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| DATE: | February 7, 2025 |
| TO: | Finance Commission |
| FROM: | Chris Constantin, Town Manager |
| SUBJECT: | Review and Make a Recommendation to the Town Council on the FY 2025-26 Five-Year Forecast and Supporting Work Product |

## RECOMMENDATION:

Review and provide recommendations to the Town Council regarding the Five-Year Forecast (Fiscal Years 2025-26 – 2029-30), assumptions, and scenarios, and provide input for the FY 2025-26 budget direction.

## EXECUTIVE SUMMARY:

The base case Five-Year Forecast (FY2025-26 – 2029-30) (**Exhibit B**) identifies deficits for all future years, using already negotiated salary cost increases (FY 2025-26 and FY 2026-27) and 2% salary increase assumption (beyond FY 2027-28), 4.6% vacancy saving factor and other assumptions (see Exhibits C and D to Attachment 2). The projected deficits start at $5.6M in FY 2025-26 and can be mitigated in the short term by expenditure controls and using one-time funds. Revenue projections are not keeping pace with rising costs. Future discussions of revenue capacity to match expenditures and service levels will need to occur to address increasing pressure on Town finances.

This report demonstrates the forecast sensitivity. The Finance Commission can provide recommendations on the assumptions for Council consideration for the FY 2025-26 budget and provide other budget direction as appropriate.

## BACKGROUND:

With the passage of Measure A, the Finance Commission has been tasked with several mandated duties as described in the provisions of the adopted Ordinance. Section 2.50.225. – Duties states that:

PREPARED BY: Gitta Ungvari
Finance Director

Reviewed by: Town Manager, and Assistant Town Manager

(a) The Finance Commission shall:
Serve as an on-going substantive and expert advisory body to the Town and Town Council so that the Town and Town Council can make informed decisions about the Town's financial, budgetary and investment matters and operations related thereto.

On February 20, 2025, the Town Council is scheduled to consider the FY 2025-26 Five Year Forecast which is an important component of the annual budget cycle (**Exhibit A**).

The Commission is welcome to provide comments on the Forecast, its assumptions, and scenarios as well as any comments for consideration in the preparation of the FY 2025-26 Operating Budget.

Forecasting Approach Consistent with Government Finance Officers Association (GFOA)

A "conservative" forecast as described by GFOA is conservative with revenue assumptions and builds in a layer of contingencies for expenditures. This approach might make it harder to balance the budget but reduces the risk of an actual shortfall. The Town's past forecasting practice represented this conservative approach.

During the last couple of years, staff changed elements of the budgeting and forecasting methodology. Starting FY 2020-21, the salaries are budgeted and forecasted at actual salary plus one step higher. Beginning in FY 2023-24, the budget and the forecast included a 4.6% vacancy savings factor, moving toward a less conservative approach.

An "objective" forecast as described by GFOA seeks to estimate revenues and expenditures as accurately as possible, making it easier to balance the budget, yet increasing the risk of an actual shortfall.

It is very important that the approach to the forecast and the underlying assumptions are clear, analyzing the risk between being objective versus conservative. While one-time solutions can solve near term shortfalls, the best practice is to build a structurally balanced forecast where recurring revenues (the portion of the Town's revenues that can reasonably be expected to continue year to year with some degree of predictability) equal or exceed recurring expenditures (salaries, benefits, and other operational expenditures).

DISCUSSION:

An important aspect of the Town's budget development process is taking a multi-year approach to understand revenue and expenditure trends over time. Serving as the foundation of the budget planning process (Exhibit A), the Town develops a Five-Year Financial Forecast ("Forecast") beginning in the winter of each year. The Forecast enables the Town to evaluate its fiscal condition and to help guide policy, programmatic planning, and budget decisions.

Developing a financial forecast as part of the budget development process has been identified as a best practice by the Government Financial Officers Association (GFOA).

This process helps to provide a snapshot of what the future may look like as a result of the decisions made to date.

The initial Forecast (FY 2025-26 – 2029-30) is predicated on estimates derived from the FY 2024-25 Mid-Year review and includes updates to Town revenues and expenditures based on the end of year estimates projected at mid-year. Like any forecast, the Forecast's revenue estimates for the first year are the most critical in the process as they ultimately define the expenditure limitations for the upcoming budget year.

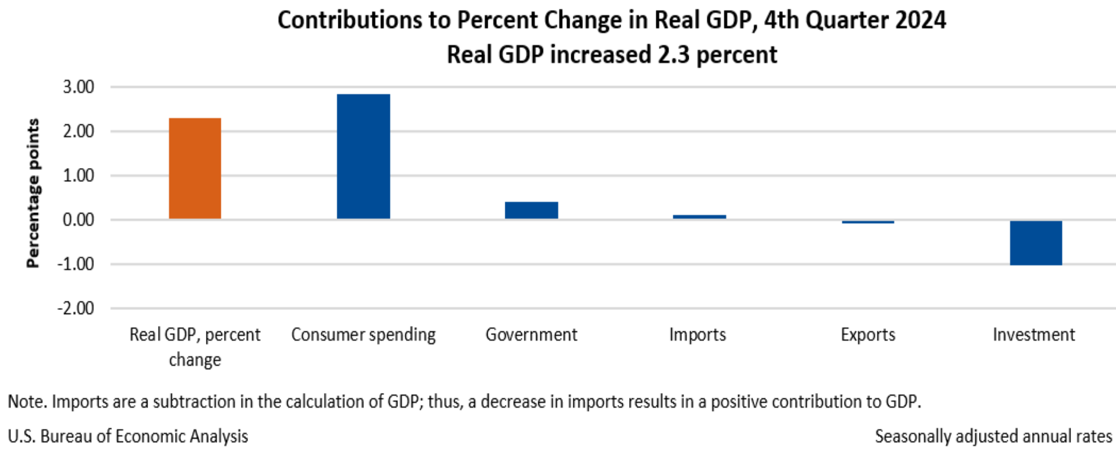
This report contains detailed information that contributes to the preparation of the annual budget, including the Town's "Base Case" Five-Year Forecast, its data sources, and budget assumptions. It also provides two additional forecast scenarios utilizing a sensitivity analysis for four of the major revenue assumptions. These additional forecast scenarios illustrate the effects on future budgets of a 1% higher revenue growth scenario ("Greater Growth") and a 1% lower revenue growth scenario ("Lower Growth").

The Five-Year Financial Forecast is not a budget, nor a proposed plan. The Five-Year Financial Forecast sets the stage for the upcoming budget process and is a tool in facilitating both the Town Council and Town Manager in establishing priorities and allocating resources appropriately.

National and Local Economic Backdrop

The UCLA Anderson School of Business publishes a quarterly economic forecast for the nation and California. The results of this forecast are used as part of the macroeconomic foundation for the Five-Year Forecast development. The Winter 2024 (December 2024) UCLA Anderson Report predicts that the incoming administration's policies, including tariffs on major trading partners (China, Mexico, and Canada), mass deportations, and tax cuts, will have a negative impact on the U.S. economy. These measures are anticipated to increase the cost of living by raising the prices of various goods and services and creating labor shortages in the agriculture, hospitality, manufacturing, and construction sectors. Consequently, while the U.S. economy is expected to outperform other countries, GDP growth is projected to fall below 2% in 2025, with only a partial rebound in 2026.

The US economy's resiliency is demonstrated by the Gross Domestic Product (GDP) increase of 3.1% in the third quarter and 2.3% in the fourth quarter of 2024 (Advance Estimate). As the graph below illustrates, the 2.3% increase in GDP is comprised of positive gains in consumer and government spending offset by decreases in investment and imports (positive value is subtracted from GDP).




The UCLA forecast anticipates that California's economy will mirror U.S. growth rates, as the State faces .

Operating Revenue Trends and Five-Year Forecast Scenarios

The Town is highly dependent on four economically sensitive revenues comprising 65% of General Fund forecasted revenues. Following are summaries of the Town's major revenues, including property tax, sales tax, business license tax, and transient occupancy tax (TOT).

Updated growth assumptions are provided for each revenue source and the resultant projected revenues for the new Forecast period. The revenue assumptions provided are informed by the County Tax Assessor, the Town's sales tax consultant, and direct communication with the Town's hospitality industry. In addition, alternative forecast scenarios for these four revenue streams are discussed in this report. Please see Exhibit C for a description of all revenue categories with a comprehensive listing of revenue forecast assumptions.

*Property Tax*

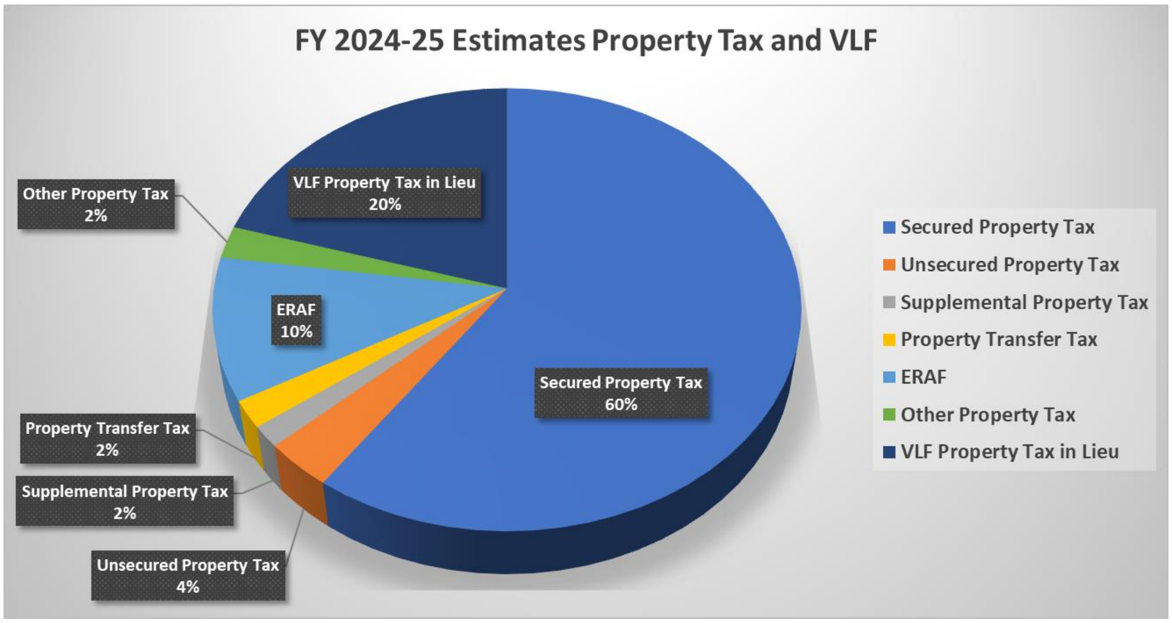
As the following table illustrates, Los Gatos has benefited from the economic expansion as evidenced by year-over-year (YOY) total property assessment roll growth since 2018. For the 7-year period, the average annual growth rate was 6.3%.

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | Seven Year Average Growth |
|---|---|---|---|---|---|---|---|---|
| **Total Assesment Roll (Values in Billions)** | 13.15 | 13.84 | 14.9 | 15.6 | 16.8 | 18.1 | 18.8 | 6.3% |
| **Percent Growth** | 6.95% | 5.23% | 7.70% | 4.33% | 7.77% | 7.72% | 4.10% | |

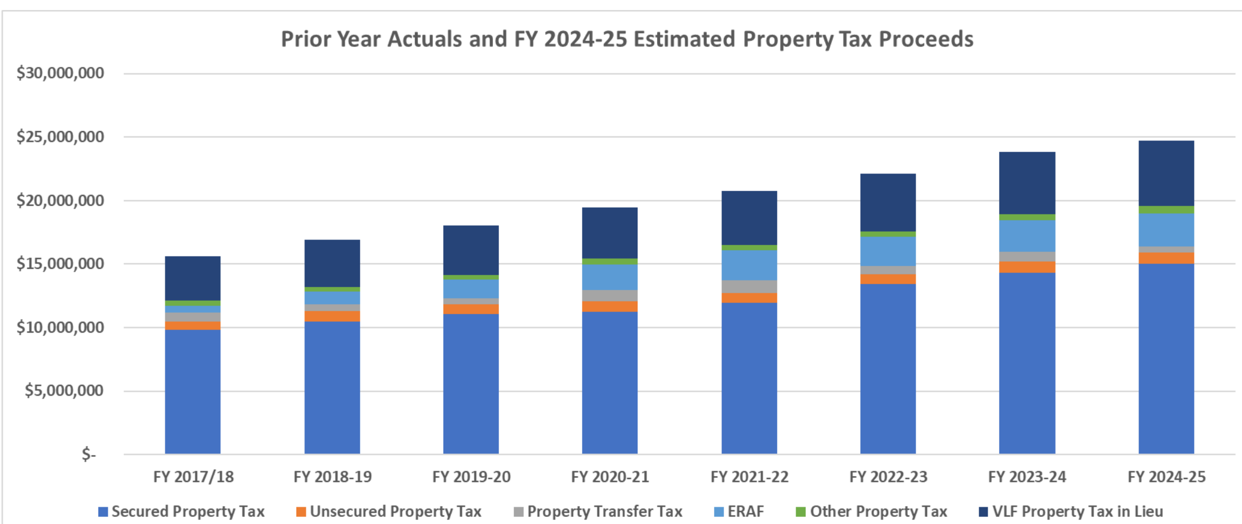
Property tax is the single largest revenue source for the Town and comprised approximately 42% of total Town estimated General Fund revenues for FY 2024-25. **Secured Property Tax**,

**Motor Vehicle in Lieu (VLF)**, and **Excess Education Revenue Augmentation Fund (ERAF)** constitute 90% of the current year's property tax proceeds. The following table and graphs illustrate how the actual year-over-year (YOY) performance for the different property tax categories varies from fiscal year to fiscal year.

The following chart illustrates the FY 2024-25 Estimated Property Tax categories.




The following graph illustrates the historical amounts based on the major categories and their YOY growth.




The following table illustrates the historical YOY growth based on the major categories.

| Percentage of Total Proceeds | Property Tax Categories | FY 2018-19 Actuals | FY 2019-20 Actuals | FY 2020-21 Actuals | FY 2021-22 Actuals | FY 2022-23 Actuals | FY 2023-24 Actuals | FY 2024-25 Estimates | Average YOY Growth |
|---|---|---|---|---|---|---|---|---|---|
| 60% | Secured Property Tax | 6.9% | 5.6% | 1.6% | 6.1% | 12.3% | 7.0% | 4.9% | **6.3%** |
| 20% | Motor Vehicle in Lieu (VLF) | 6.9% | 5.2% | 4.6% | 4.4% | 7.7% | 7.7% | 4.1% | **5.8%** |
| 10% | ERAF | 90.5% | 46.1% | 41.4% | 16.1% | -3.1% | 8.8% | 3.2% | **29.2%** |
| 4% | Unsecured Property Tax | 16.4% | -5.1% | 6.9% | -7.8% | 8.8% | 6.1% | -0.5% | **3.9%** |
| 2% | Property Transfer Tax | -21.8% | -9.2% | 76.0% | 17.0% | -37.8% | -23.2% | -32.9% | **1.3%** |
| 2% | Other Property Tax | -11.1% | -0.2% | 10.7% | 1.0% | -2.6% | 4.1% | 28.1% | **5.0%** |
| 2% | Supplemental Property Tax | 17.7% | -31.8% | 40.3% | -9.0% | 61.1% | -40.5% | -37.4% | **3.3%** |

The staff analysis includes the three most significant property tax categories – Secured Property Tax and VLF Property Tax generally increase alongside the growth of the Total Assessment Rolls. The Total 2024 Assessment Roll will be published in July 2025 by the Santa Clara Assessor's Office.

In addition to the annual assessment increases and the reassessments of Proposition 13 properties as they change ownership, historical growth encompasses the annexation of 24 pockets from Santa Clara County and property sales from the First Phase of the North Forty development. The VLF Property Tax in Lieu collection, based on the assessed roll, is also included.

ERAF, as the table illustrates above, can vary yearly, and it is not tied to the Total Assessment Roll. A portion of property tax revenue goes to the ERAF to support local school districts. When the amount contributed to ERAF exceeds the minimum cost of funding local schools, excess funds have traditionally been returned to the county, cities, and special districts. Santa Clara County has only provided projections for the current fiscal year. FY 2025-26 Excess ERAF projections will not be available until March 2025. The Town has been monitoring ongoing developments regarding the distribution of excess ERAF funds. A portion of property tax revenue goes to the ERAF to support local school districts. When the amount contributed to ERAF is more than the minimum cost of funding local schools, excess funds have traditionally been returned to the counties, cities, and special districts.

During the last couple of years, the Santa Clara County redistribution formula was contested by the State, and additional risk raised from State Controller's audit findings for Marin County. The Town received the full amount since FY 2021-22; however, the Santa Clara County Assessor's Office recommended reserving a certain percentage based on the risk. According to the most recent (January 2025) communication from the Santa Clara State Controller Office the risk remains for the State Controller Office Audit findings that varies from 20% to 22% for the Town. Estimated at risk amounts and the Town Actual and Estimates ERAF Risk Reserves are presented below.

The Town Estimated ERAF Risk Reserve is $1,215,154 as of June 30, 2025. With the FY 2024-25 budget adoption Council action $1,000,000 of the ERAF Risk Reserve was transferred to the Pension/OPEB Reserve. The total reserve amount of $2,215,154 is still below the Town's estimated risk amount of $2,558,139, therefore, staff recommends continuing to reserve 30% of the anticipated FY 2024-25 ERAF proceeds.

| | FY 2020-21 Actual | FY 2021-22 Actual | FY 2022-23 Actual | FY 2023-24 Actual | FY 2024-25 Estimated | Total $ |
|---|---|---|---|---|---|---|
| **Excess ERAF** | $ 2,043,321 | $ 2,371,984 | $ 2,298,692 | $ 2,534,820 | $ 2,617,000 | |
| ***According to Santa Clara County State Controller Office January 2025 Communication*** | | | | | | |
| **State Controller Audit Finding Risk %** | 22% | 22% | 22% | 22% | 20% | |
| **State Controller Audit Finding Risk ($)** | $ 449,531 | $ 521,836 | $ 505,712 | $ 557,660 | $ 523,400 | $ 2,558,139 |
| **Town ERAF Risk Reserve as of 6/30/2024** | | | | | | $ 1,430,054 |
| Estimated Addition to the Reserve - 30% of the FY 2024-25 proceeds | | | | | | $ 785,100.00 |
| Allocation of the ERAF Risk Reserve to Pension/OPEB Reserve per June 4, 2024 Council Action | | | | | | $ (1,000,000.00) |
| **Town Estimates ERAF Risk Reserve as of 6/30/2025** | | | | | | **$ 1,215,154.00** |

Staff recommendations for property tax growth assumptions are listed below based on the above information.

*Secured Property Tax:*
Staff recommends growing the secured property tax by 4.1%.

*Motor Vehicle in Lieu (VLF):*
Staff recommends growing the VLF by 4.1%.

*Excess ERAF:*
Staff recommends the assumption that the Town will receive 100% of the ERAF proceeds; however, per prior Council direction and the Santa Clara County Assessor's Office advice, 30% is set aside until the audit findings are resolved.

*Unsecured, Supplemental, Other Property Tax, and Property Transfer Tax:*
Staff recommends increasing the rest of the property taxes (Unsecured, Supplemental, Other Property Tax, and Property Transfer Tax), which represents 10% of the current proceeds, by 3%.

For purposes of the Forecast, the "Base Case" utilizes staff recommendations. "Higher Growth" and "Lower Growth" scenarios represent 1% above and below the recommended growth to illustrate the forecast sensitivity. The following tables display three cases related to all property tax and vehicle license fee.

| Property Tax (Property Tax & VLF) | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2029-30 Forecast ($M) |
|---|---|---|---|---|---|
| Lower Growth (1% Lower) | $25.70 | $26.30 | $27.10 | $27.80 | $28.60 |
| Base Case | $25.90 | $26.80 | $27.80 | $28.80 | $29.80 |
| Greater Growth (1% Higher) | $26.10 | $27.20 | $28.50 | $29.80 | $31.20 |

*Sales Tax*

Sales tax is the second largest revenue source for the Town's General Fund, accounting for 15% of budgeted General Fund projected revenues for FY 2024-25. The Town currently receives 1.125 cents for every 9.125 cents of sales tax paid per dollar on retail sales and taxable services transacted within Los Gatos, including the Town of Los Gatos residents' approved ballot Measure G in 2018 enacting a one-eighth cent (0.125%) district sales tax for 20 years.

Sales tax estimates are based on actual sales tax data and annual sales tax estimates for five years provided by the Town's consultant, MuniServices. In addition to brick-and-mortar sales tax generation, the MuniServices estimates include several online sales tax projections. The 2018 Wayfair Decision resulted in e-commerce vendors utilizing the Amazon platform to collect sales tax based on destination; however, items shipped directly from Amazon fulfillment centers are collecting sales tax based on the point of distribution. Regular sales tax collected through online transactions are distributed through the Santa Clara County pool for which the Town receives a pro rata share of the sales tax generated in Santa Clara County for that particular quarter. The Town directly receives the one-eighth district tax portion of the sales tax generated by the residents of Los Gatos. Most recent estimates for FY 2024-25 are estimating declining sales tax collection comparing the FY 2024-25 adopted budget, a $223,253 decrease for the current fiscal year

The following tables display MuniService's Most Likely scenario relative to their "Conservative" and "Optimistic" scenarios for the forecast period. As illustrated below even the optimistic scenario is presenting modest growth in this category.

| Base Sales Tax | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2029-30 Forecast ($M) |
|---|---|---|---|---|---|
| Conservative | $6.28 | $6.39 | $6.52 | $6.64 | $6.74 |
| Most Likely | $6.50 | $6.62 | $6.76 | $6.88 | $6.98 |
| Optimistic | $6.74 | $6.85 | $7.00 | $7.22 | $7.23 |

| Measure G 1/8 District Tax | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2029-30 Forecast ($M) |
|---|---|---|---|---|---|
| Conservative | $1.24 | $1.27 | $1.37 | $1.34 | $1.37 |
| Most Likely | $1.27 | $1.30 | $1.34 | $1.37 | $1.40 |
| Optimistic | $1.29 | $1.33 | $1.36 | $1.40 | $1.43 |

Staff recommends forecasting the sales tax according to the Most Likely assumption.

*Transient Occupancy Tax*

TOT is an important revenue source for the Town and comprises approximately 4% of the total Town's estimated revenues in the amount of $2.3 million for FY 2024-25. The Town levies a 12% transient occupancy tax (TOT) on all hotel and motel rooms within the municipal limits of Los Gatos. The 12% rate has been in effect since January 1, 2017, after the voters approved a ballot measure to increase the TOT from 10% to 12% during the November 8, 2016 election. During the pandemic, TOT experienced the most significant percentage decline relative to historically adopted budgets. Due to a significant rebound in leisure "staycation" travel and modest improvements in business travel, TOT collections are trending slightly higher than the prior year due to the variance in the timing of the payment received. Overall revenue collection is trending within the budget with no significant change from the prior year's actual collection. Staff anticipates a modest growth in TOT collection and recommends a 2% growth assumption in this category.

| TOT | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2029-30 Forecast ($M) |
|---|---|---|---|---|---|
| Proposed Growth | 2% | 2% | 2% | 2% | 2% |
| Estimated Revenues | $2.39 M | $2.42 M | $2.47 M | $2.52 M | $2.57 M |

For purposes of illustrating the Forecast sensitivity, the "Base Case" utilizes a growth factor of 2% recommended by staff as illustrated above, and the "Greater Growth" and "Lower Growth" scenarios utilize a 1% differential from the Base Case.

| TOT | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2029-30 Forecast ($M) |
|---|---|---|---|---|---|
| Lower Growth (1% Lower) | $2.36 | $2.38 | $2.40 | $2.43 | $2.45 |
| Base Case 2% | $2.39 | $2.42 | $2.47 | $2.52 | $2.63 |
| Greater Growth (1% Higher) | $2.40 | $2.47 | $2.55 | $2.63 | $2.70 |

*Business License Tax*

Business License Tax is an important revenue source for the Town and comprises approximately 4% of the total Town's estimated revenues in the amount of $2.3 million for FY 2024-25. The Town requires all businesses located within Los Gatos and/or those that operate within Los Gatos to obtain a business license. The amount of business license tax paid by each business is based on its business activity.

In November 2022, Los Gatos voters approved Measure J, which modernized the Town's business license tax program. This was the first update to the program since 1991, strengthening funding for core Town services that are enjoyed by Town businesses. Measure J included a 30% increase on flat rate fees, a 40% increase in retailing gross receipts, and a 120%

increase in e-commerce, manufacturing, wholesaling, and jobbing gross receipts. Fees for activities such as wholesale sales and manufacturing are charged on a sliding scale based on gross receipts, as is retail, with retail being capped at $1,365. These gross receipt activities account for approximately 25% of annual business licenses, while the remaining 75% are flat fee businesses.

Payments for new flat-fee-based businesses are prorated by quarter. Current year business license tax revenue projections provided by HdL, the Town third party business license processor, are trending higher than the adopted budget due to the timing of business license tax received across fiscal years. FY 2025-26 collection is forecasted at 2.4 million in line with the FY 2022-23 actual collections. Staff recommends 3% growth in this category.

| Business License Tax | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2029-30 Forecast ($M) |
|---|---|---|---|---|---|
| Proposed Growth | 3% | 3% | 3% | 3% | 3% |
| Estimated Revenues | $2.29 | $2.57 | $2.65 | $2.72 | $2.81 |

For purposes of the Forecast, the “Base Case” utilizes a 3% growth factor as illustrated above and the “Greater Growth” and “Lower Growth” scenarios utilize a 1% differential from the Base Case.

| Business License Tax | 2023/24 Forecast ($M) | 2024/25 Forecast ($M) | 2025/26 Forecast ($M) | 2026/27 Forecast ($M) | 2027/28 Forecast ($M) |
|---|---|---|---|---|---|
| Lower Growth (1% Lower) | $2.47 | $2.52 | $2.57 | $2.62 | $2.67 |
| Base Case 3% | $2.29 | $2.57 | $2.65 | $2.72 | $2.81 |
| Greater Growth (1% Higher) | $2.52 | $2.62 | $2.72 | $2.83 | $2.95 |

<u>Operating Expense Trends and Five-Year Forecast Scenarios</u>

Forecasts of future operating expenditures consider two key factors: cost escalation and new operating expenditures. New operating expenditures refer to costs created by new or enhanced service programs approved during the annual budget process. Exhibit D contains the expenditure assumptions.

Cost escalation refers to largely unavoidable increases in the cost of doing business. It includes inflation, multi-year contract costs, health care costs, and unfunded State mandates. Cost escalation also includes other unavoidable cost increases to a government organization, such as a rise in wages consistent with collective bargaining agreements and annual pension payments mandated by CalPERS. The Town has three bargaining units, including the Town Employees’ Association (TEA), the American Federation of State, County and Municipal Employees (AFSCME), and the Police Officers’ Association (POA). The unrepresented groups are Management, Confidential, and Temporary.

For FY 2024-25, General Fund Operating expenditures (not including debt payments and transfers out) are programmed at $56.6 million. The delivery of Town services is highly dependent on talent which comprises 68.5% of budgeted General Fund operating expenditures for FY 2024-25. Given the high dependence on labor for service delivery, the Town has helped manage salary escalation (and benefits) through the maintenance of lower staffing levels.

Mandated pension payments to CalPERS have consistently been one of the major cost drivers for the Town over the past decade with persistent unanticipated increases in pension costs. The Town's plans over the past several decades, like all other CalPERS participants, have experienced unfavorable investment returns, changes in actuarial assumptions, and demographic changes which have outweighed any positive plan experiences. The outcome of these unfavorable economic and demographic results is the development of unfunded pension and Other Post-Employment Benefit (OPEB) obligations for the Town. Previously, the Town has allocated additional discretionary pension funding to address the escalation in pension costs.

The Town and its bargaining groups have also worked to contain benefit costs. The Town closed the CalPERS retiree Tier 1 benefit for non-safety employees and created a new Tier 2 for non-safety new employees in 2012, implemented the Public Employees' Pension Reform Act (PEPRA) for all new non-classic employees starting in 2013, and participates in the CalPERS discounted prepayment option.

In addition to the management of the Town's pension obligations, the Town and the Town's bargaining groups have worked to curb cost escalation in OPEB. In 2009, the Town initiated prefunding of the retiree healthcare benefit and has since established approximately $29.2 million in OPEB assets (as of 9/31/2024) from zero in 2009. In 2016, the Town's bargaining groups approved the introduction of dependent cost sharing and a reimbursement cap to Medicare-eligible employees, and in 2018, the elimination of the Town's existing retiree healthcare benefit prospectively.

While these collective measures have helped to slow the growth in salary and benefit expenses, the forecast anticipates continued increases in the Town's pension obligations.

Provided below are the expense assumptions for salary and benefits and alternate case scenarios for pension contributions. Most other expenses are assumed to increase at 3% per annum. Detailed expenditure assumptions and factors can be found in Exhibit D to Attachment 2.

*<u>Salary and Benefits</u>*

*Salary*

The Town has historically budgeted vacant and non-sworn positions at the top step of the range for the position. Sworn and management positions were budgeted at one step higher than the current step in anticipation of any merit increases expected to be awarded in the upcoming fiscal year. Based on Council's direction from FY 2021-22, salaries were budgeted at actual salary plus a one step increase, which was a significant budgeting methodology change from previous practice. In addition, the FY 2023-24 budget built in a 4.6% vacancy factor. These methodologies will be continued in the FY 2025-26 budget development, unless modified by the Town Council.

For the forecast, positions are budgeted at the actual rate of pay of employees, including benefits, as of January 2024. Then, by position, salary costs are updated in accordance with the applicable Memorandum of Understanding (MOU) between the Town and its bargaining units. The Memoranda of Understanding that outline the individual agreements between the Town and each unit related to compensation, health benefits, leave time, and grievance procedures will expire with POA, TEA, and AFSCME on June 30, 2026. The Management, Confidential, and Temporary groups are unrepresented, but all salary schedules were approved through June 30, 2026 for these groups as well.

In addition to the economic terms of the MOUs, the forecast assumes step and merit increases for employees in applicable positions. In addition, based on prior Council guidance, 2% cost of living wage adjustments (COLA) are included in the forecast for each year starting in FY 2026-27.

| Salaries<br>Current Agreements<br>4.6% Vacancy Factor | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2029-30 Forecast ($M) |
|---|---|---|---|---|---|
| Base Case | $24.72 | $25.85 | $26.27 | $26.81 | $27.37 |

*Pension and Other Benefits*

The Town's required employer contribution rate estimates were developed using data provided by each plan's most recent CalPERS actuarial valuation. The employer contribution rates reflect percentages of covered payroll. Rates shown for FY 2024-25 are actual rates as prescribed by CalPERS. Forecasted rates for FY 2025-26 and subsequent years are based on the most recent CalPERS actuarial valuation Reports as adjusted by the impact related to the FY 2022-23 CalPERS 6.1% investment return and forecasted payroll.

Beginning in FY 2021-22, the estimates of employer contributions were credited with an anticipated reduction associated with the approximate $4.8 million additional discretionary payment (ADP) toward the 2016 unfunded amortization base paid off in October 2019 and the total of approximately $5.8 million in ADPs toward unfunded 2013 and 2015 amortization bases that were paid off in FY 2020-21. Other Benefits include health insurance, life insurance, and workers' compensation insurance premiums.

| Pension Benefits | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2029-30 Forecast ($M) |
|---|---|---|---|---|---|
| Base Case | $9.55 | $10.69 | $10.92 | $11.89 | $12.09 |

| Other Benefits | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2029-30 Forecast ($M) |
|---|---|---|---|---|---|
| Base Case | $6.03 | $6.30 | $6.45 | $6.59 | $6.82 |

Given that investment returns have one of the largest impacts on contribution variability, CalPERS provides projected employer Unfunded Actuarial Liability (UAL) contributions under alternate investment returns. Analysis using the investment return scenarios from the Asset Liability Management process completed in 2023 was performed to determine the effects of various future investment returns on required employer contributions.

The projections below reflect the impact of the CalPERS Funding Risk Mitigation policy. The projected normal cost rates reflect that the rates are anticipated to decline over time as new employees are hired into lower-cost benefit tiers. The projections also assume that all other actuarial assumptions will be realized and that no further changes in assumptions, contributions, benefits, or funding will occur. The table shows projected contribution requirements if the fund were to earn either 3.0% or 10.8% annually. These alternate investment returns were chosen because 90% of long-term average returns are expected to fall between these levels over the 20-year period ending June 30, 2043.

| UAL Town Contributions (Misc & Safety) | 2026-27 Forecast | 2027-28 Forecast | 2028-29 Forecast | 2029-30 Forecast | 2030-31 Forecast |
|---|---|---|---|---|---|
| ~~Greater~~ Investment Return Scenario (10.8%) | $6,329,000 | $6,398,000 | $6,519,000 | $6,047,000 | $4,020,000 |
| ~~Base~~ Investment Return Case (3.0%) | $6,647,000 | $7,344,000 | $8,427,000 | $9,262,000 | $10,241,000 |

CalPERS Actuarial Valuations as of June 30, 2023.

For the year ending June 30, 2024, the Public Employees Retirement Fund (PERF) preliminary investment return was 9.3%. The table below illustrates the historic investment returns for five years, ten years, twenty years, and thirty years.

| CalPERS Compound Annual Rates of Return (as of June 30, 2023) | 5 Years | 10 Years | 20 Years | 30 Years |
|---|---|---|---|---|
| Compound Annual Return | 6.1% ~~9.5%~~ | 7.1% ~~7.8%~~ | 7.0% ~~8.4%~~ | 7.5% ~~8.8%~~ |

Five-Year Financial Forecast Alternative Scenarios

The tables below present the "Base Case" forecast contrasted against the two alternative revenue scenarios of "Greater Growth" and "Lower Growth." All scenarios include a 4.6% salary saving factor, the approved salary increases and assume a 2% cost of living adjustment beyond FY 2026-27.

| 5 Year Forecast "Base Case" with 4.6% Vacancy Factor 70% of ERAF | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2030-31 Forecast ($M) |
|---|---|---|---|---|---|
| Total Revenues & Transfers and Use of Reserves | $56.2 | $57.8 | $59.2 | $60.5 | $60.9 |
| Total Expenditures & Reserve Allocations | $61.8 | $65.0 | $66.2 | $68.7 | $68.9 |
| Surplus/Deficit | ($5.6) | ($7.2) | ($7.0) | ($8.2) | ($8.0) |

| Alternative Scenario "Greater Growth" with 4.6% Vacancy Factor 70% of ERAF | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2030-31 Forecast ($M) |
|---|---|---|---|---|---|
| Total Revenues & Transfers and Use of Reserves | $56.5 | $58.2 | $60.0 | $61.7 | $62.4 |
| Total Expenditures & Reserve Allocations | $61.8 | $65.0 | $66.2 | $68.7 | $68.9 |
| Surplus/Deficit | ($5.3) | ($6.8) | ($6.2) | ($7.0) | ($6.5) |

| Alternative Scenario "Lower Growth" with 4.6% Vacancy Factor 70% of ERAF | 2025-26 Forecast ($M) | 2026-27 Forecast ($M) | 2027-28 Forecast ($M) | 2028-29 Forecast ($M) | 2030-31 Forecast ($M) |
|---|---|---|---|---|---|
| Total Revenues & Transfers and Use of Reserves | $56.0 | $57.1 | $58.4 | $59.2 | $59.3 |
| Total Expenditures & Reserve Allocations | $61.8 | $65.0 | $66.2 | $68.7 | $68.9 |
| Surplus/Deficit | ($5.8) | ($7.9) | ($7.8) | ($9.5) | ($9.6) |

CONCLUSION:

The Finance Commission should review and discuss the elements and confirm the assumptions of the initial Five-Year Forecast and other budget considerations. All forecast scenarios estimate deficits at this time. Staff looks forward to answering the Finance Commission questions and receiving any recommendations for Council consideration for the preparation of the proposed FY 2025-26 Operating Budget that results from the discussion.

The preparation of the FY 2025-26 Operating and Capital Budgets is taking into account the Town's current economic reality and long term fiscal picture, as well as maintaining the Town's high level of municipal services. Key budget principles include:

- Develop and recommend a balanced budget that maintains service levels;
- Address projected deficits;
- Continue to make progress on Strategic Priorities identified by the Town Council; and
- Identify opportunities to maintain or enhance service delivery through new revenue sources and technology.

The Finance Commission may also discuss budget assumptions. The Draft FY 2025-26 Operating and Capital Budgets will be available in April for the Finance Commission elaboration with the budget hearing tentatively scheduled for May 20, 2025.

COORDINATION:

This Report was prepared by the Finance Department and the Town Manager's Office.

ENVIRONMENTAL ASSESSMENT:

This is not a project defined under CEQA, and no further action is required.

Exhibits:

1. Annual Budget Process
2. Base Case Five-Year Forecast
3. Forecast Revenue Assumptions
4. Forecast Expense Assumptions