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Sent: Thursday, April 15, 2021 10:53 AM
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Subject: Recommendations - Improving the usefulness of the Five-Year Financial Plan

Dear Members of the Finance Commission,

Measure A gives the Finance Commission the legal authority to recommend to the Council the approval or disapproval of the Town Manager's proposed operating and capital budgets. To be clear, the Commission can make a recommendation to approve the proposed budgets, conditional upon the Town Council accepting one or more the Commission's recommendations. This is an important tool of Measure A which was purposely included to ensure independent resident input is given directly to the Council as the Council deliberates the annual operating and capital budgets.

Shortly the Commission will receive the Town Manager's FY 2022 operating and capital budget proposals. Included in the budget will be a revised Five-Year Financial Plan. I previously forwarded to the Commission the City of San Jose Budget Principles document (copy attached) which established the principle that "the annual General Fund Proposed Budget balancing plan shall be presented and discussed in context of the five-year forecast. Any revisions to the Proposed Budget shall include an analysis of the impact on the forecast out years. If a revision(s) creates a negative impact on the forecast, a funding plan shall be developed and approved to offset the impact".

This is sound financial policy and common sense. The fundamental purpose of a Five-Year Financial Plan is to provide Council and residents a picture of the most likely longer-term financial trajectory of the Town. This requires sound analysis and reasonable estimates to be used so the Council can make good short and long-term decisions regarding capital allocation. **I recommend that the Commission review the City of San Jose Budget Principles document and make a recommendation to our Council that the Town develop and adopt a budget principles document which would include among other items the development of a structurally balanced budget (as defined by the City of San Jose) and the integration of proposed budget revisions into the Five-Year Financial Plan.**

I have also attached two Five-Year Financial Plans for your review and consideration. The first one was prepared May 2016 and includes a projection for FY 2021. The second one was prepared February 2021 and reflects the most current estimate for FY 2021. A comparison of the two forecasts for FY 2021 is very instructive and highlights a major flaw that has existed for years in the preparation of the Five-Year Financial Plan. This flaw is the lack of forecasting any salary increases and the resultant impact on total salary, pension, and health costs. It has been the Staff's long-standing policy to not forecast salary increases because Staff believes that in so doing bargaining units will gain an unfair advantage when negotiating their contract renewals.

While there might be some merit (how much is debatable) to this claim, the cost of doing this has greatly exceeded any imagined benefit and essentially makes the Five-Year Financial Plan useless as a financial planning tool. In the most recent Town Manager's budget transmittal letter to the Council, it

states “The delivery of Town services is highly dependent on labor, which makes up 59.5% of budgeted General Fund expenditures for FY 2020/21”. To not accurately forecast the single largest expenditure which accounts for 60% of the General Fund expenditures is obviously problematic. And to intentionally understate the cost is grossly misleading to all, especially the residents.

I have surveyed many cities within Santa Clara County and have yet to find one that subscribes to the Town’s theory of forecasting salary, retirement and health benefit costs when building a Five-Year Financial Plan. In fact, the City of San Jose uses a very sophisticated budgeting process for longer term forecasting of salary, retirement, and health benefits. **My second recommendation is for the Commission to review the Town’s current methodology for preparing the Five-Year Financial Plan and to develop a recommendation to the Council on “best practices” for forecasting the longer-term expenses associated with salary, retirement, and health benefits as well as revenues and other costs so accurate projections are included in the five-year outlook.**

Let’s compare the salary and benefit costs for FY 2021 that were forecasted in May 2016 to the costs forecasted by Staff in February 2021. In the May 2016 forecast, total salary cost for FY 2021 was forecasted to be \$15.9m which was essentially flat over the entire five-year forecast period. The total benefit cost was forecasted to be \$9.6m, increasing modestly over the five- year period. Furthermore, the May 2016 forecast for FY 2021 projected a \$1.1m surplus of net revenue less expenditure. In May 2016, based on the Five-Year Financial Plan, FY 2021 looked like a good year.

Based on the most recent February 2021 forecast, total salary cost is now projected to be \$20.3m which is 27.7% or \$4.4m greater than the 2016 forecast. And total benefit costs are projected to be \$11.4m which is 18.8% or \$1.8m greater. In total, salary and benefit costs will be \$6.2m or 24.3% greater in FY 2021 than projected in May 2016. Additionally, the forecast for FY 2021 now projects a \$1.2m deficit of net revenues less expenditures, even though operating revenues are \$1.8m higher than originally forecasted. (Note – the cumulative impact of not forecasting salary increases over the five-year period could be as much as \$15m under statement).

The point here is the salary increases were approved by the Town Council over the span of five years. Every Council knew that salary and benefit costs were going to increase over time. And yet, when it came to include the cost increases in the Five-Year Financial Plan, the increases were not reflected. This raises the obvious question as to how did each Council starting in 2016 reasonable know whether the Town could afford to grant these increases? The answer is they didn’t since the only tool available to them was the Five-Year Financial Plan which did not model any increases. **It is reasonable to assume if in May 2016 the Council knew by FY 2021 there would be an incremental cost of \$6.2m with no revenue forecasted to pay for these increases, the Council most likely would have taken different actions over the five year period.**

The City of San Jose exercises great care when preparing a longer-term forecast. A Five-Year Financial Plan should not be a “collective bargaining” tool. It needs to be as accurate as possible, reflecting all “knowns” so the Council can make appropriate long-term decisions. The Town of Los Gatos needs to take the same approach as the City of San Jose and stop intentionally under forecasting the largest General Fund cost element when preparing the Five-Year Financial Plan. This Commission has the authority to make appropriate recommendations directly to the Council. Please make these recommendations and help the Council improve their financial decision making for the benefit of all.

Thank you.

Phil Koen

CITY OF SAN JOSE BUDGET PRINCIPLES

The Mission of the City of San José is to provide quality services, facilities and opportunities that create, sustain and enhance a safe, livable and vibrant community for its diverse residents, businesses and visitors. The General Fund Budget shall be constructed to support the Mission.

1) STRUCTURALLY BALANCED BUDGET

The annual budget for the General Fund shall be structurally balanced throughout the budget process. A structurally balanced budget means ongoing revenues and ongoing expenditures are in balance each year of the five-year budget projection. Ongoing revenues shall equal or exceed ongoing expenditures in both the Proposed and Adopted Budgets. If a structural imbalance occurs, a plan shall be developed and implemented to bring the budget back into structural balance. The plan to restore balance may include general objectives as opposed to using specific budget proposals in the forecast out years.

2) PROPOSED BUDGET REVISIONS

The annual General Fund Proposed Budget balancing plan shall be presented and discussed in context of the five-year forecast. Any revisions to the Proposed Budget shall include an analysis of the impact on the forecast out years. If a revision(s) creates a negative impact on the forecast, a funding plan shall be developed and approved to offset the impact.

3) USE OF ONE-TIME RESOURCES

Once the General Fund budget is brought into structural balance, one-time resources (e.g., revenue spikes, budget savings, sale of property, and similar nonrecurring revenue) shall not be used for current or new ongoing operating expenses. Examples of appropriate uses of one-time resources include rebuilding the Economic Uncertainty Reserve, early retirement of debt, capital expenditures without significant operating and maintenance costs, and other nonrecurring expenditures. One time funding for ongoing operating expenses to maintain valuable existing programs may be approved by a majority vote of the Council.

4) BUDGET REQUESTS DURING THE YEAR

New program, service or staff requests during the year that are unbudgeted shall be considered in light of the City's General Fund Unfunded Initiatives/Programs List and include a spending offset at the time of the request (if costs are known) or before final approval, so that the request has a net-zero effect on the budget.

5) RESERVES

All City Funds shall maintain an adequate reserve level and/or ending fund balance as determined annually as appropriate for each fund. For the General Fund, a contingency reserve amount, which is a minimum of 3% of the operating budget, shall be maintained. Any use of the General Fund Contingency Reserve would require a two-thirds vote of approval by the City Council. On an annual basis, specific reserve funds shall be reviewed to determine if they hold greater amounts of funds than are necessary to respond to reasonable calculations of risk. Excess reserve funds may be used for one-time expenses.

CITY OF SAN JOSE BUDGET PRINCIPLES

6) DEBT ISSUANCE

The City shall not issue long-term (over one year) General Fund debt to support ongoing operating costs (other than debt service) unless such debt issuance achieves net operating cost savings and such savings are verified by appropriate independent analysis. All General Fund debt issuances shall identify the method of repayment (or have a dedicated revenue source).

7) EMPLOYEE COMPENSATION

Negotiations for employee compensation shall focus on the cost of total compensation (e.g., salary, step increases, benefit cost increases) while considering the City's fiscal condition, revenue growth, and changes in the Consumer Price Index (cost of living expenses experienced by employees.)

8) CAPITAL IMPROVEMENT PROJECTS

Capital Improvement Projects shall not proceed for projects with annual operating and maintenance costs exceeding \$100,000 in the General Fund without City Council certification that funding will be made available in the applicable year of the cost impact. Certification shall demonstrate that funding for the entire cost of the project, including the operations and maintenance costs, will not require a decrease in existing basic neighborhood services.

9) FEES AND CHARGES

Fee increases shall be utilized, where possible, to assure that fee program operating costs are fully covered by fee revenue and explore opportunities to establish new fees for services where appropriate.

10) GRANTS

City staff shall seek out, apply for and effectively administer federal, State and other grants that address the City's priorities and policy objectives and provide a positive benefit to the City. Before any grant is pursued, staff shall provide a detailed pro-forma that addresses the immediate and long-term costs and benefits to the City. One-time operating grant revenues shall not be used to begin or support the costs of ongoing programs with the exception of pilot projects to determine their suitability for long-term funding.

11) GENERAL PLAN

The General Plan shall be used as a primary long-term fiscal planning tool. The General Plan contains goals for land use, transportation, capital investments, and service delivery based on a specific capacity for new workers and residents. Recommendations to create new development capacity beyond the existing General Plan shall be analyzed to ensure that capital improvements and operating and maintenance costs are within the financial capacity of the City.

12) PERFORMANCE MEASURES

All requests for City Service Area/departamental funding shall include performance measurement data so that funding requests can be reviewed and approved in light of service level outcomes to the community and organization.

13) FIRE STATION CLOSURE, SALE OR RELOCATION

The inclusion of the closure, sale or relocation of a fire station as part of the City Budget is prohibited without prior assessment, community outreach, and City Council approval on the matter.

Updated Five-Year Financial Plan
(\$ millions)

		FY 1	FY 2	FY 3	FY 4	FY 5	
Account	Revenue Category	2015/16 Estimated	2016/17 Forecast	2017/18 Forecast	2018/19 Forecast	2019/20 Forecast	2020/21 Forecast
4100	Property Tax	\$ 10.1	\$ 10.5	\$ 10.8	\$ 11.1	\$ 11.4	\$ 11.8
4110	VLF Backfill Property Tax	3.0	3.0	3.0	3.1	3.1	3.1
4200	Sales & Use Tax	8.1	8.2	8.2	8.5	8.8	9.1
4250	Franchise Fees	2.1	2.2	2.3	2.3	2.4	2.5
4251	Transient Occupancy Tax	1.8	1.9	2.0	2.0	2.1	2.1
4400	Business License Tax	1.3	1.3	1.3	1.3	1.3	1.3
4400	Licenses & Permits	3.1	2.9	3.0	3.1	3.2	3.3
4500	Intergovernmental	0.9	0.7	0.7	0.7	0.7	0.7
4600	Charge for Services	2.8	2.4	2.2	2.3	2.3	2.4
4700	Fines & Forfeitures	0.7	0.7	0.7	0.7	0.7	0.7
4800	Interest	0.3	0.3	0.3	0.4	0.4	0.4
4850	Other Sources	4.2	3.4	3.2	3.2	3.3	3.3
4900	Fund Transfers In	0.4	0.4	0.4	0.4	0.4	0.4
TOTAL REVENUES		38.8	37.9	38.1	39.1	40.1	41.1
Use of Reserves/Deposits		0.7	10.0	0.5	0.5	0.5	0.5
TOTAL REVENUES & TRANSFERS		\$ 39.5	\$ 47.9	\$ 38.6	\$ 39.6	\$ 40.6	\$ 41.6

Account	Expenditure Category	2015/16 Estimated	2016/17 Forecast	2017/18 Forecast	2018/19 Forecast	2019/20 Forecast	2020/21 Forecast
5110	Salary	\$ 13.6	\$ 14.4	\$ 14.4	\$ 14.5	\$ 14.7	\$ 14.7
5120	Furlough	-	-	-	-	-	-
5130	Temporary Employees	1.1	0.7	0.7	0.7	0.7	0.7
5140	Overtime	0.3	0.4	0.4	0.4	0.4	0.4
5170	Other Salary	0.7	0.1	0.1	0.1	0.1	0.1
5200	Benefits	7.5	8.0	8.4	9.0	9.5	9.6
6000	Supplies, Materials, & Services	5.9	5.8	5.6	5.7	5.8	6.0
6000	Pass Through Expenditures	0.6	-	-	-	-	-
7200	Grants & Awards	0.2	0.2	0.2	0.2	0.2	0.2
7400	Utilities	0.5	0.4	0.5	0.5	0.5	0.5
7700	Fixed Assets	-	-	-	-	-	-
8060	Internal Service Charges	3.5	3.7	3.8	4.1	4.2	4.4
8900	Debt Service	1.9	1.9	1.9	1.9	1.9	1.9
TOTAL EXPENDITURES		\$ 35.8	\$ 35.6	\$ 36.0	\$ 37.1	\$ 38.0	\$ 38.5
9900	Operating Transfers Out	0.1	-	-	-	-	-
9900	Capital Transfers Out to GFAR	0.5	9.9	0.4	0.4	0.4	0.4
9900	GASB 45 Retiree Medical Actuarial	1.5	1.6	1.6	1.6	1.6	1.6
EXPENDITURES		37.9	47.1	38.0	39.1	40.0	40.5
TOTAL EXPENDITURES & ALLOCATIONS		\$ 37.9	\$ 47.1	\$ 38.0	\$ 39.1	\$ 40.0	\$ 40.5
REVENUES LESS EXPENDITURES		\$ 1.6	\$ 0.8	\$ 0.6	\$ 0.5	\$ 0.6	\$ 1.1
ONGOING SHORTFALL MITIGATION		\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
NET REVENUES LESS EXPENDITURES		\$ 1.6	\$ 0.8	\$ 0.6	\$ 0.5	\$ 0.6	\$ 1.1

\$ 15.9

*FY 2016/17 9.9 million in use of Reserves/Deposit is for capital projects funding, inclusive of 9.5 million for Phase 2 of the Almond Grove Street Rehabilitation Project.

The updated forecast for fiscal year 2016/17 year-end estimates indicate excess revenues over expenditures in the amount of approximately 800,000. The forecasted excess is reflective of moderate growth in the Town's Property Tax collections, Transient Occupancy Taxes, business licenses, and other licenses and permits. As per the current Town General Fund Reserve Policy, because the minimum combined levels in the Catastrophic and Budget Stabilization reserves satisfies the required funding level of the 25% of the FY 2016/17 operating budget, year-end savings typically transfers to the General Fund Reserve for Capital Projects to be available to fund future capital projects. The Council may wish to discuss other priorities for the excess such as the establishment of a CalPERS Reserve (see Pension Liabilities discussion) and/or other purposes.

BASE CASE

Town of Los Gatos General Fund 5-Year Forecast (in \$ million)								
Account	Revenue Category	2020/21 Budget	2020/21 Estimates	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
4100	Property Tax	\$ 14.7	\$ 13.9	\$ 14.1	\$ 15.2	\$ 15.6	\$ 16.2	\$ 16.6
4110	VLF Backfill Property Tax	4.0	4.1	4.2	4.3	4.4	4.5	4.7
4200	Sales & Use Tax	7.0	6.7	7.3	7.5	7.7	7.8	7.9
4200	Measure G District Sales Tax	1.0	1.0	1.0	1.0	1.1	1.1	1.1
4250	Franchise Fees	2.5	2.5	2.6	2.7	2.8	2.8	2.8
4251	Transient Occupancy Tax	2.3	0.7	1.0	1.1	1.2	1.2	1.3
4400	Business License Tax	1.3	1.1	1.2	1.2	1.2	1.2	1.2
4400	Licenses & Permits	3.1	3.0	2.9	2.9	3.0	3.1	3.1
4500	Intergovernmental	1.0	1.3	0.7	0.8	0.8	0.8	0.9
4600	Town Services	4.0	3.8	3.5	3.5	3.5	3.5	3.6
4700	Fines & Forfeitures	0.4	0.1	0.3	0.3	0.3	0.3	0.3
4800	Interest	0.6	0.6	0.5	0.3	0.2	0.2	0.3
4850	Other Sources	2.3	3.5	2.3	2.3	2.3	2.3	2.3
4900	Fund Transfers In	0.6	0.6	0.5	0.5	0.5	0.5	0.5
TOTAL OPERATING REVENUES & TRANSFERS*		\$ 44.8	\$ 42.9	\$ 42.1	\$ 43.6	\$ 44.5	\$ 45.5	\$ 46.6
	Use of Capital/Special Project Reserve - Capital	3.4	3.4	0.6	0.6	0.6	0.6	0.6
	Use of Pension/OPEB Reserve	4.2	4.5	0	0	0	0	0
	Use of Capital/Special Project Reserve - Other	0.9	0.9	0	0	0	0	0
TOTAL REVENUES, TRANSFERS, AND USE OF RESERVES		\$ 53.3	\$ 51.7	\$ 42.7	\$ 44.2	\$ 45.1	\$ 46.1	\$ 47.2
Account	Expenditure Category	2020/21 Budget	2020/21 Estimates	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
5110	Salary	20.2	20.3	19.7	19.7	19.9	20.1	20.2
5120	CalPERS Benefits	7.3	6.4	7.5	7.5	7.2	7.5	7.6
5200	All Other Benefits	4.1	3.7	3.9	3.9	4.0	4.1	4.2
6211	OPEB Pay as You Go	1.3	1.3	1.4	1.4	1.4	1.5	1.8
6000	Operating Expenditures	6.7	6.1	5.4	5.4	5.6	5.7	5.8
7200	Grants & Awards	0.2	0.2	0.2	0.2	0.2	0.2	0.3
7400	Utilities	0.6	0.6	0.6	0.6	0.6	0.6	0.6
8060	Internal Service Charges	2.4	2.4	2.6	2.6	2.8	3.0	3.2
8900	Debt Service	1.9	1.9	1.9	1.9	1.9	1.9	1.9
TOTAL OPERATING EXPENDITURES		\$ 44.7	\$ 42.8	\$ 43.1	\$ 43.1	\$ 43.7	\$ 44.6	\$ 45.7
	GASB 45 Retiree Medical Actuarial	0.6	0.6	0.6	0.5	0.4	0.3	0.2
	Additional Discretionary Payment - Pension	4.6	4.9	0.4	0.4	0.4	0.4	0.4
TOTAL OPERATING & DISCRETIONARY EXPENDITURES		\$ 49.9	\$ 48.3	\$ 44.1	\$ 44.0	\$ 44.5	\$ 45.3	\$ 46.3
	Capital Transfers Out to GFAR	3.4	3.4	0.6	0.6	0.6	0.6	0.6
	Transfer to Internal Service Funds	0	0	0	0	0	0	0
	Pension/OPEB Transfer to Pension Trust Fund	0	0	0	0	0	0	0
	Allocate to Compensated Absences	0	0	0	0	0	0	0
	Allocate to Vehicle Maintenance and Stores Surplus	0	0	0	0	0	0	0
	Allocate to Property Surplus Reserve	0	1.2	0	0	0	0	0
TOTAL EXPENDITURES & RESERVE ALLOCATIONS		\$ 53.3	\$ 52.9	\$ 44.7	\$ 44.6	\$ 45.1	\$ 45.9	\$ 46.9
NET REVENUES RESERVE TRANSFERS LESS EXPENDITURES & RESERVE ALLOCATIONS		\$ -	\$ (1.2)	\$ (2.0)	\$ (0.4)	\$ -	\$ 0.2	\$ 0.3

* Due to rounding of individual categories FY 2020/21 Total Expenditures and Reserve Allocations omits \$0.1 million.