**ATTACHMENT D**

# General Fund Base Case Expense Assumptions

*__Salary and Benefits__*

Consistent with prior years, the FY 2026 salaries and benefits costs represent approximately 60% of the General Fund budget expenditures. Salary and Benefits are projected to increase $8.4 million or 4.7% from the prior year, from $179.9 million to $188.3 million. Discussed in the following sections, this is primarily attributable to increases in salaries ($4.5 million), retiree healthcare costs ($1.9 million) and pension costs ($1.4 million).

*Salary*

Consistent with the City's salary budget methodology for recent budgets, positions are budgeted at the actual rate of pay of employees including benefit selections as of Fall 2024. Then, by position, salary costs are updated in accordance with applicable Memorandum of Agreements (MOA's) between the City and its labor groups and the Management and Professional Personnel and Council Appointees Compensation Plan(s).

In FY 2023, the City Council engaged with labor groups to negotiate new agreements for wages, benefits, and other terms and conditions of employment. These agreements extend through January 2025 (SEIU) and June 2025 (all other labor groups) for full-time staffing and include target market adjustments to align salaries with benchmark studies, Cost of Living Adjustments (COLAs), and other benefits such as a flexible compensation benefit.

The forecast assumes step increases for employees in applicable positions, including Service Employees International Union (SEIU), International Association of Fire Fighters (IAFF), and Palo Alto Peace Officers' Association (PAPOA), and merit increases for Management and Professional employees including Utilities Management & Professional Association of Palo Alto (UMPAPA). A general wage adjustment of 2% is included for all employees starting in either January 2025 or July 2025 for all years of the forecast since no MOA's would be in effect at that time. This is consistent with prior Council direction in previous LRFF reporting to use the 2% increase as a forecasting assumption, not as a commitment to future negotiations. The FY 2025 Budget includes MOA terms for a 4% COLA adjustment (all labor groups), 2% market alignment (Safety only), and increase in flexible compensation payment from $100 to $200 per month (all labor groups except SEIU).

A reserve is included for potential changes to future labor costs including changes in vacancy rates, labor and benefit rate variability, and inflation assumptions. Offering competitive compensation plans aligns with industry standards for attracting and retaining a skilled and motivated workforce and better positions the City of Palo Alto as an employer of choice. This level of funding does not reflect a commitment to future negotiations and may differ from actual outcomes. Negotiations for new labor agreements are anticipated to occur in the next year for new terms beginning in FY 2025-26. An alternative scenario is included in this report for increases beyond the assumptions described above.

Additionally, the budget includes vacancy savings that are expected to materialize as positions are vacated and new employees are hired through the normal course of business. As of the timing of this LRFF, the vacancy rate is approximately 10%. Vacancy savings from public safety positions are typically exhausted by uses such as backfill, hire ahead programs, and overtime. Consistent with changes in the previous LRFF, this forecast assumes a vacancy rate of 5% in all years. This results in additional savings of approximately $5.1 million in FY 2026 and increases to $6.5 million annually over the forecast period. Consistent with past practice, the vacancy assumption is lower than the actual vacancy rate to allow departmental use of those savings for other staffing strategies, such as filling staffing gaps by contracting for professional services, hiring ahead to allow overlap and smooth transitions, piloting new technologies to increase efficiency in the absence of staff, and supporting a summer internship program.

*Benefits*

*Pension:* Pensions are budgeted based on CalPERS determined rates as of the June 30, 2023 valuation for the City's miscellaneous and safety plans (CMR 2405-3062[1]). CalPERS determines the City's total contributions for a given Fiscal Year as the sum of two factors: Normal Cost (NC) and Unfunded Accrued Liability (UAL). Together the NC and the UAL expressed as a percentage of payroll is the 'blended rate' and is used to represent total costs in the discussion below.

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

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

The miscellaneous plan total costs are projected to decrease from the current 47.4% in FY 2025 to 43.7% in FY 2026. In the safety plan, total costs are projected to decrease from the current 83.1% in FY 2025 to 81.7% in FY 2026. These rates do not consider the employee pick-up of the

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[1] Finance Committee, September 17, 2024; Agenda Item #1; CMR 2405-3062, https://portal.laserfiche.com/Portal/DocView.aspx?id=98648&repo=r-704298fc&searchid=1dfcc5e6-076e-444f-8151-446c5257fe0f

employer share; that pick-up materializes as savings in the City's pension costs. Consistent with applicable MOAs, the LRFF presumes that the miscellaneous plan will pick up 1 to 2% of the employer pension cost and that safety plan members will pick up 3 to 4%.

The FY 2024 and FY 2025 budgets were impacted by significant swings in investment gains and losses earned by CalPERS in the periods ending June 30, 2021 and 2022. The FY 2024 budget reflected significant investment returns of +21.3% (+6.8% target) and changes to economic and demographic assumptions resulting from the CalPERS Asset Liability Management (ALM) process and Experience Study completed in November 2021. As part of the ALM, the CalPERS board approved a reduction to the discount rate (from 7.0 to 6.8%), revised actuarial assumptions (price inflation from 2.5 to 2.3%), and a new asset allocation targeting 1/3 investment in private assets, 5% leverage, and reduced public equity exposure. FY 2025 on the other hand reflected an investment loss of -6.1% (+6.8% target), nearly offsetting the positive impacts experienced in the prior year's investment gains.

The current LRFF uses an investment return of 5.8% as indicated in the June, 30, 2023 valuation report. Since the issuance of the current valuation, CalPERS announced a preliminary investment return of +9.3% (+6.8% target) for the period ending June 30, 2024[2] which has been recently revised to 9.5%. These results will be included in the CalPERS valuation report issued in Fall 2025 to inform the development of the 2027-2036 LRFF and FY 2027 budget. The resulting liability from investment returns that did not meet target levels will be amortized over 20 years with a 5-year ramp-up period. To inform this LRFF, staff used the CalPERS Pension Outlook Tool to calculate the estimated impacts, resulting in additional costs of $0.2 million ($0.1 million in the General Fund) in FY 2026, and increasing to $1.2 million ($0.5 million in the General Fund) at the peak of the 5-year ramp in FY 2030.

In the General Fund, it is anticipated the City will spend a total of $51.1 million on total pension costs in FY 2026, including both CalPERS contributions and supplemental Pension Trust Fund contributions. This is approximately $1.4 million higher than the prior year costs of $49.7 million, or a 2.9% increase. These expenses represent approximately 16% of the General Fund's total expenses.

**TABLE 1: CalPERS' Projected FY 2025-2035 Blended Retirement Rates**

(percentage of payroll)

| | FY 2025 | FY 2026 | FY 2027 | FY 2028 | FY 2029 | FY 2030 | FY 2031 | FY 2032 | FY 2033 | FY 2034 | FY 2035 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Miscellaneous** | 47.4 | 43.7 | 40.6 | 41.0 | 43.1 | 42.7 | 42.2 | 38.7 | 37.2 | 34.5 | 32.7 |
| **Safety** | 83.1 | 81.7 | 82.8 | 83.3 | 86.3 | 85.4 | 84.4 | 80.2 | 77.6 | 72.3 | 69.7 |

[2] CalPERS Reports Preliminary 9.3% Investment Return for 2023-24 Fiscal Year: https://news.calpers.ca.gov/calpers-reports-preliminary-9-3-investment-return-for-2023-24-fiscal-year/#:~:text=CalPERS%20today%20reported%20a%20preliminary,were%20valued%20at%20%24502.9%20billion.

*Retiree Healthcare/Other Post-Employment Benefits (OPEB):* Retiree Medical is based on the June 30, 2023 actuarial study prepared by Foster & Foster (previously Bartel Associates), which is completed every two years. The most recent study was completed in June 2024 to inform the development of the FY 2026 and FY 2027 operating budgets (CMR 2406-3140[3]). Consistent with City Council direction and the Retiree Benefit Funding Policy, this forecast continues the practice to budget the full payment of the Actuarial Determined Contribution (ADC) for retiree healthcare and uses alternative assumptions, such as a more conservative 5.75% discount rate (6.25% assumption), to transmit amounts above the recommended payment as an additional discretionary payment ("prefunding") to the California Employers' Retiree Benefit Trust (CERBT) Fund.

CalPERS blends active employees with pre-Medicare retirees and charges the same medical premium, even though younger employees on average consume less healthcare. The higher premium to younger employees thereby subsidizes older employees and retirees who, on average, have higher claims and premiums. The LRFF estimates $12.4 million in the General Fund in FY 2026 for ADC, an approximate $1.9 million or 18.4% increase from FY 2025 levels of $10.5 million in the General Fund. The implied subsidy is $2.9 million in FY 2026 and effectively lowers the funding necessary to meet the ADC.

**TABLE 2: Retiree Medical General Fund Contributions**

| FY 2025 | FY 2026 | FY 2027 | FY 2028 | FY 2029 | FY 2030 | FY 2031 | FY 2032 | FY 2033 | FY 2034 | FY 2035 |
|---|---|---|---|---|---|---|---|---|---|---|
| $10.5 | $12.4 | $12.8 | $13.2 | $13.6 | $14.0 | $14.5 | $14.9 | $15.4 | $15.8 | $16.3 |

*Retiree Benefit Funding Policy (formerly "Pension Funding Policy"):* The City has taken several proactive steps to address rising pension costs and long-term liabilities, including cost-sharing in labor agreements, establishing an irrevocable Section 115 Pension Trust ("Pension Trust") and California Employers' Retiree Benefit Trust (CERBT) Fund, and adopting a policy that guides financial planning of these benefits (CMR 11722 as modified by 2212-0513[4]).

The City initially contributed to the Pension Trust in FY 2017 on an ad-hoc basis, using one-time savings or excess revenues. Beginning in FY 2019, the City Council directed staff to use a more conservative discount rate as compared to CalPERS for the Normal Cost (NC) portion of the payment and transferring the supplemental funding beyond CalPERS required employer contributions to the Pension Trust. This practice was reinforced with Council approval of the Retiree Benefit Funding Policy, and as of FY 2024 the City's NC discount rate is 5.3% as compared to CalPERS 6.8%. Additionally, one-time contributions continue to be made each year if excess

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[3] City Council, June 17, 2024; Agenda Item #28; CMR 2406-3140 (Attachment D), https://portal.laserfiche.com/Portal/DocView.aspx?id=73983&repo=r-704298fc&searchid=2c9494ad-bd72-4ebd-b0f6-9b22ab7c6ca5

[4] City Council, November 30, 2020; Agenda Item #7; CMR 11722, https://portal.laserfiche.com/Portal/DocView.aspx?id=105077&repo=r-704298fc

revenues or unspent savings are available, subject to City Council approval. As part of policy goals, the City seeks to reach a 90% funded status by FY 2036.

Every four years, the City's Retiree Benefit Funding Policy requires that staff consult with an actuary to inform the City Council of progress the City has made towards achieving a 90% funded status goal and assess and respond to changes impacting the City's retiree benefit plans. This comprehensive review was most recently completed in FY 2023 and resulted in several policy revisions, most notably reducing the discount rate used to calculate supplemental contributions to the Pension Trust from 6.2% to 5.3% and extending actuary reporting from 3 to 4 years to align with the CalPERS ALM Study. Additionally, the title of the policy was revised from the Pension Policy to the Retiree Benefit Policy to recognize actions approved by the City Council to proactively plan for retiree healthcare plans in a similar manner to pensions, including the use of a lower 5.75% discount rate (CMR 2212-0513[5]). The most recent actuary analysis projects that the City will meet a 90% funded goal for pension plans by FY 2034 (miscellaneous plan) and FY 2036-37 (safety plan); the City's practice of transmitting excess one-time savings will help reach these goals sooner.

In this forecast, approximately $8.5 million in the General Fund in supplemental contributions to the City's Pension Trust is assumed in FY 2026. Through FY 2025, a total of $87.4 million ($56.4 million in the General Fund) in principal contributions are expected to be made to the Pension Trust for pension benefits. Through FY 2025, it is expected that $14.7 million in principal contributions will be made to the CERBT Fund for retiree healthcare benefits.

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

*Workers' Compensation:* The budget appropriation for workers' compensation includes an estimate for claims incurred and reserves for current filings at an 85% confidence level, based on actuarial studies completed by Bickmore. Actuarial estimates completed in August 2023 informed FY 2025 budget levels of $7.6 million (approximately 72% in the General Fund). More recent actuary estimates completed in August 2024 project expense levels to increase, but the allocation between the General Fund and other funds to remain consistent. Staff will continue to monitor expenditures in the fund and bring forward adjustments as necessary. Claim estimates and reserves for FY 2026 are $9.0 million, representing a $1.4 million or 18.4% increase from the FY 2025 Adopted Budget. Estimates for workers' compensation increase in the forecast at rates consistent with general CPI increases.

[5] City Council, February 6,2023; Agenda Item #3; CMR 2212-0513, https://portal.laserfiche.com/Portal/DocView.aspx?id=61647&repo=r-704298fc&searchid=d3b87446-2f24-46e1-a412-fa0ae4a0ee58

*Contract Services*

This forecast assumes contract services of $34.6 million in FY 2026, a 3.1% increase from the FY 2025 Adopted budget of $33.5 million. This increase for FY 2026 is driven primarily by known contractual increases and a general 3% CPI cost increase on contracts that do not have defined annual increases, based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust contract funding needs as part of the FY 2026 budget process.

*Contract Services - Committed Additions*

The Committed Additions included in this forecast account for anticipated operating and maintenance (O&M) costs in the General Fund for capital projects anticipated to come online within the ten-year forecast period. Costs for projects that came online in FY 2025 have been annualized into the ongoing General Fund operating budget as part of the LRFF. The preliminary total estimate is $50,800 for costs associated with the following projects anticipated to come online in FY 2026: Dog Park Installation (PG-18001), Fire Station 4 (PE-18004), Library Automated Materials Handling (LB-21000), and Park Restroom Installation (PG-19000). Additional cost increases of 3.0% annually are included throughout the ten-year forecast based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period. Timing and analysis of the funding needs for these projects will be evaluated as part of the FY 2026 Budget process and development of the 2026-2030 Capital Improvement Plan (CIP).

**TABLE 3: FY 2026 – FY 2035 Committed Additions (Millions)**

| FY 2026 | FY 2027 | FY 2028 | FY 2029 | FY 2030 | FY 2031 | FY 2032 | FY 2033 | FY 2034 | FY 2035 |
|---|---|---|---|---|---|---|---|---|---|
| $0.05 | $0.05 | $0.07 | $0.11 | $0.12 | $0.12 | $0.14 | $0.14 | $0.16 | $0.16 |

*Supplies and Materials*

The FY 2025 Adopted Budget for the General Fund included $3.5 million for Supplies and Materials, which is anticipated to increase by a 3.0% CPI cost increase in FY 2026 to $3.6 million based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period. This annual increase is adjusted to 4% starting FY 2028 through the ten-year forecast period. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for supplies and materials as part of the FY 2026 budget process.

*General Expense*

This category includes costs for travel and meetings, telephone and non-city utilities, contingency accounts and reserves, bank card service charges, and subsidies and grants provided through the Human Services Resource Allocation Program (HSRAP). The FY 2025 Adopted Budget of $22.1 million is expected to decrease to $18.2 million in FY 2026, primarily reflecting a planned year over year reduction in appropriations for Green Case settlement payouts and the anticipated use of the Budget Uncertainty Reserve to balance the FY 2026 budget. This reserve was partially used to balance the FY 2025 Adopted Budget ($6.1 million), leaving approximately $6.1 million to partially fund the anticipated gap in FY 2026 ($12.0 million). The reduction is partially offset by a 3.0% annual CPI cost increase on smaller items that do not have a set annual budget, based on a review of the changes in the California Consumer Price Index (CCPI) in the San Francisco Bay Area from the August-to-August period. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for general expense items as part of the FY 2026 budget process.

*General Expense – Project Homekey*: On September 27, 2021 the City Council directed staff to apply for Project Homekey funding in conjunction with LifeMoves to build an emergency shelter at the former Los Altos Treatment Plant (LATP) site (CMR 13595[6]). This project will deploy modular housing to provide interim housing opportunities for homeless individuals and families in the City of Palo Alto. Project Homekey is a program, funded by the State of California Department of Housing and Community Development, intended to provide grant funding and facilitate a partnership with the State to quickly acquire, rehabilitate, or master lease a variety of housing types. Once developed, these projects provide interim or permanent housing options for persons experiencing homelessness. The site will be operated for at least fifteen years as interim housing per the program's durational requirement. This project will utilize a combination of funding sources including the Project Homekey Program for capital expenses and donations, grant funds, and City support for ongoing operations expenses. This LRFF includes the City's committed investment of $7.0 million in operating expenses ($1.0 million annually FY 2025 through FY 2031). Some operating funding support is expected from Project Homekey as well as the County of Santa Clara. Any remaining gaps in funding will need to be closed by fundraising, operating cost containment strategies, and/or grant funds.

*General Expense - Cubberley Lease*: Recently, a tentative agreement between the City and PAUSD has been developed that will amend the City's leased portion of the Cubberley site. Although this agreement still needs to be approved by the City Council, this report assumes a reduction to the annual lease costs for Cubberley to $2.0 million plus the ongoing $0.8 million for child daycare sites and utilities. As part of the original lease agreement, the City Council approved creation of the Cubberley Infrastructure Improvements Fund supported by an annual $1.9 million transfer from the General Fund, which is classified as an Operating Transfer-Out and discussed in further detail in that section of this report below.

*Rents and Leases*

The Rents and Leases expense category for FY 2026 is estimated to increase from the FY 2025 Adopted Budget level by approximately 2.7% to $1.45 million. This is based on current lease terms that include previously negotiated lease increases This category includes the lease agreement for Development Services staff at locations outside City Hall (285 Hamilton and 526

[6] City Council, September 27,2021; Agenda Item #10; CMR 13595: https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2021/09-september/20210927/210927accsm-amended-final.pdf

Bryant) as well as lease with Stanford for El Camino Park. A new lease agreement was executed in December 2020 for the Development Services office location at 526 Bryant Street, limiting the space to the basement level (CMR 11426[7]). The lease was amended in September 2022 to extend the term initially for 12 months with the right to automatically extend for four successive 12-month periods, potentially through January 31, 2028 (CMR 14713). In June 2021, the City entered into a seventh amendment for the Development Services office lease at 285 Hamilton Avenue to extend the term from February 2022 to January 2025 (CMR 12334[8]). As expenses for rent for Development Services are adjusted, a corresponding revenue adjustment will be made to ensure Development Services maintains cost recovery levels.

*Facilities and Equipment*

Along with funding for various equipment needs across departments, this budget category includes subscription payments for equipment like public safety radios. The Facilities and Equipment expense category is expected to decrease from the FY 2025 Adopted level of $656,000 to $536,000 due to the elimination of one-time funding to replace fire equipment budgeted in FY 2025. It is expected that the estimated CPI increases will be substituted with department base budget requests to adjust funding for equipment needs as part of the FY 2026 budget process.

*Allocated Charges*

Allocated Charges represent expense allocations by the City's Enterprise and Internal Service Funds for services and products they provide to other departments. The FY 2025 Adopted Budget for the General Fund included $26.9 million for these expenses, including utilities usage, general liability insurance, technology costs, vehicle equipment maintenance and replacement costs, and other charges for services provided by other City departments and funds. The FY 2026 allocated charges in the LRFF update the revenues and expenses for these various allocations based on the information available at the time of the LRFF development. FY 2025 is anticipated to experience an increase of 14.0% to a total of $30.7 million. This increase is primarily due to anticipated higher costs associated with technology services and utilities for City facilities such as water, electricity, and gas.

*Operating Transfers Out*

Operating Transfers Out include transfers from the General Fund to Debt Service Funds, the Technology Fund, and various other funds but excludes transfers to the Capital Improvement Fund, which are detailed in the following Transfer to Infrastructure section. The FY 2025 Adopted Budget included Operating Transfers Out of $6.3 million. In FY 2026, Operating Transfers Out are anticipated to increase to $6.4 million due to increases in the technology surcharge transferred to the Technology Fund to cover the General Fund's portion of new technology costs. Consistent with the FY 2025 Adopted Budget, a total of $2.0 million across the University Avenue, California

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[7] City Council, December 14, 2020; Agenda Item #5; CMR 11426, https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2020-2/id-11426.pdf?t=59979.32

[8] City Council, June 21, 2021; Agenda Item #15; CMR 12334, https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/2021/id-12334.pdf

Avenue, and Residential Permit Parking Funds is factored into this LRFF. Staff will continue evaluating these funds as part of the FY 2026 budget development and will bring forward recommendations as needed to keep the parking permit funds solvent.

*Transfer to Infrastructure*

Recovery from the COVID-19 pandemic is reflected in improved revenue levels in the FY 2025 budget compared to the FY 2024 budget. The total General Fund transfer to the Capital Improvement Fund budgeted in FY 2025 is $30.2 million compared to the $24.7 million transferred in FY 2024. This is comprised of a $14.5 million base transfer, interest earnings of $2.0 million, and $13.7 million from TOT revenue generated through voter-approved rate increases and new hotels that is dedicated to the Capital Improvement Fund to support the 2014 Council Infrastructure Plan, consistent with City Council direction. Estimated transfers from TOT revenues in FY 2026 are currently projected to increase to $14.2 million and the base transfer to increase to $17.2 million, along with estimated interest earnings of $2.0 million, for a total $33.4 million transfer to the Capital Improvement Fund. This forecast continues the goal established as part of the 2022-2026 Capital Improvement Plan (CIP) to restore the base portion of this transfer to pre-pandemic levels by FY 2026. This budget category also includes the separate $1.9 million transfer to the Cubberley Property Infrastructure Fund. This transfer to the Cubberley Property Infrastructure Fund supports facility systems maintenance needs at the Cubberley Community Center facility as well as capital improvement projects to maintain and upkeep the facility.