



CITY OF
**PALO
ALTO**

CITY COUNCIL STAFF REPORT

From: City Manager

Report Type: ACTION ITEMS

Lead Department: Administrative Services

Meeting Date: February 6, 2023

TITLE

Review and Accept the FY 2024 - FY 2033 Long Range Financial Forecast (LRFF) and FY 2024 Budget Development Guidelines

RECOMMENDATION

The Finance Committee and staff recommend that the City Council accept the Fiscal Year (FY) 2024 to 2033 General Fund Long Range Financial Forecast Revised Base Case and annual Budget Development Guidelines (Attachment B) and direct staff to use this forecast as the starting point for the initiation of the FY 2024 budget process.

EXECUTIVE SUMMARY

The FY 2024 - 2033 Long Range Financial Forecast (LRFF) was reviewed with the Finance Committee on December 6, 2022 (Attachment A) along with the annual Budget Development Guidelines (Attachment B) and were unanimously approved by the Committee. This report 1) summarizes the key discussion points with the Finance Committee, 2) provides a revised Base Case Forecast in alignment with cost estimates of City and labor group positions on economic proposals¹, and 3) provides preliminary information regarding Utility rates which may impact development of the FY 2024 Budget.

The Revised Base Case General Fund forecast reflects projected gaps in the first four years (FY 2024-FY 2027) with expenses out pacing revenues resulting in deficits ranging between \$500,000 to \$5.8 million annually. Staff expect that a combination of one-time funds and the eventual collection of new Business tax revenues from the passage of Measure K will assist in resolving these deficits.

Per City Council policy, items that are unanimously approved by the Finance Committee are placed as a consent agenda item for the City Council. However, staff and the Committee have placed this item on the City Council's action agenda for deliberation of the full Council in

¹ Subsequent to the Finance Committee review in December 2022, the City has reached tentative agreement with two labor groups, on this same February 6, 2023 agenda for approval, and adopted a new management and professional compensation plan.

acknowledgement of the importance for financial planning in the continued varied economic conditions.

BACKGROUND

The LRFF is a preliminary ten-year forecast based on the most current information available, actual revenues for FY 2022, and projected results through FY 2023 at the point in time of release. 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.

- Base Case Long Range General Fund forecast (as of December 2022) projects a surplus of \$0.4 million in FY 2024, followed by a \$3.4 million gap in FY 2025 and a \$2.6 million gap in FY 2026, with small but increasing surpluses in FY 2027 through FY 2033. This forecast maintains current service levels approved in FY 2023 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.
- Alternate forecast scenario that reflects a more severe recession. Compared to the Base Case, this scenario increases the General Fund gap over the next ten years. FY 2024 changes from a surplus to a gap of \$3.5 million, and revenues are not anticipated to be able to fund the annual expenditures until FY 2029.
- Alternate forecast that reflects estimated funding from Measure K (new business tax) and the impacts on the General Fund over the next ten years reflects a surplus in FY 2024 of \$1.1 million, a gap in FY 2025 of \$1.9 million, and surpluses in FY 2026 through FY 2033. 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.

As the COVID-19 pandemic is waning, economic uncertainty has heightened the intensity of financial forecasting and the budget development process including the need for complex problem-solving within an engaged public process across a wide range of issues. There are also several issues across the City continuing to impact the ability to transition beyond impacts of the pandemic including staff turnover, recruitment and retention, supply chain issues, and inflation that continue to increase costs across all aspects of the City. Development of the FY 2024 budget and planning for the subsequent years will balance the increased service level needs of the community with the financial resources projected. Ongoing revenues are unable to keep pace with expenses in the short term.

Based on this forecast, it is anticipated that the prioritization of spending and the use of one-time surplus funding from FY 2022 to cover short-term gaps over the next several years will be necessary to ensure continued financial stability. More detailed guidelines or Budget Policies to inform the development of the FY 2024 budget are discussed in Attachment B.

ANALYSIS

This report

- 1) Summarizes the key discussion points with the Finance Committee,
- 2) Provides a revised Base Case Forecast in alignment with cost estimates of City and labor group positions on economic proposals, and
- 3) Provides preliminary information regarding Utility rates which may impact development of the FY 2024 Budget.

Finance Committee December 2022 Review and Discussion

As part of the Finance Committee's review of the LRFF, there were no requests for additional information or changes to the report for the Council's review; however, a few topics were highlighted as part of the discussion. Staff has compiled these items below.

Economic Development:

- Potential for ongoing remote work and reduced office occupancy to impact major tax revenues, and lead to an extended local economic shift rather than a short term "blip".
- Permanent parklet program should be evaluated as a revenue source, or at minimum, cost neutral.
- Evaluate the potential for revenue from a new Fiber Utility.

Major Projects/Council Priorities:

- Repair of the Cubberley Gym should be prioritized as it impacts many children citywide.
- A majority of work related to the Sustainability and Climate Action Plan (S/CAP) is currently funded in the Utility Funds; however, as work continues to expand, this will become a shared responsibility across other funds.

Labor Costs and Staffing Analysis:

- As the biggest source of costs to the City, ensure that salaries and benefits such as pensions and medical plans are managed carefully, as outlined in the pension and retiree medical policies recently reviewed and updated by the Finance Committee.
- Quantifying service reinvestments should be evaluated in a manner other than just comparing headcount pre and post pandemic.

Revised Base Case Fiscal Year (FY) 2024 to 2033 General Fund Long Range Financial Forecast

Subsequent to the Finance Committees review of the LRFF, a new agreement with Management Employees has been approved by the City Council at the December 19, 2022 meeting, and agreements with the International Association of Fire Fighters (IAFF) and Service Employees International Union (SEIU) are scheduled for City Council approval on February 6, 2023. This report includes a revised LRFF forecast that aligns cost estimates with this updated status of City and labor group positions on economic proposals.

Consistent with prior Council direction in previous long range financial forecasts, a general wage adjustment of 2.0% was included for all years of the forecast along with a level of reserve to reach a target market placement for employee compensation in new labor agreements as a forecasting assumption, not as a commitment to future negotiations.

Staff will continue to refine these estimates during the FY 2024 annual budget process as labor agreements are finalized and more information is gathered on revenue trends. This revised Base Case, revises the LRFF reflecting gaps in the first four years, FY 2024 through FY 2027.

Table 1: Summary of Net One-Time Surplus/(Gap) – Base Case vs. Revised

Net Surplus/(Gap)	FY23 (Est.)	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
Base Case	\$0-6.0M	\$0.4M	(\$3.4M)	(\$2.6M)	\$1.5M	\$2.9M
REVISED Base Case	\$0-4.7M	(\$0.5M)	(\$5.8M)	(\$5.1M)	(\$1.0M)	\$0.3M

Table 2: REVISED Base Case, FY 2024 -2033 Long Range Financial Forecast

	Actual 2022	Adopted 2023	Projected 2023	2024	2025	2026	2027	2028
Total Revenue	\$238,735	\$237,751	\$238 - 244M	\$251,177	\$261,671	\$272,065	\$282,203	\$290,671
BSR Contribution (One-Time)	-	\$9,670	\$9,670	-	-	-	-	-
Total Source of Funds	\$238,735	\$247,421	\$247 - 253M	\$251,177	\$261,671	\$272,065	\$282,203	\$290,671
Year over Year increase (revenue only)				5.6%	4.2%	4.0%	3.7%	3.0%
Total Expenditures	\$197,963	\$247,421	\$248,721	\$251,715	\$267,500	\$277,159	\$283,240	\$290,359
Total Use of Funds	\$197,963	\$247,421	\$248,721	\$251,715	\$267,500	\$277,159	\$283,240	\$290,359
Year over Year increase				1.7%	6.3%	3.6%	2.2%	2.5%
Net One-Time Surplus/(Gap)	\$40,772	(\$0)	\$0 - 4.7M	(\$537)	(\$5,829)	(\$5,094)	(\$1,037)	\$313
Cumulative Net Operating Margin (One-Time)								
Net Operating Margin				(\$537)	(\$5,292)	\$735	\$4,057	\$1,349

Preliminary Utility Rate Forecasts

Current economic uncertainty and commodity prices are expected to result in recommended increases to the utility rates for FY 2024. New information, not available when the LRFF was published in late November, is being provided for review and a preliminary preview of rates expected to be discussed as part of the FY 2024 budget process. These rates will impact customers residential and commercial, including the City itself as a consumer of these commodities. This information can be seen in Attachment C. At the time of this preliminary review of estimated rate forecasts, the state of California has seen unprecedented rainfall and flooding. Staff are reviewing the impacts of this storm on rate forecasts and will ensure this is factored into the recommended rate changes for FY 2024. These recommendations are scheduled to be reviewed in March – May 2023 by the Finance Committee and adopted the City Council in June 2023.

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 2024 budget.

Upcoming milestones related to the City's fiscal standing and the FY 2024 Budget Process include:

- **February 13** Council Meeting – FY 2023 Mid-Year Budget Review and Second Quarter Fiscal Analysis Report
- **March/April** Utilities Advisory Commission (UAC) and Finance Committee Meetings – Five Year Utility Financial Plans and FY 2024 Rate Recommendations
- **May 1** Council Meeting – FY 2024 Proposed Operating and Capital Budgets Published
- **May** Finance Committee Hearings – FY 2024 Proposed Budget Review, including Utility Rates, Municipal Fees, and Five-Year Capital Improvement Plan
- **June** Finance Committee Meeting – FY 2023 Third Quarter Fiscal Analysis Report
- **June 19** Council Meeting – Adoption of the FY 2024 Operating and Capital Budgets, the Utility Rates, and Municipal Fees

STAKEHOLDER ENGAGEMENT

The preliminary forecast for FY 2024 represents the beginning of the fiscal year 2024 budget development process. As in previous years, the City Council discussion of 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 2023, 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.

ATTACHMENTS

Attachment A: FY 2024-2033 Long Range Financial Report (LRFF), CMR 14629

Attachment B: FY 2024 Budget Development Guidelines

Attachment C: Preliminary Utility Rates Forecast

APPROVED BY:

Kiely Nose, Assistant City Manager

Report #: 2301-0753