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Sent: Wednesday, February 3, 2021 8:14 AM
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Subject: Additional Background Information for Council and Finance Commission

Dear Laurel,

Would you please distribute this to the Council and Finance Commission as a follow up to last Thursday's Joint Study Session? Also, I would appreciate if the Staff could review the work product to make sure the statements made are accurate. Given the Town Council will shortly be reviewing a new five-year forecast, it is important that the Council is aware of the challenges ahead and the trend of the past five years. If there are errors, I apologize.

Thank you.

Phil Koen

ATTACHMENT 4

Dear Council Members and Members of the Finance Commission,

This past Thursday the Staff presented a comprehensive overview of the various documents and reports the Staff prepares throughout the year. They also reviewed several actions the Town has taken to address pension funding, controlling expenditures, staffing levels, and increasing tax revenues. These actions have all been constructive and certainly strengthened the financial standing of the Town. I want to thank the Staff for preparing this presentation.

However, the presentation stopped short of painting the entire picture of the financial challenges the Town is currently facing. One way to look at this would be to compare the financial statements (Statement of Net Position and Statement of Activities) for the Town as of June 30, 2015 to June 30, 2020. The attached exhibit does that.

Discussion

Since FY 2015 the financial status of the Town has weakened as shown by the following metrics:

- a) Net Government Expenditures have increased 86% while total tax revenues have increased 19% over this five-year period. The increase in net governmental expenditure is largely being driven by increases in wages, an increase in actual (as opposed to budgeted) staffing levels, a 232% increase in pension expense and a 9% decrease in off-setting program revenues. In dollar terms, net governmental expenditures have increased \$15.2m over the five-year period.
- b) Total tax revenues have grown 19%, or \$4.9m, leaving a \$10m cumulative funding gap. It is important to understand that the Town's expense base cannot continue to grow at a rate that is 4x the growth rate of tax revenues. It also needs to be noted that the increase in tax revenues reflects the passage of 2016 Measure T tax, 2018 Measure G sales tax, the \$1m incremental property taxes associated with annexed unincorporated county pockets and raising an incremental \$100k in short-term rentals tax.
- c) In FY 2015 the Town had a surplus of tax revenue over net governmental expenditures totaling \$7.6m. In FY 2020, the Town had a deficit of \$2.7m – in other words, the total tax base of the Town in FY 2020 was insufficient to fund the annual net governmental expenditures. This deficit was "covered" by a one-time increase in investment earnings driven by the "mark to market" accounting rules for measuring the Town's investments. This is not sustainable and should not be relied upon in future periods as a predictable income source.
- d) In FY 2015 the Town had a positive unrestricted net position of \$7.1m, which indicates the Town's "spendable" assets exceeded the Town's total liabilities. That is a very good position to be in. Fast forward to FY 2020, the Town had a negative unrestricted net position of \$3.9m. This means that the Town's total liabilities now exceed "spendable" assets. By comparison, the City of Los Altos which is very comparable to the Town, has a positive unrestricted net position for governmental activities of approximately \$20m. Stated another way, the City of Los Altos "spendable assets" exceed the City's liabilities by \$20m.
- e) Part of the decline in unrestricted net position was driven by an increase in investment in capital assets. The increase was primarily due to a cumulative \$23.7m investment in street

infrastructure over the five-year period. A major portion (approximately \$13m) of this investment was for the Almond Grove street project. To qualify for a broader use of the 2016 VTA Measure B funds, the Town had to increase and maintain a street pavement condition index of 70 or greater. Once obtained, the Town would gain more flexibility over the use of Measure B funds and be allowed to invest in a variety of congestion relief projects and programs. It is believed that the Town now has a PCI greater than 70.

- f) Most of the decline in unrestricted net position is because total liabilities due in more than one year have increased 60%, or \$25.8, over the five-year period. This is being driven by the increase in pension and OPEB unfunded pension liabilities, despite the considerable actions taken to increase funding of the pension and OPEB plans. If the unfunded pension liability continues to increase, the annual pension expense will also grow largely because of the 7% interest charged by CALPERS on the unfunded pension liability. This is why the total pension expense has increased by 233% over the past five years.

Summary

When you compare the Town's Statement of Net Position (balance sheet) and the Statement of Activities (income statement) for FY 2015 vs. FY 2020, there have been adverse changes over the past five-year period. Today the Town's government-wide tax revenue base does not cover the total net governmental expenditures and the town's liabilities exceed "spendable" assets. While finding new revenue sources should be a priority, the obvious step is to also examine how the growth rate in expenditures can be contained and to continue to actively manage the Town's pension and OPEB liabilities.

Lastly, as I pointed out in a prior note, the Town has very limited financial capacity in the GFAR to fund any new capital projects beyond those already approved (including all carryforward projects) and the future annual \$2.1m in street, curb, gutter and sidewalk maintenance and repair projects (CIP #811-9901, 9902, 9910, 9921 and 9930) that are currently programmed in the GFAR through FY 2025 (\$8.4m cumulatively spending through FY 2025).

To frame this clearly, over the five-year period from FY 2015 to FY 2020, the Town invested a total of \$40.5m in all capital asset classes, which included making investments in streets, buildings, and equipment/vehicles. Assuming the required investment in capital assets stays at \$40.5m for the next five years, the Town will be extremely challenged to fund this level of investment from the go forward, five-year government wide operating cash flows.

I am confident that the Staff working cooperatively with the new Finance Commission will be able to help the Council navigate through these very challenging next five years. It is clear, however, this will not be "business as usual".

TOWN OF LOS GATOS, CALIFORNIA
STATEMENT OF NET POSITION
JUNE 30, 2015

| | Governmental Activities |
|--|------------------------------------|
| ASSETS | |
| Cash and investments | \$ 67,822,471 |
| Restricted cash and investments | 96,595 |
| Receivables: | |
| Accounts | 1,233,915 |
| Interest | 127,379 |
| Intergovernmental | 1,878,863 |
| Materials, supplies and deposits | 26,110 |
| Long term notes receivables | 1,419,490 |
| Capital Assets: | |
| Nondepreciable | 22,569,141 |
| Depreciable, net of accumulated depreciation | 71,117,888 |
| Total Assets | <u>\$ 166,291,852</u> |
| DEFERRED OUTFLOWS OF RESOURCES | |
| Pension contributions | \$ 4,300,096 |
| Prepaid pension obligations | 4,307,811 |
| Total Deferred Outflows of Resources | <u>\$ 8,607,907</u> |
| LIABILITIES | |
| Accounts payable | \$ 1,369,677 |
| Accrued payroll and benefits | 2,859,335 |
| Due to other governments | 12,872 |
| Unearned Revenue | 4,444,921 |
| Deposits | 5,305,148 |
| Claims payable | 1,002,072 |
| Long-term liabilities: | |
| Due within one year | |
| Compensated absences | 1,519,817 |
| Due in more than one year | |
| Postemployment benefits | 3,212,390 |
| Net pension liabilities | 39,199,892 |
| Compensated absences | 928,880 |
| Total Liabilities | <u>\$ 59,855,004</u> |
| DEFERRED INFLOWS OF RESOURCES | |
| Difference from actual and projected pension plan earnings | <u>\$ 8,513,625</u> |
| NET POSITION | |
| Net investment in capital assets | \$ 93,687,029 |
| Restricted for: | |
| Capital projects | 5,482,974 |
| Lighting and landscape repairs and maintenance | 180,208 |
| Total Restricted Net Position | 5,663,182 |
| Unrestricted | 7,180,919 |
| Total Net Position | <u>\$ 106,531,130</u> |

The notes to the financial statements are an integral part of this statement.

TOWN OF LOS GATOS, CALIFORNIA
STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2015

| Functions/Programs | Expenses | Program Revenues | | | Net (Expense) Revenues and Changes in Net Position |
|------------------------------------|----------------------|-------------------------|--|--|---|
| | | Charges for Services | Operating Grants and Contributions | Capital Grants and Contributions | Governmental Activities |
| Governmental Activities: | | | | | |
| General government | \$ 6,465,852 | \$ 1,888,213 | \$ - | \$ 176,705 | \$ (4,400,934) |
| Public safety | 12,644,221 | 3,529,166 | 24,838 | - | (9,090,217) |
| Parks and public works | 8,069,352.14 | 2,206,765 | 907,745 | 2,338,154 | (2,616,688) |
| Community development | 4,047,737.59 | 5,027,497 | - | - | 979,759 |
| Library services | 2,553,414.44 | 53,123 | 4,062 | - | (2,496,229) |
| Sanitation | 491,359.05 | 328,868 | - | - | (162,491) |
| Total Governmental Activities | <u>\$ 34,271,936</u> | <u>\$ 13,033,632</u> | <u>\$ 936,645</u> | <u>\$ 2,514,859</u> | <u>(17,786,800)</u> |
| General revenues: | | | | | |
| Taxes: | | | | | |
| Property taxes | | | | | 12,931,603 |
| Sales taxes | | | | | 8,202,678 |
| Franchise taxes | | | | | 2,215,430 |
| Other taxes | | | | | 2,062,893 |
| Investment earnings | | | | | 428,772 |
| Miscellaneous | | | | | 813,324 |
| Total general revenues | | | | | 26,654,700 |
| Change in Net Position | | | | | 8,867,900 |
| Net Position - Beginning | | | | | 142,129,628 |
| Prior Period Adjustment, GASB 68 | | | | | (44,466,398) |
| Net Position - Beginning, Adjusted | | | | | 97,663,230 |
| Net Position - Ending | | | | | <u>\$ 106,531,130</u> |

The notes to the financial statements are an integral part of this statement.

TOWN OF LOS GATOS
STATEMENT OF NET POSITION
JUNE 30, 2020

| | Governmental Activities |
|--|------------------------------------|
| ASSETS | |
| Cash and investments | \$ 71,609,969 |
| Restricted cash and investments | 784,191 |
| Receivables: | |
| Accounts | 1,459,473 |
| Interest | 317,209 |
| Intergovernmental | 1,555,607 |
| Materials, supplies and deposits | 30,960 |
| Long term notes receivables | 237,752 |
| Long-term prepaid pension obligations | |
| Capital Assets: | |
| Nondepreciable | 22,338,953 |
| Depreciable, net of accumulated depreciation | 89,361,272 |
| Total Assets | <u>187,695,386</u> |
| DEFERRED OUTFLOWS OF RESOURCES | |
| Pension contributions subsequent to measurement date | 10,753,665 |
| Pension related amounts | 4,179,339 |
| OPEB contributions subsequent to measurement date | 2,508,306 |
| Total Deferred Outflows of Resources | <u>17,441,310</u> |
| LIABILITIES | |
| Accounts payable | 3,772,685 |
| Accrued payroll and benefits | 1,700,778 |
| Due to other governments | 37,969 |
| Unearned Revenue | 4,596,403 |
| Deposits | 6,736,953 |
| Claims payable | 1,248,411 |
| Long-term liabilities: | |
| Due within one year: | |
| Compensated absences | 335,642 |
| Due in more than one year: | |
| Net OPEB liability | 9,126,387 |
| Net pension liabilities | 57,230,935 |
| Compensated absences | 2,772,061 |
| Total Liabilities | <u>87,558,224</u> |
| DEFERRED INFLOWS OF RESOURCES | |
| Pension related amounts | 2,098,547 |
| OPEB related amounts | 628,894 |
| Total Deferred Inflows of Resources | <u>2,727,441</u> |
| NET POSITION | |
| Net investment in capital assets | 111,700,225 |
| Restricted for: | |
| Capital projects | 6,257,756 |
| Pension | 669,978 |
| Lighting and landscape repairs and maintenance | 190,250 |
| Total Restricted Net Position | 7,117,984 |
| Unrestricted | (3,967,178) |
| Total Net Position | <u>\$ 114,851,031</u> |

The notes to the financial statements are an integral part of this statement.

**TOWN OF LOS GATOS
STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2020**

| Functions/Programs | Expenses | Program Revenues | | | Net (Expense) Revenues and Changes in Net Position |
|-------------------------------|----------------------|-------------------------|--|--|---|
| | | Charges for Services | Operating Grants and Contributions | Capital Grants and Contributions | Governmental Activities |
| | | | | | |
| Governmental Activities: | | | | | |
| General government | \$ 7,405,368 | \$ 1,470,324 | \$ 12,290 | \$ 8,258 | \$ (5,914,496) |
| Public safety | 20,446,188 | 1,549,207 | 952,045 | 9,100 | (17,935,836) |
| Parks and public works | 11,803,005 | 3,674,222 | 2,824,638 | 832,755 | (4,471,390) |
| Community development | 5,001,958 | 3,351,753 | 15,864 | - | (1,634,341) |
| Library services | 3,347,523 | 11,522 | 49,351 | - | (3,286,650) |
| Sanitation | 3,041 | 231,323 | - | - | 228,282 |
| Total Governmental Activities | <u>\$ 48,007,083</u> | <u>\$ 10,288,351</u> | <u>\$ 3,854,188</u> | <u>\$ 850,113</u> | <u>(33,014,431)</u> |
| General revenues: | | | | | |
| Taxes: | | | | | |
| Property taxes | | | | | 18,330,426 |
| Sales taxes | | | | | 7,531,425 |
| Franchise taxes | | | | | 2,495,792 |
| Other taxes | | | | | 1,911,774 |
| Motor vehicle in lieu | | | | | 24,526 |
| Investment earnings | | | | | 2,428,470 |
| Miscellaneous | | | | | <u>323,940</u> |
| Total general revenues | | | | | 33,046,353 |
| Change in Net Position | | | | | 31,922 |
| Net Position - Beginning | | | | | <u>114,819,109</u> |
| Net Position - Ending | | | | | <u>\$ 114,851,031</u> |

The notes to the financial statements are an integral part of this statement.

| Statement of Activities | FY 2015 | FY 2020 | Change % |
|---|----------------|----------------|-----------------|
| Total Government Expenditures (a) | 34,271,936 | 48,007,083 | 40.1% |
| Less: Program Revenues | 16,485,136 | 14,992,652 | -9.1% |
| Net Government Expenditures | 17,786,800 | 33,014,431 | 85.6% |
| Less: Revenues from Taxes | 25,412,604 | 30,293,943 | 19.2% |
| Excess/(deficit) Revenues | 7,625,804 | (2,720,488) | -135.7% |
| Plus: Investment earnings | 428,772 | 2,428,470 | 466.4% |
| Plus: Miscellaneous | 813,324 | 323,940 | -60.2% |
| Change in Net Position | 8,867,900 | 31,922 | -99.6% |
| Footnote to Statement of Activities | | | |
| a) Total Pension Expense | 3,247,119 | 10,809,763 | 232.9% |
| Net Position | | | |
| Net Investment in Capital Assets (a) | 93,687,029 | 111,700,225 | 19.2% |
| Restricted For: | | | |
| > Capital Projects | 5,482,974 | 6,257,756 | 14.1% |
| > Pension | | 669,978 | |
| > Lighting and Landscape | 180,208 | 190,250 | 5.6% |
| Total Restricted | 5,663,182 | 7,117,984 | 25.7% |
| Unrestricted (b) | 7,180,919 | (3,967,178) | -155.2% |
| Total Net Position | 106,531,130 | 114,851,031 | 7.8% |
| Footnotes to Net Position | | | |
| a) Net Investment in Streets Infrastructure | 28,731,625 | 44,346,846 | 54.3% |
| b) Liabilities due in more than 1 year | | | |
| > Pension Liabilities | 39,199,892 | 57,230,935 | 46.0% |
| > OPEB Liabilities | 3,212,390 | 9,126,387 | 184.1% |
| > Compensated Absence | 928,880 | 2,772,061 | 198.4% |
| Total Due in more than 1 year | 43,341,162 | 69,129,383 | 59.5% |