



CITY OF
**PALO
ALTO**

CITY COUNCIL Staff Report

From: City Manager

Report Type: INFORMATION REPORTS

Lead Department: Administrative Services

Meeting Date: June 5, 2023

Report #:2303-1164

TITLE

Fiscal Year 2023 Third Quarter Financial Status Report

RECOMMENDATION

This report transmits information regarding the City of Palo Alto's Fiscal Year 2023 Third Quarter Financial Status Report.

EXECUTIVE SUMMARY

The purpose of this report is to provide the Finance Committee with information on the financial status of the City's General Fund and Enterprise Funds as of the end of the 3rd Quarter of Fiscal Year (FY) 2023 (July 1, 2022 through March 31, 2023). Actuals are preliminary or unaudited balances.

The General Fund FY 2023 Adjusted Operating budget was approved with a \$224.3 million estimate for revenue sources (excluding Operating Transfers-in). Of this, \$150.1 million has been collected to date, 66.9% of the budget estimate. Major tax revenues are \$139.3 million, which is higher than FY 2022 Adjusted Budget levels by \$28.0 million or 25.2%, from the approximately \$111.3 million budgeted. General Fund expenditures for the 3rd quarter are 11.8% higher than prior year and are tracking at 56.3% of the Adjusted Budget. The General Fund Third Quarter Financial Report (Attachment A) contains a line-by-line report of major General Fund revenues by source and expenditures by department for 3rd Quarter Year-to-Date (YTD) as of March 31, 2023, and the comparison between the FY 2023 Adopted Budget and Adjusted Budget. The Adjusted Budget column includes prior year commitments that were carried forward into FY 2023 and the City Council approved amendments to the FY 2023 Adopted Budget YTD. The changes in Adjusted Budget - Revenue and Sources (excluding Operating Transfers-in) is a \$9.2 million upward adjustment, a 4.3% increase over the FY 2023 Adopted Budget. Expenses (excluding Operating Transfers-out) were also adjusted from \$222.0 million to \$259.1 million, a 16.7% increase over the FY 2023 Adopted Budget. The adjusted budget includes \$14.5 million in budget amendments authorized by Council (detailed in Attachment A). Actual revenues and

expenditures (including encumbrances) are tracking at 66.9% and 63.2%, respectively, with the adjusted budget.

The balancing strategy for the FY 2024 Proposed Budget used revised major tax revenue projections for FY 2023 using data available after March 31, 2023. This report serves as a financial status and does not include budgetary adjustments for major tax revenues; budgetary transactions necessary to align FY 2023 activity with the FY 2024 balancing strategy will be brought forward during year-end close. In the discussion of the various major tax revenue categories below, staff indicates generally how each category is trending compared to the adjusted budget from the FY 2023 Mid-Year Review. In addition, the Budget Stabilization Reserve (BSR) discussion in this report has been updated to align with FY 2023 year-end projection in the FY 2024 Proposed Budget.

All Enterprise Funds ended with a positive change in positive Net Position for the 3rd quarter of FY2023.

ANALYSIS

General Fund

Revenue Highlights for FY 2023 3rd Quarter Year to Date (YTD)

The actual revenues totaled \$150.1 million which is 10.3% higher than the same period of the prior year. All the major taxes except documentary transfer taxes were higher compared to the same period of the prior year. This recovery trend continued from FY 2022; however, the economic outlook remains uncertain with national, state, and local economic indicators in transition. Revenue is tracking at 66.9% of adjusted budget but it is not indicative of the annual expected receipts in FY2023, mainly due to timing of sales tax, property tax and transient occupancy tax received over the fiscal year.

The following is a table that highlights the City's major revenue sources for the 3rd Quarter YTD, compared to the same period of the prior year. Revenue for each period is expressed as a percentage of the Adjusted/Final Budget.

Table 1

General Fund Revenue FY 2023 3rd Quarter (000's)							
	3rd Quarter Actuals			Adjusted Budget			
	FY 2023	FY 2022	% change	FY 2023	%	FY 2022	%
Property Tax	\$37,126	\$34,136	8.8%	\$60,270	61.6%	\$53,228	64.1%
Sales Tax	21,291	18,432	15.5%	34,080	62.5%	28,184	65.4%
Charges for Services	25,678	20,755	23.7%	30,624	83.8%	24,932	83.2%
Transient Occupancy Tax	14,756	7,895	86.9%	22,199	66.5%	8,428	93.7%
Utility User Tax	13,254	11,174	18.6%	15,579	85.1%	14,370	77.8%
Permits and Licenses	4,804	4,820	-0.3%	9,828	48.9%	8,273	58.3%
Documentary Transfer Tax	3,214	8,802	-63.5%	7,217	44.5%	7,137	123.3%
All Other Revenue Sources	29,985	30,083	-0.3%	44,506	67.4%	42,424	70.9%
Total Revenue	\$150,108	\$136,097	10.3%	\$224,303	66.9%	\$186,976	72.8%

Property Tax

At the close of the third quarter, property tax revenue receipt was \$37.1 million, 61.6% of the adjusted budget, and an increase of 8.8% over the same period in the prior year, due to higher assessed values mainly driven by change in ownership. Property tax is received from the County of Santa Clara during second, third, and fourth quarters of the calendar year. The compound annual growth rate (CAGR) over the 10 years has been approximately 8.4%. The FY 2023 secured property tax assessed value growth rate and unsecured property tax assessed values (AV) growth rates are 6.4 % and - 6.5%, respectively, with a combined rate of 5.8%.

At FY 2023 mid-year property tax budget was revised upward by \$0.5 million to \$60.3 million. The County of Santa Clara's Finance Agency and Office of the Assessor, the entities responsible for managing the property tax billing, collection, and processing changes (e.g., sales, assessment appeal, etc.) forecasts indicate the upward revised FY 2023 forecast of \$60.3 million will be met or exceeded.

FY 2022 actual property tax revenue was \$59.4 million which included \$6.6 million for Education Revenue Augmentation Fund (ERAF) distributions from the County of Santa Clara. Of this \$6.6 million receipt, \$1.7 million has been set aside for the at-risk amount due to the lawsuit filed in November 2021 by the California School Boards of Association and its Education Legal Alliance against the Controller of the State of California for over the calculation methodology of the Excess ERAF. The County estimates that 20% to 25% of excess ERAF in FY 2022, FY 2023, and beyond are at risk due to this litigation. The FY 2022 disputed amount that has been received has been reserved and the FY 2023 adopted budget excludes this amount (\$1.5 million). Though Excess ERAF receipt has steadily grown over the last nine years, excess ERAF is not considered a permanent local revenue source.

Sales Tax

As of the third quarter, sales tax revenue has seen an increase of \$2.9 million or 15.5%, from the same period last year due to combination of continued pandemic recovery and inflation. Due to the timing of the California Department Tax and Fee Administration (CDTFA) sales tax collection and distribution, third quarter sales tax represents seven months of sales tax activity and does not represent sales tax activity for the full three quarters of the fiscal year. Actual performance for this fiscal year will not be known until August/September.

At FY 2023 mid-year, this revenue was revised upward by \$1.5 million to \$34.1 million or 4.6% based on inflation, performance to date, recent consumer trends, and the projected outlook by City's sales tax consultant. Staff expect that the actuals for the year will be higher than the \$34.1 million adjusted budget.

Transient Occupancy Tax (TOT)

TOT revenues reached \$14.8 million the end of the third quarter, an increase of 86.9% over the prior year. The current receipts indicate that TOT continues to have significant growth from the unprecedented lows seen during the pandemic. The third quarter results represent 7.5 months of TOT receipts due to the one-month timing delay in receipts. At FY 2023 mid-year, the budget was revised upward by \$4.0 million to \$22.2 million, or 22.0%. Of this amount, \$12.5 million is anticipated to fund General Fund Expenses, while \$9.7 million will be transferred to the Capital Improvement Fund to cover costs associated with the remaining 2014 Council Infrastructure Plan capital projects and associated debt service costs. With continued resiliency and growth in travel and tourism it is expected that actuals will be even higher than adjusted budget. As of this writing, receipts as of February 2023 or 8 months of the fiscal year were 88.6% higher, average occupancy was 67.7%, an increase of 18.4%, and average daily room rate was \$257, an increase of 41.45%, all from the same period last year. If the current trend continues, receipts are likely to exceed the adjusted budget.

Utility User Tax (UUT)

The UUT is levied on electric, gas, and water consumption, as well as on telephone usage. As of the third quarter, UUT revenues were \$2.1 million or 18.6%, higher than the same period last year. UUT on electric, water, and gas services increased by 27.8% while telephone services decreased by 0.6%. This revenue is showing a combination of pandemic recovery as workers return to the office and commodity prices increase. The purchase commodity price for electricity, gas, and water is increasing the cost to provide utility services due to unprecedented gas and electric prices, higher transmission, operating and maintenance costs, plus inflation. The higher utility costs result in higher UUT revenue. As a result, the outlook is actuals for the year will be substantially higher than the \$15.6 million budget.

Documentary Transfer Tax

Cash receipts total \$3.2 million, or 44.5% of the FY 2023 Adjusted Budget and \$5.6 million lower than prior year receipts for the same period. The number of transactions is 43% lower compared to the prior year's third quarter. This revenue source is volatile since it is highly dependent on

sales volume and the mix of commercial and residential sales. The prior year had a record receipt due to nine large commercial sales that occurred in FY 2022. Though the housing market continues to intensify as homes are selling faster, the number of homes available for sale continues to tighten. It is expected this revenue will be below budget by year-end based on current trends. Staff continues to monitor these receipts closely due to significant fluctuations that can occur anytime depending on the real estate sales activity.

Charges for Services

This revenue category consists of charges to Stanford for fire services and paramedic services, fees related to the City's golf course, arts and science classes, plan check fees, and payments to the City for issuance of Building and Fire Permits. The first three quarters of FY 2023 are up by \$4.9 million, or 23.7% compared to the same period last year mainly due to the following:

- Charges to Stanford for fire services increased \$1.3 million due to higher reimbursement level consistent with the negotiated fire agreement.
- Plan Check Fee increased by \$2.8 million mainly driven by higher commercial permit activity.
- Program and classes increased by \$0.9 million due to higher demand for several programs such as ceramic classes and tennis programs.
- Junior Museum & Zoo (JMZ) increased \$0.4 million; this FY 2023 represented the first full year of operations since it opened in October 2021.
- The increases mentioned above were partially offset by the decrease in golf revenues \$0.3 million, or 9.0%, which can be attributed to the several weeks of heavy rains and winter storms.

Expenditures Highlights for FY 2023 3rd Quarter Year to Date (YTD)

Table 2 highlights General Fund expenses by department for FY 2023 third quarter, compared to the same period of the prior year. Each quarter's expenses are expressed as a percentage of the Adjusted Budget for each year.

Table 2

General Fund Expenditures FY 2023 3rd Quarter (000's)							
Expenditures	3rd Quarter Actuals			Adjusted Budget			
	FY 2023	FY 2022	% change	FY 2023	%	FY 2022	%
Police	\$ 36,276	\$ 31,975	13.5%	\$ 48,332	75.1%	\$ 44,346	72.1%
Fire	31,024	28,147	10.2%	43,092	72.0%	37,731	74.6%
Community Services	20,699	19,370	6.9%	35,528	58.3%	32,958	58.8%
Public Works	14,184	12,010	18.1%	23,078	61.5%	20,000	60.1%
Planning and Development Services	14,534	12,438	16.9%	26,879	54.1%	21,554	57.7%
Library	6,711	6,218	7.9%	10,321	65.0%	9,145	68.0%
Administrative Services	7,214	6,561	10.0%	9,992	72.2%	9,614	68.2%
All Other Departments	15,241	13,816	10.3%	61,881	24.6%	39,100	35.3%
Total Expenditures	\$ 145,883	\$ 130,535	11.8%	\$ 259,103	56.3%	\$ 214,448	60.9%

Total expenditures through the first three quarters of the fiscal year were 56.3% of the adjusted budget and represent a \$15.3 million, or 11.8 %, increase over last year. The increase is mainly due to salaries and benefit costs and allocated charges. Allocated charges were higher in the current year primarily due to the vehicle equipment maintenance service and replacement charges and Information Technology support and replacement.

Through the end of the third quarter, 56.3% of adjusted budget was expended, which is slightly lower than the percent expended through the 3rd quarter in FY 2022, 60.9%. The variance is mainly due to All Other Departments which only expended 24.6% of the adjusted budget. Non-Departmental is in this category and only expended 7.9%, because there is a large unspent reserve of \$17.5 million for settlement of claims related to *Green v. City of Palo Alto* (Santa Clara Superior Court, Case No. 1-16-CV-300760). In addition, a \$14.0 million for budget uncertainty reserve was established to offset anticipated shortfalls in FY 2024 and FY 2025. Excluding both these reserves, the percentage of total expenditure to adjusted budget is 64.1%.

As a service-driven organization, the largest expenses are salaries and benefits. Salary and Benefit costs through these nine months reflect approximately 74% of the adjusted budget, compared to an average expected of 75%. Total General Fund salary and benefits expenditures through March 2023 are approximately \$110.0 million, compared to \$97.8 million in the same period in the prior year. The increase in salaries and benefits is mainly due to the following:

- \$4.3 million in regular salaries because of positions added and hired in FY2023, general, merit and market adjustments.
- \$4.0 million in City's pension contribution.
- \$0.9 million in medical, dental and vision expenses

- \$1.1 million pension contribution to Section 115 irrevocable Pension Trust which is based on approximate lower discount rate of 5.8%.
- Temporary salaries, overtime, paid leave, and workers compensation are also trending higher due to increase in salary rates, vacancies across departments, and increases in workers compensation cases.

Police and Fire The total actual expenses for the Police and Fire Departments comprised approximately 46.1% of total General Fund expenditures for the third quarter, which is consistent with prior year trends. The following table highlights Police and Fire salaries and overtime for the third quarter. Net overtime cost analysis for the Police and Fire Departments can be found in Attachment B.

Table 3

Police and Fire Salaries and Overtime FY 2023 3rd Quarter YTD (000's)							
	3rd Quarter YTD Actuals			Adjusted Budget			
	FY 2023	FY 2022	% change	FY 2023	%	FY 2022	%
	Inc (Dec)			Inc (Dec)			
Police - Salaries	\$ 13,028	\$ 12,260	6.3%	\$ 19,186	67.9%	\$ 17,650	69.5%
Police - Overtime	2,155	1,581	36.3%	1,063	202.7%	944	167.5%
Total Police	15,183	13,841	9.7%	20,249	75.0%	18,594	74.4%
Fire - Salaries	11,072	9,786	13.1%	15,291	72.4%	14,052	69.6%
Fire - Overtime	2,848	3,585	-20.6%	3,801	74.9%	3,304	108.5%
Total Fire	13,920	13,371	4.1%	19,092	72.9%	17,356	77.0%
Total Police and Fire							
Salaries & Overtime	\$ 29,103	\$ 27,212	6.9%	\$ 39,341	74.0%	\$ 35,950	75.7%

Police overtime is 36.3% higher than FY 2022 and represents 202.7% of the adjusted budget due to backfilling vacancies, benefited leave or industrial injuries, training is higher than usual due to the volume of new hires and responding to storm-related calls for services in Palo Alto and as mutual aid to the community of Pajaro, Monterey County- to be reimbursed subsequently. As of this writing, the Department has a total of 11.0% of positions vacant: eight positions are police officers, one business analyst, one community service officer, three in records and two dispatchers. Another 4% of staff are unavailable to work due to benefited leave or industrial injury and 9% of filled positions have new staff in training (in-house or at the police academy). Although overtime is tracking higher, overall, the Department is trending within the budget for total salary and benefits and anticipates doing so through the remainder of FY 2023. The Department's net overtime cost is \$0.7 million after deducting the reimbursements and salary savings due to vacancies. Analysis is included in Attachment B.

Fire overtime is 20.6% lower than FY 2022 and 75% of the adjusted budget. Overtime is generated when there are firefighter positions vacant, employees go on leave or call in sick, as well as when entry level firefighters are completing the academy. These situations create shift positions that must be backfilled with overtime. The Department had more shift positions to backfill in FY 2022 mainly due to the timing of hiring and trainings in Fire Academy resulting to a decrease of overtime in FY 2023. In midyear of FY 2023, \$1.7M was moved from salary savings into overtime to account for these vacancies and staffing of Fire Station 8. Training typically takes 18 weeks before firefighters can fill positions on engines and ambulances. Overall, the Department is trending within budget for all salary and benefit categories and anticipates doing so through the remainder of FY 2023. The Department's net overtime cost is \$1.6 million after deducting the reimbursements and salary savings due to vacancies. Analysis is included in Attachment B.

General Fund Budget Stabilization Reserve (BSR) Balance

As a result of budget amendment actions taken in FY 2023, including the FY 2023 Midyear Budget Report¹ the Budget Stabilization Reserve (BSR) was \$49.2 million at the end of Q3, which is above the City Council recommended 18.5% level of \$45.6 million by \$3.6 million. The balancing strategy for the FY 2024 Proposed Budget used revised major tax revenue projections for FY 2023 using data available after March 31, 2023. These projections included an additional \$3.6 million in major tax revenue, increasing the FY 2023 year-end BCR estimate to \$52.9 million. This report serves as a financial status and does not include budgetary adjustments for major tax revenues; budgetary transactions necessary to align FY 2023 activity with the FY 2024 balancing strategy will be brought forward during year-end close. This funding above the 18.5% level has been recommended to be used as part of the FY 2024 Proposed Budget Process to maintain General Fund BSR at 20% of the FY 2024 budgeted expenses.

?

¹ Staff Report 2212-0515 City Council Special Meeting, February 13, 2023,
<https://portal.laserfiche.com/Portal/DocView.aspx?id=61660&repo=r-704298fc>

Enterprise Funds

The following is a summary of changes in net position for each of the Enterprise Funds for the nine months ended March 31, 2023, including a comparison of results from the same period last year.

Table 4: Enterprise Funds Change in Net Position

	3rd Quarter YTD Actuals		Increase (Decrease)	% Change
	FY 2023	FY 2022		
Water	\$ 2,192	\$ 4,834	\$ (2,642)	-54.7%
Electric	677	(7,155)	7,832	109.5%
Fiber Optic	1,206	1,035	171	16.5%
Gas	5,341	1,703	3,638	213.6%
Wastewater collection	775	86	689	801.2%
Wastewater treatment	4,408	2,260	2,148	95.0%
Refuse	3,532	4,866	(1,334)	-27.4%
Storm Drainage	1,821	2,411	(590)	-24.5%
Airport	541	2,759	(2,218)	-80.4%
Total Change in Net Position	\$ 20,493	\$ 12,799	\$ 7,694	60.1%

Water Fund decreased \$2.6 million, or 54.7%, from the prior year due to overall decrease in revenues and an increase in operating costs. Revenue decreased despite of 8.9 rate increase effective July 1, 2022 due to, up until recent weather events, a voluntary water use reduction caused by drought conditions. The increase in operating costs is primarily from commodity purchases, salaries and benefits and vehicle replacement allocation. San Francisco Public Utilities Commission (SFPUC) commodity rate increased from \$4.10 to \$4.75, a 15.9% increase due to drought conditions.

Electric Fund increased \$7.8 million, or 109.5%, due to 5% rate increase effective July 1, 2022 and an increase to the Electric Hydro Rate Adjuster effective January 1, 2023. On December 19, 2022² the Palo Alto City Council approved an increase to the Electric Hydro Rate Adjuster (E-HRA), increasing the current Electric Hydro Rate from \$0.013/kWh to \$0.048/kWh effective on January 1, 2023. Activation of the E-HRA surcharge creates a temporary rate increase which is approximately a 20% or \$17.15 monthly increase for a median electric residential customer. The rate increases were implemented to offset increasing market commodity prices and transmission costs. In addition, the Electric Operations Reserves were at the minimum guideline level at the end of FY2022 and is forecasted to drop below minimum in FY2023, as costs were outpacing

² CMR 14874 City Council Meeting, December 19, 2022,
<https://portal.laserfiche.com/Portal/DocView.aspx?id=46283&repo=r-704298fc>

revenues. In FY2021 and FY2022, the utility did not raise rates to mitigate the economic impact of the COVID-19 pandemic on residents and businesses resulting in minimum reserve levels.

Gas Fund increased \$3.6 million, or 213.6% from the same period prior year due to increase in revenue from customer sales partially offset by higher commodity purchases. The customer sales increased by \$25.8 million primarily due to the unprecedented spike in natural gas market price during January 2023 along with the 4% rate increase effective July 1, 2022. The commodity costs are pass-through in nature and offsets extraordinarily high gas prices due to weather, gas production, as well as national and international trade and demand. In addition, revenues are below costs as the utility kept rate increases low during the pandemic while operations and construction costs continue to rise. The extreme gas prices in FY 2023 and unexpected expenses in FY 2022 lowered the gas utility's reserves below minimum guideline.

Wastewater Collection Fund increased \$0.7 million, or 801.2%, from prior year due to increase in residential and commercial sales because of 3% rate increase effective July 1, 2022.

Wastewater Treatment Fund increased \$2.1 million, or 95.0% from prior year due to the timing of the fourth quarter billing which occurred in Q3 for FY 2023 compared to Q4 in FY 2022 and increase in operating expenses. The largest increase in operating expenses were the salaries and benefits as a result of new hires and overtime for both routine and emergency coverage and interdepartmental utility charges. During FY 2023, Wastewater Treatment received \$8.8 million reimbursements from the Clean Water State Revolving Fund (CWSRF) for certain project expenses of the Primary Sedimentation Tank and Secondary Treatment Process. These reimbursements are recorded as a liability as the City is expected to repay the loans following the completion of each project.

Refuse Fund decreased \$1.3 million, or 27.4%, from prior year due to timing of the February Greenwaste payment amounting to \$1.1 million which occurred in March 2023 compared to April 2022 in FY 2022 and an increase in Greenwaste quarterly extra service compensation.

Storm Drain Fund decreased \$0.6 million, or 24.5% from prior year due to increase in operating and maintenance expenses specifically salaries and benefits.

Airport Fund decreased \$2.2 million or 80.4% due to higher federal grants received from Federal Aviation Administration in prior year.

FISCAL/RESOURCE IMPACT

There are no financial impacts recommended in this report. Staff will return to Council as part of the review of the FY 2023 Annual Comprehensive Financial Report with year-end budget adjustments to recommend any adjustments needed to align budgets with actuals.

STAKEHOLDER ENGAGEMENT

This report has been coordinated between the Treasury Division, Accounting Division, and the Office of Management and Budget in the Administrative Services Department, as well as with City departments.

ENVIRONMENTAL REVIEW

This activity is not a project under California Environmental Quality Act (CEQA) as defined in CEQA Guidelines, section 15378, because it has no potential for resulting in either a direct or reasonably foreseeable indirect physical change in the environment.

ATTACHMENTS

Attachment A: FY 2023 Third Quarter Financial Report

Attachment B: FY 2023 Q3 Public Safety Overtime Analysis

APPROVED BY:

Kiely Nose, Assistant City Manager

Lead Staff: Rocelyn Fernando, Finance Manager; Paul Harper, Budget Manager