal/DocView.aspx?id=69142&repo=r-704298fc&searchid=b316cc0f-f843-4290-8390-b2abbc3f61d4>

ATTACHMENTS

Attachment A: FY 2025-2034 Long Range Financial Report (LRFF), CMR 2307-1773

Attachment B: FY 2025 Budget Development Guidelines

Attachment C: Additional Information as Requested by Finance Committee

APPROVED BY:

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