



**TOWN OF LOS GATOS
COUNCIL AGENDA REPORT**

MEETING DATE: 05/17/2022

ITEM NO: 7

DATE: May 9, 2022

TO: Mayor and Town Council

FROM: Laurel Prevetti, Town Manager

SUBJECT: Consider the Recommendations of the Finance Commission and Staff, and Provide Direction on the Town of Los Gatos Proposed Operating and Capital Budget for Fiscal Year (FY) 2022/23 and on the Proposed Capital Improvement Program for FY 2022/23 – FY 2026/27; Including but Not Limited to:

- a. Provide direction to Balance the FY 2022/23 Proposed Budget;
- b. Provide Direction on the Proposed Operating Budget;
- c. Provide Direction on the Proposed Capital Budget; and
- d. Consider the FY 2022/23 List of Potential Donations Consistent with the Town's Donation Policy

RECOMMENDATION:

Staff recommends the Town Council consider the recommendations of the Finance Commission and staff, and provide direction on the Town of Los Gatos Proposed Operating and Capital Budgets for Fiscal Year 2022/23 and the Town of Los Gatos Proposed Capital Improvement Program for Fiscal Years 2022/23 - 2026/27, including but not limited to:

- a. Provide direction balancing the FY 2022/23 Proposed Budget;
- b. Provide direction on the Proposed Operating Budget;
- c. Provide direction on the Proposed Capital Budget; and
- d. Consider the FY 2022/23 List of Potential Donations consistent with the Town's Donation Policy.

PREPARED BY: Arn Andrews
Assistant Town Manager

Reviewed by: Town Manager, Town Attorney, and Finance Director

BACKGROUND:

On April 18, 2022, the Town Manager's Proposed FY 2022/23 Operating and Capital Budgets were posted on the Town's website for the public's review and comment (see Attachments 1 and 2). Per Measure A, the Finance Commission received the Proposed Budgets 21 business days before May 17, 2022, which is the first meeting at which the Proposed Budgets will be considered by the Town Council. The transmittal letter in the Proposed FY 2022/23 Operating Budget provides an executive summary of the budget, including the fiscal outlook, key budget assumptions, and other information.

The Proposed Operating and Capital Budget for FY 2022/23 (Attachment 1) is the Town Manager's recommended comprehensive financial plan to provide services to the Town of Los Gatos and address the priorities set by the Town Council. The Proposed FY 2022/23 – 2026/27 Capital Improvement Program (Attachment 2) is a five-year capital improvement plan which identifies projects to construct and maintain the Town's infrastructure. Please see the transmittal letters contained in each Budget document for a detailed overview and summary.

Both budget documents were prepared with contributions from all Town Departments. Of particular note, the Finance Department took the lead in developing revenue and expenditure forecasts, ensuring that the most current information was used in the preparation of the proposed budgets. In addition, the Department of Parks and Public Works identified high priority projects for inclusion in the Capital Budget based on its familiarity with the Town's facilities, equipment, and infrastructure, and its work with various Town Commissions on these assets.

The FY 2022/23 Budget endeavored to maintain essential public services while controlling operational costs in light of the Five-Year Financial Forecast, which predicts operating shortfalls in subsequent fiscal years. The loss of previously projected future growth in revenues in conjunction with increasing expenses continues to illustrate persistent deficits in future years. The deficits are on the order of approximately \$2.0 to \$3.0 million per year and can currently be resolved through a combination of expenditure controls, revenues reverting to pre-pandemic trends, and the use of one-time funds.

Even with areas of continued uncertainty, this Budget positions the organization well for continued excellence in service delivery to the community. However, in the event pre-pandemic revenue growth projections do not return and/or new revenue sources are not identified, the current projected deficits may need to be addressed through service delivery reductions or service outsourcing. If this occurs, the Council will need continued input from the community to identify acceptable organizational changes and service levels. The recently completed community survey provide useful insight into community prioritization of service delivery.

BACKGROUND (continued):

In addition to the Town Manager's Proposed Budget, the Town Council is being asked to consider the Finance Commission recommendations contained in Attachment 3. The Town Council is also being asked to consider corrections based on additional review and analysis since publication (Attachment 5). Any recommended changes and additional direction to the Proposed Operating and/or Capital Budgets provided by Council at the May 17, 2022 budget hearing will be incorporated into the implementing resolution to be presented for final Council approval on June 7, 2022. Finally, the Council is asked to review the annual list of donations (Attachment 8).

To help the Council work through all of this material, staff recommends that the Council discuss and make individual motions as appropriate on the items in the following order as presented in this staff report:

- Five-Year Forecast (motions are welcome to change any of the assumptions in the Forecast)
- Direction to Balance the Proposed FY 2022/23 Operating Budget
- Finance Commission's four recommendations
- Consideration of any funding requests (as of the date of this report, the Town has not received any)
- Any other direction on the Proposed FY 2022/23 Operating Budget
- Any other direction on the Proposed FY 2022/23 – 2026/27 Capital Budget
- Consideration the Proposed Donation List

DISCUSSION:

Overview of Proposed Operating Budget and Five-Year Forecast

The FY 2022/23 General Fund Budget programs total revenues and reserve transfers of \$50.4 million, and expenditures and allocations of \$50.4 million. The Budget currently anticipates no significant new programming and does maintain existing service levels with modest staffing additions. Even with the budgetary challenges of the last several years associated with the COVID-19 pandemic, many of Council's primary goals and priorities have been programmed in the FY 2022/23 Operating and Capital Budgets. Specifically, the Council would like continued progress on wildfire protection safety; emergency preparedness; semi-permanent parklets; diversity, equity, and inclusion; community policing; parking study implementation; and the General Plan and Housing Element updates.

The Five-Year Forecast takes a forward look at the Town's General Fund revenues and expenditures and is updated regularly. Its purpose is to identify financial trends, potential shortfalls, and other issues so the Town can proactively address them and budget accordingly. It does so by projecting out into the future the fiscal results of continuing the Town's current

DISCUSSION (continued):

service levels and policies. This process helps to provide a snapshot of what the future may look like as a result of the decisions made to date. The economic ramifications of the pandemic have created lower revenue bases than in prior years which reverberate throughout the forecast period as future revenue growth is extrapolated from the lower initial base revenues. Revenue forecasts for the current Budget (Attachment 4) have been developed in close consultation with the Santa Clara County Assessor, Town Sales Tax consultant MuniServices, and a review of national and regional hospitality research.

In addition to revenue growth projections, the Proposed Budget also forecasts anticipated increases in the Town's pension obligation payments and salaries as well as other expenditures (Attachment 4). As a service delivery enterprise, the cost of salaries and benefits are a significant portion of the budget. The delivery of Town services is highly dependent on recruiting and retaining talent which comprises 66% of budgeted General Fund expenditures for FY 2022/23. 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. However, even with the Town reducing its full-time employees by 15.0% to 153 FTE employees since 2001, pension benefit costs per employee continue to escalate as evidenced by an average 11.9% increase per year versus a 3.3% average increase for regular salaries per year in the past seven years.

Balancing the Proposed FY 2022/23 Operating Budget

For FY 2022/23 the Proposed Operating Budget was balanced utilizing two primary budget balancing strategies. The first was direction to all Departments to develop a status quo budget. To that end most Departments programmed existing resources by either maintaining current structures or realigning operations to remain effective while staying within prior year budgets. In addition, Departments were provided guidance to enhance capacity where necessary through limit-dated, non-benefited personnel options and increases to temporary staffing when possible.

The second strategy is the use of \$1.0 million of the Town's \$7.2 million allocation from the American Rescue Plan Act (ARPA) to replace lost revenue anticipated in FY 2022/23. This is consistent with prior Council direction for the use of ARPA in FY 2020/21 (\$1.4 million) and FY 2021/22 (\$1.9 million). It's important to note, that as the economically sensitive revenues of sales tax and transient occupancy tax continue to revert toward pre-pandemic levels, no ARPA funding was ultimately expensed for revenue loss replacement in FY 2020/21. At this time, staff estimates that no ARPA funding will be needed at the close of FY 2021/22. The actual surplus/shortfall will be determined upon the final close and audit of the fiscal year.

DISCUSSION (continued):

Overview of Proposed Capital Budget

The FY 2022/23 – FY 2026/27 Capital Improvement Program (CIP) sets forth a five-year plan for proposed streets, parks, and public facility projects. The transmittal letter contained in the CIP provides a summary of the program including funding sources, recently completed projects, and the proposed projects for FY 2022/23. The proposed \$32.5 million in the first year of the CIP is comprised of approximately \$20.0 million in carryover funds from FY 2021/22 and approximately \$12.5 million in new funding. The \$12.5 million of new funding is comprised of \$6.0 million in General Fund Appropriated Reserve (GFAR), \$5.0 million in Grants and \$1.5 million from other sources. Only the first year of the plan is formally adopted with funds appropriated by the Town Council as part of the budget process.

The first year of the five-year CIP (FY 2022/23) continues funding for the Town Council Strategic Priorities, including basic infrastructure needs. In January 2022, the Town Council established the 2022-24 Strategic Priorities. In terms of capital projects, the Town Council stated its priorities to begin phased implementation of the recommendations in the Comprehensive Parking Study, continue mobility improvements for all transportation modes, manage the vegetation on Town lands to protect against wildfire, and advance other needed improvements.

Street maintenance remains a high Council priority as the Town is making efforts to improve its Pavement Condition Index (PCI), a standard rating of street conditions. The Town utilizes funding from the Metropolitan Transportation Commission (MTC) to hire a consultant to conduct a regular assessment of pavement condition with a full assessment occurring every three years. The recent assessment concluded that after completion of FY 2021/22 street pavement projects, PCI is anticipated to jump to 75 or 76. The assessment indicated that the Town can maintain a PCI of 75 with an annual funding of \$3.3M for the next five years. While this is welcome news, the Town will need to identify dedicated ongoing sources of revenue for future deferred and routine capital maintenance.

Town staff go through a rigorous process to evaluate all previously funded projects and potential new projects when preparing the CIP. There are more needs than available funding, and staff recommends high priority projects that are consistent with the Strategic Priorities. This year, due to limited available funds, the proposed CIP concentrates on funding key ongoing maintenance commitments (e.g., street paving), projects that have grant funding and a FY 2022/23 schedule obligation, and supplementing projects that are underway to ensure they are completed. These funding priorities leave funds for only one additional project. As a result, the CIP documents several unfunded projects within the respective programs. On April 27, 2022, the Planning Commission reviewed the proposed CIP, found it consistent with the General Plan, and recommended its adoption by the Town Council.

DISCUSSION (continued):

Finance Commission Recommendations

As previously mentioned, the newly constituted Finance Commission is tasked with a thorough review of the FY 2022/23 Proposed Operating and Capital Budgets. The Finance Commission recommended approval of the Proposed Budgets predicated on four recommended changes to the Proposed Budget (see Attachment 3).

The Commission's deliberations coalesced around the following goals and observations:

- The Commission's interest for continued enhancement of transparency in budget development, budget assumptions, and budget presentation.
- The Proposed Budget continues to restrict capital expenditures relative to historic allocations.
- The Proposed Capital Improvement Program (CIP) continues to be challenged by a lack of dedicated funding.
- The higher percentage increases in the primary expenditures of Salary and Benefits relative to revenues is constraining other investments.
- The Forecast projects deficits throughout the forecast period.
- The Commission's continued review of the Town's Internal Service Funds.

The Finance Commission (FC) made two recommendations for additional funding allocations to the General Fund Appropriated Reserve (GFAR). The Council should consider the recommendations in relation to other budgetary priorities. For each FC recommendation, potential impacts are identified.

FC Recommendation: Recommend to Council the allocation of \$3.77 million to the General Fund Appropriated Reserve (GFAR) for FY 2022/23 for capital budgeting purposes as determined by the Town Council's priorities. (This amount is based on an historic average of 8.28% from 2005/06 through 2022/23 of operating revenues transferred to the Capital program.)

Potential Impacts: The recommendation would increase the FY 2022/23 operating deficit by approximately \$700k. The Finance Commission did not make a recommendation as to how to close this new deficit. If the Council moves forward with this recommendation, the Town Council would need to identify modifications to the Operating Budget to maintain a balanced budget. For example, the Council may wish to allocate \$700,000 from the unallocated American Rescue Plan Act (ARPA) monies.

FC Recommendation: Recommend to Council the allocation of approximately \$3.7 million of unallocated ARPA funds to the General Fund Appropriated Reserve (GFAR) for FY 2022/23 for capital budgeting purposes as determined by the Town Council's priorities.

DISCUSSION (continued):

Potential Impacts: ARPA funds would become unavailable for other uses.

If Council wishes to proceed with one or both of these recommendations, staff suggests that the Council consider potential modifications to the CIP and specific projects in August. At that time, staff will be prepared to identify priority improvements within existing staff limitations that constrain the Town's ability to deliver a large Capital program.

The Finance Commission (FC) made one recommendation regarding the Town's existing Internal Service Fund structure.

FC Recommendation: Recommend to Council the dissolution of the Workers Compensation and Self-Insurance Internal Service Funds starting in FY 2022/23 with remaining balances being transferred to the General Fund.

Potential Impacts:

Workers Compensation and Self-Insurance are considered "risk financing" due to their associated liabilities. The use of the Internal Service funds (ISFs) is one of the only two types of funds permitted by the Governmental Accounting Standards Board (GASB) to be used for the accounting for risk financing, the other being the General Fund. The pros and cons of closing the Workers Compensation and Self-Insurance Internal Service Funds are discussed below.

Pros of Closing Internal Service Funds and Merging into the General Fund

- Because of the fees charged to the user Departments, there is an unavoidable doubling of costs in the budget which increases the total expenditures when looking at a financial summary of expenditures for all Town funds. This occurs because allocated costs for Workers Compensation is budgeted in the front-line program receiving workers compensation services such as public safety and the full cost of workers compensation is also budgeted in the home base Internal Service Fund where the costs are centralized leading to a "doubling up" of expenses. This "doubling up" leads to what some critics describe as an unnecessary artificial increase of revenue and expenditure budget totals. Recognizing this anomaly, GASB requires that for the Annual Comprehensive Annual Financial Report, the "doubling up" of expenses is eliminated.
- Frees up current ISF balances for any General Fund purpose desired by the Council.
- Operating Departments often desire to be informed and educated to fully understand the rationale for the internal service costs being allocated to their Departments and absorbed in their budgets in the form of user charges. Staff time required for users of the service and administrators of the Internal Service funds to provide the required analysis for rate setting of user charges including the development of sustainable

DISCUSSION (continued):

ongoing user fee charges that can be absorbed in future operating budgets may be better allocated to other activities.

- Net position balances can be viewed by some as excessive if believed to be above the amounts necessary to achieve a balance of revenues and expenses over the long term. Because of the unpredictability of claims, it is difficult to be definitive over the adequacy of net position at a given point in time

Cons of Closing Internal Service Funds and Merging into the General Fund

- Loss of the ability to assess reasonable user charges to increase/decrease the net position of the fund to provide resources for unanticipated catastrophic losses, the estimation of future anticipated losses and known hazards, or amounts derived from actuarial studies.
- Less disruption to the adopted budget process. ISF balances allow for the smoothing of variability associated with these risk-financing expense categories.
- Use of these funds allows for full accrual accounting and full cost of providing risk financing services as provided in the Internal Service Fund.
- Long term Self-Insurance/General Liability and Workers Compensation claims liabilities not paid from “expendable and available resources” (short term) will not be reported on the General Fund balance sheet. Instead, they will be reported as a long-term liability in Government Wide Statement of Net Position.

If the Council wishes to eliminate these two ISFs, staff recommends that full implementation occur with the Council’s consideration of the Mid-Year Review of the FY 2022/23 Budget (February 2023). Staff needs time to close the ISFs, recalculate the user fees for each Department, distribute the funds to the General Fund, and ensure all accounts are properly managed. All of this work is not feasible prior to the July 1, 2022 start of the fiscal year.

The Finance Commission (FC) made one recommendation regarding projected deficits in the current Five-Year Forecast.

FC Recommendation: Recommend to Council that the Commission believes that a “Structural Financial Deficit” currently exists and for Council to acknowledge the Commission’s finding and direct the Commission to work with Town management to confirm the actual amount of the

DISCUSSION (continued):

deficits that the Town is facing and come back to the Council with suggestions/ideas on how we can fix this “Structural Financial Deficit” and fund capital projects.

Potential Impacts: The recommendation has no direct impact on the Proposed Operating Budget for this fiscal year.

If the Council agrees with this recommendation, then staff would work with the Commission on refined projections of revenues and costs; identification of potential revenue enhancements and cost cutting strategies; and determination of other balancing mechanisms that would ultimately be forwarded to the Town Council for its consideration.

Consideration of Any Funding Requests

If there are individual requests for new spending, the Council should consider these requests in the context of the Proposed Operating Budget and identify the source(s) of funding for the(se) item(s). At the time of the preparation of this report, no requests have been submitted to the Town. On May 4, 2021, the Council approved “Principles for Considering Future Funding Requests” (Attachment 6), which the Council may find helpful.

Donation Opportunities - FY 2022/23 List of Town Needs

As part of the budget development process, the List of Town Needs is updated annually per Town Council Donation Policy (Attachment 7) to reflect goods, services, and other contributions that would help enhance Town services, programs, and events (Attachment 8).

CONCLUSION AND NEXT STEPS:

At its May 17, 2022 meeting, the Council will have an opportunity to listen to public testimony, ask questions, consider the Finance Commission’s recommendations, deliberate, and direct changes to the Proposed Operating and/or Capital Improvement Program Budgets. Any changes to the Proposed Operating and/or Capital Budgets directed by Council or identified by staff (see Attachment 5.) will be included for Council consideration in the resolution formally adopting the Budgets to be considered by Council on June 7.

During and after the Budget adoption, staff continues to monitor revenues and expenditures closely and will report to the Town Council actual revenues and expenditures later in the year as the data become available. Any modifications needed will be brought back to the Council as Budget Adjustments.

Public comment received after the Finance Commission meetings and before 11 a.m. on May 12, 2022 is contained in Attachment 9.

COORDINATION:

The preparation of the budget documents involved the participation of all Town Departments. The Finance Commission deliberated and provided its recommendations to the Council as discussed in this report.

FISCAL IMPACT:

Under State law, the Town Council is required to enact a balanced budget. The Proposed Operating and Capital Budgets are balanced and as the Council directs changes, the outcome must be a balanced fiscal plan.

ENVIRONMENTAL ASSESSMENT:

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

Attachments Provided to the Council Prior to the Distribution of this Report:

1. FY 2022/23 Proposed Operating and Capital Budget
<https://www.losgatosca.gov/DocumentCenter/View/30442/FY-2022-23-Proposed-Budget>
2. FY 2022/23 – 2026/27 Proposed Capital Improvement Program Budget
<https://www.losgatosca.gov/DocumentCenter/View/30428/FY-2022-23-Capital-Budget>

Attachments Provided with this Report:

3. FY 2022/23 Finance Commission Operating and Capital Budget Recommendations
4. Revenue and Expense Forecast Assumptions
5. List of proposed changes related to corrections and adding clarifications
6. Council's Principles for Considering Funding Requests (Approved May 4, 2021)
7. Town of Los Gatos Donation Policy
8. Town of Los Gatos Donation Opportunities: FY 2022/23
9. Public Comment Received Before 11 a.m. on May 12, 2022