

Recommendations for The Town Council – FY 25 Operating and CIP Budget

Pursuant to Town Code section 2.50.225 – Duties, the Finance Commission shall review the Town Managers’ annual proposed budget and provide written comments and recommendations to the Town Council including a recommendation whether the Town Council should approve or disapprove of the proposed budget.

The Town Manager’s proposed FY 2025 Operating and CIP Budget was made available to the public on April 22. The Finance Commission reviewed and discussed the proposed budget during commission meetings held on April 29, May 6<sup>th</sup>, and May 13<sup>th</sup>. The Finance Commission wishes to express our appreciation to Staff in supporting the Commission during this deliberative process.

Below are the Commission’s comments and recommendations for the Town Council’s consideration and action.

Proposed FY 2025 Operating Budget.

Comments

- It has been challenging to analyze the FY 2025 Operating Budget. The FY 25 operating plan includes many revenue and expenditure items such as tracking budgets, pass-through accounts, and debt service costs in addition to reclassifications of revenue from franchise tax to license and permits fees which are not consistent with historical financials prepared under GAAP. This lack of comparability makes it difficult to compare historical results to the FY 25 operating plan. Being able to analyze year-over-year changes in revenues and expenditures on a comparable basis is an important part of evaluating the reasonableness of a budget. Historical performance is an excellent predictor of future outcomes and can be used to quickly find anomalies. This analysis only works if there is consistency in reporting.
- Using the statement of revenues and expenditures format presented in the ACFR, the FY 25 General Fund Excess of Revenues over Expenditures is \$0. In FY 23 the excess of revenues over expenditures was \$5.7m. That means Town’s Operating Expenditures for FY 25 are forecasted to increase \$5.7m MORE than Operating Revenues. That is a troubling trend that requires cost containment strategies that are not well defined in the FY 25 plan. For example, consultant and contractor services are increasing \$625k (25% growth) levels and fee charges and services are increasing \$240k (15% growth) from FY 23 with little explanation provided as to the underlying cost forces.
- The Town Manager references “status quo” budgeting, but the town needs a more structured approach to cost management that sends a message that taxes and spending will be held in check. The City of Los Altos recently implemented zero-base budgeting claiming much success. A starting point would be for Staff to study Los Altos and learn from their success.

- The decrease in the General Fund balance of \$514,285 shown on schedule C-8 and referenced in the Town Manager's transmittal letter is the result of General Fund Transfers-Out exceeding General Fund Transfers-In by \$514,285 and not the result of a structural imbalance where operating expenditures exceed operating revenues.
- There is one risk the Town Council needs to be aware of. Not all salary and benefit increases are reflected in the FY 25 Operating Budget. This is because the MOUs for the other two bargaining units expire June 30, 2024 and the Town is negotiating successor MOU's. Any increases agreed in the successor MOU will require a funding source to offset the expense increase. The Finance Commission was not informed of the most likely outcome of these discussions.
- In looking at tax revenues, the Finance Commission believes Staff has been too conservative in forecasting sales tax and TOT revenues. Sales Tax revenue is forecasted to decline 10% from FY 23 actual level with TOT revenues being flat from FY 23. This appears to be overly conservative. Any overachievement in revenue can be used to cover incremental salary and benefit costs arising from the new MOU's. If in fact sales tax revenues are expected to decline, the Town should aggressively develop and pursue strategies to revitalize and diversify the business base of the Town.
- The Finance Commission also believes Staff has been overly conservative in increasing the General Fund reserve for ERAF risk to \$2.2m. In direct discussions with Santa Clara County Counsel, a worst-case scenario of 22% of the excess ERAF could be clawed back. But the probability of that happening is very low. In addition to the ERAF reserve, Town has set up budget and catastrophic reserves totaling over \$13m. To have over \$15m in reserves strikes us as being overly conservative and an inefficient allocation of the Town's capital. The Council should consider redeploying at least \$1m of the ERAF reserve to reduce the Town's unfunded pension liability. This would have the added benefit of reducing future pension contributions.

#### Recommendation

The Finance Commission recommends that the Town Council approve the FY 2025 Operating Budget subject to the comments above.

#### Proposed FY 25 CIP Budget

##### Comments

- The FY 25 CIP Budget totals \$32.8 million made up of \$25.7 million carryforward funds for 58 projects approved in prior years, new money totaling \$5.6m for 20 of the 58 carryforward projects (35% of the projects in flight have budgets increased), and \$1.5m for only 7 new projects.
- Over the five-year period through FY 29, the total CIP budget is \$53.7m, with \$20.m programmed for spending from FY 26 – FY 29.
- The Finance Commission is not able to judge the merit of the 65 projects programmed for FY 25. We assume these projects have been properly vetted and are consistent with the Town Council's priorities. Our comments are focused on the planning and control

processes surrounding the CIP Budget. We are concerned by the substantial number of carry-forward projects and the small number of projects that are annually closed out annually. This suggests there is insufficient project management capacity to manage a \$32.8m capital budget. This might also be why 35% of the projects have their budget increased because they are running behind schedule and are subject to cost increases.

- A major concern is how the CIP expenditures are planned to be spent. The expenditure budget is built on the assumption that all \$32.8m (carryforward and new money) will be spent in FY 25. This will never happen. In fact, for the five-year period FY 19 – FY 23 the average annual expenditure for all capital assets per year was approximately \$8m. This aggressive assumption leads to incorrect projections that the GFAR Fund balance will be substantially drained by the end of FY 25.
- The assumption that all capital expenditures will be made in FY 25 also leads to the loss of normal capital project management techniques which are used to track progress against a project timeline, a project dollar budget, and a project quality spec. While we understand the need to authorize the total project cost for a given phase, how these funds will be deployed over time should also be authorized. The CIP Budget does not include a capital expenditure time profile.
- For each capital project there is a project description which includes identifying the project phase (e.g., design or construction), the original date, a revised date, and a timeline for spending. However, the timeline reflects all carryforward funds and new FY 25 funds are deployed in FY 25. This should be adjusted to reflect the most likely deployment timeline which will become the basis for tracking performance to plan and on-time and on budget completions.
- The CIP Budget process also seems to be more focused on the new money being approved, in this case \$7m, than understanding why carry-forward projects are not being closed out on a prompt basis and why their budgets are increasing. There is little explanation as to why the carryforward amounts continue to be carried forward. This appears to be a vicious cycle the Town is trapped in.
- Lastly, when we asked the staff to prove out the carryforward number in the FY 25 plan of \$25.7m they were unable to do so. We computed a carryforward number of \$19.9m starting with FY 24 total capital budget of \$37.8m and subtracting the Town's estimated capital spend for FY 24 of \$17.9m. This is \$5.8m less than the carry forward amount in the FY 25 CIP budget of \$25.7m. Staff later was able to explain \$2m of the \$5.9m difference, but the remaining \$3.8m is unexplained.

## Recommendation

The Finance Commission's recommends the Town Council not accept the FY 25 CIP Budget without an expenditure profile being provided in addition to the "authorization" profile currently presented. Staff should properly time all capital expenditures so projects can be properly project managed against time, dollars, and quality specifications. This was a recommendation made by the Finance Commission last year, but unfortunately was not implemented for the FY 25 budgeting cycle.