



**TOWN OF LOS GATOS
COUNCIL AGENDA REPORT**

MEETING DATE: 02/16/2021

ITEM NO: 13

DATE: February 10, 2021
TO: Mayor and Town Council
FROM: Laurel Prevetti, Town Manager
SUBJECT: Discuss the Five-Year Forecast, Provide Direction on the Other Budget Assumptions, and Provide any Specific Direction for the Preparation of the Town's Fiscal Year 2021/22 Operating and Capital Budgets

RECOMMENDATION:

Discuss the Five-Year Forecast, provide direction on the other budget assumptions, and provide any specific direction for the preparation of the Town's Fiscal Year 2021/22 Operating and Capital Budgets.

BACKGROUND:

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 (Attachment 1), the Town develops a Five-Year Financial Forecast ("Forecast") beginning in the late fall of each year. The Forecast enables the Town to evaluate the Town's fiscal condition and to help guide policy, programmatic planning, and budget decisions. Development of a financial forecast as part of the budget development process has been identified as a best practice by the Government Financial Officers Association (GFOA).

The 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 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.

PREPARED BY: Arn Andrews
Assistant Town Manager

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

BACKGROUND (continued):

The initial Forecast is predicated on estimates derived from the Mid-Year Budget and includes updates to Town revenues and expenditures based on the Mid-Year end of year projections. Like any forecast the first year of the Forecast's revenue estimates is 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. This report also provides two additional forecast scenarios utilizing a sensitivity analysis for three of the major revenue assumptions and forecasted pension contributions. These additional forecast scenarios illustrate the effects on future budgets of a more optimistic scenario ("Greater Growth") and a pessimistic one ("Lower Growth"). Comments from the Finance Commission are also provided for Council consideration.

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.

DISCUSSION:The Pandemic's Economic Impacts Informed an Updated Forecast Last Year

As we consider the development of the Five-Year Forecast, it is helpful to provide context on the development of the Forecast that informed the current adopted FY 2020/2021 Operating Budget. On January 21, 2020, the Town Council received the following initial Five-Year Forecast which became the basis of Strategic Priority planning and budgetary considerations. The development of that original forecast did not anticipate the unforeseen economic impacts associated with the local, national, and global effects of COVID-19.

Original 5 Year Forecast "Base Case"	2020/21 Forecast (\$M)	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)
Original Surplus/Deficit	\$0.5	\$1.7	\$1.6	\$2.3	\$3.1

On May 19, 2020, staff presented an updated Five-Year Forecast and the Proposed Operating Budget which included significant revisions to growth projections for the Town's primary revenues of property tax, sales tax, and transient occupancy tax (TOT). The revised revenue projections were made in close consultation with the Santa Clara County Assessor, Town sales tax consultant MuniServices, and a review of national and regional hospitality research. The

DISCUSSION (continued):

net result of these revenue changes alone accounted for a \$1.8 million swing from the original FY 2020/21 base case revenue projections and an additional \$2.6 million revenue reduction in FY 2021/22 relative to the base case projection.

Net Changes in Revenues to Base Case	2020/21 Forecast (\$M)	2021/22 Forecast (\$M)
Sales Tax	(\$0.98)	(\$1.02)
MuniServices COVID-19 Scenario		
TOT	(\$0.4)	(\$0.1)
Shock Scenario		
Property Tax	(\$0.4)	(\$1.5)
Slow/No Growth Scenario		
Totals	(\$1.78)	(\$2.62)

In addition to reassessing revenue growth, the proposed Five-Year Forecast anticipated increases in the Town's pension obligations. Given volatility in financial markets at the time, it was anticipated that CalPERS would not achieve its assumed investment rate of return of 7% in FY 2019/20. Staff assumed a 0% return for the updated Forecast. The combined effects of changing these budget assumptions in conjunction with others is illustrated in the following updated Five-year Forecast.

Updated COVID-19 Effects Scenario	2020/21 Forecast (\$M)	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)
Surplus/Deficit	\$0.0	\$0.0	(\$0.6)	(\$0.1)	(\$0.7)

The total Five-Year Forecast revisions resulted in an initial estimate of \$9.2 million in total surpluses through FY 2024/25 ultimately becoming \$1.4 million in deficits through FY 2024/25, for a total Forecast period reduction of \$10.6 million.

As the summary table on the next page shows, the Town's financial condition continues to be impacted by the unprecedented effects of global, national, and regional pandemic mitigation measures. While the pandemic will continue to present a degree of uncertainty and complexity the Town has positioned itself well to address these challenges. Attachment 2 contains for the full Five-Year Forecast "Base Case" for revenues and expenditures.

DISCUSSION (continued):

Scenario Surplus/Deficit	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
Greater Growth Scenario	(\$1.3)	\$0.8	\$1.6	\$2.4	\$3.1
Base Case Modest Growth	(\$2.0)	(\$0.4)	\$0.0	\$0.2	\$0.3
Less Growth Scenario	(\$2.7)	(\$1.4)	(\$1.5)	(\$1.7)	(\$2.0)

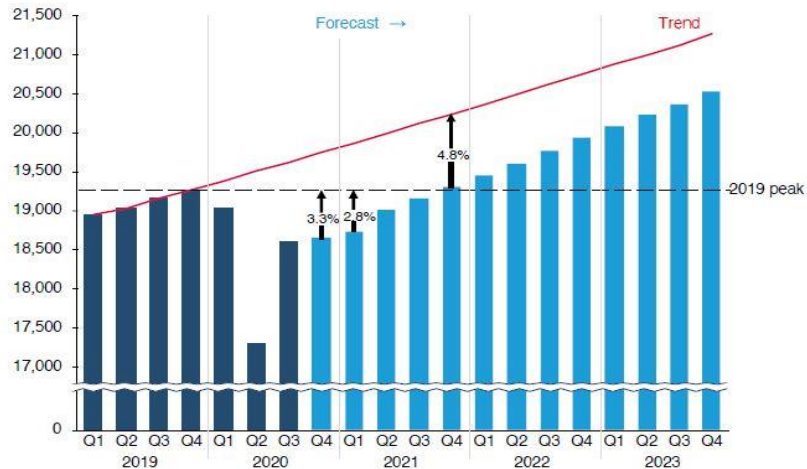
National and Local Economic Backdrop

The UCLA Anderson School of Business publishes an annual economic forecast for the nation and California. The results of the forecast are utilized as a portion of the macroeconomic basis of the Five-Year Forecast development. The December 2020 report establishes data for a 2020-2023 forecast period (see Attachment 3).

Because of rising COVID infections and continued social distancing, the UCLA Anderson Forecast is projecting slower growth in real Gross Domestic Product (GDP) for Quarter (Q) 4 2020 and Q1 2021, of 1.2% and 1.8% seasonally adjusted annual rate (SAAR), respectively. According to its Forecast, this would leave the economy 3.3% and 2.8%, respectively, below its peak in Q4 2019. With the introduction of mass vaccinations, the forecast assumes robust growth in Q2 2021 of 6.0% SAAR, and then consistent growth above 3% well into 2023. The UCLA Anderson Forecast is expecting the economy to reach its previous peak by the end of 2021. It is important to note that even with growth accelerating in Q2 2021, this still leaves GDP 4.8% below the trend of where the economy likely would have been without the COVID shock (UCLA Forecast, Attachment 2 Exhibit 2).

DISCUSSION (continued):

Exhibit 2 Real GDP levels and trends, \$ Billions SAAR



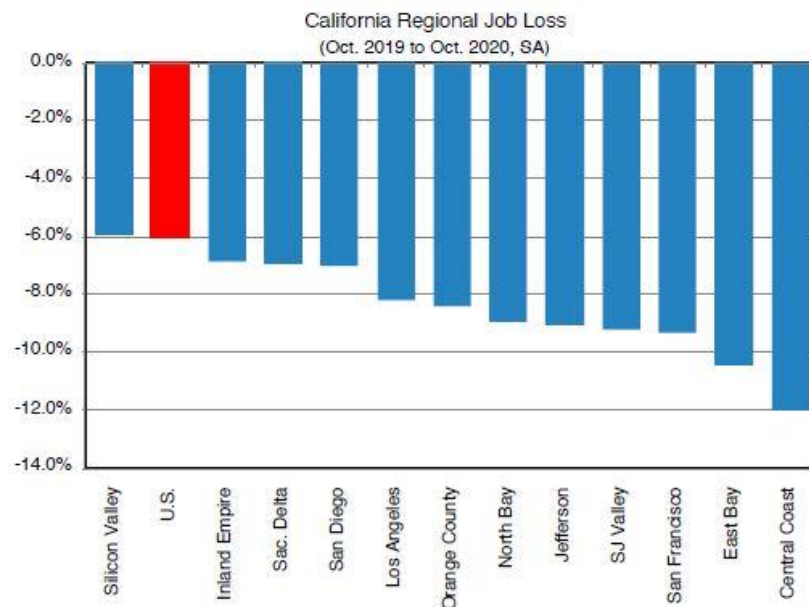
Source: U.S. Department of Commerce, Bureau of Economic Analysis and UCLA Anderson Forecast

Notes: Real GDP growth rate, seasonally adjusted annual rate.

The Report notes that for California, the impacts of the COVID led recession and subsequent job losses have not been equally distributed throughout the State. Regionally, areas less exposed to losses in tourism and with greater adaptability to remote work have been less impacted.

As the Forecast chart below illustrates, Silicon Valley had the lowest regional job losses in the State.

California Regional Jobs Loss



DISCUSSION (continued):

In addition, the Forecast states that “Looking to the future, the forecast for the state is for the technology sectors, residential construction, and logistics to lead the recovery, and for California post-pandemic to grow faster than the U.S.” This assessment should continue to bode well for economic recovery in Silicon Valley and Los Gatos. While much of the nation and the region has experienced significant financial hardship as a result of the pandemic, the Report notes that “...For those fortunate to maintain employment and income during this pandemic, their financial situation is better than before. Home values have increased, equity values have increased, and limited consumption opportunities during the past nine months mean that these households have been able to accumulate at least an additional \$1.6 trillion in savings.” Given the socioeconomic composition of Los Gatos, the Town should benefit from the Report’s forecasted trends.

Operating Revenue Trends and Five-Year Forecast Scenarios

The Town is highly dependent on three economically sensitive revenues comprising 65% of General Fund forecasted revenues. Following are summaries of the Town’s major revenues of property tax, sales tax, and transient occupancy tax (TOT). To provide context for the development of the FY 2021/22 Five-Year Forecast, the prior year’s growth assumptions and resulting revenue projections are provided. With that context, 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 will be developed for these three revenue streams. Please see Attachment 4 for a description of all revenue categories with a comprehensive listing of revenue forecast assumptions.

Finance Commission Comments

On February 8, 2021, the Finance Commission had an opportunity to review the base case revenue growth assumptions and subsequent projections as presented below. At the Commission meeting, there was considerable discussion about the amount of uncertainty that still exists due to the vagaries of continued COVID spread, variant mutations, vaccination supply, and public health mitigation responses. Two Commissioners felt the base case growth assumptions reflected reasonable conservatism. Two other Commissioners thought that while the base assumptions are potentially reasonable, they would continue to err on the side of additional conservatism.

DISCUSSION (continued):Property Tax

Property tax is the single largest revenue source for the Town and comprised approximately 28% of total Town projected revenues for FY 2020/21. As the following table illustrates, Los Gatos has benefited from the economic expansion as evidenced by year-over-year (YOY) roll growth in property assessment since 2011. For the 10-year period, the average annual growth rate was 6.10%.

Los Gatos Assessment Roll Growth
(values in billions)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Roll	8.37	8.68	9.46	9.99	10.63	11.54	12.29	13.15	13.84	14.90
Percent Growth	1.30	3.67	9.06	5.62	6.40	8.56	6.54	6.95	5.23	7.70

Source: Santa Clara County Assessors Annual Reports

The County of Santa Clara provides property tax collection updates and projections throughout the year. The following table illustrates the most recent estimates relative to the Adopted FY 2020/21 Budget and 2019 actuals. The current County estimate indicates a modest deviation from budget of approximately \$700,000 (3.74%) unrelated to COVID which is primarily the result of the Redevelopment Agency (RDA) residual payment decrease, which the County has already retained, and staff modeling a 50% reduction in Educational Revenue Augmentation Fund (ERAF) payments from the County estimate.

	FY 2019 Actual	FY 2020-21 Adopted Budget	County Estimate with ERAF	County Estimate 50% ERAF
Property Tax Revenue & Vehicle License Fee Backfill	\$18.4 M	\$18.7 M	\$18.9 M	\$18.00 M

The Town has been monitoring developments regarding the normal 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 county, cities, and special districts. Five counties, including Santa Clara, have been using a redistribution allocation formula for years that is now being contested by the State. The Town's Adopted FY 2020/21 Budget had ERAF base revenue estimated at \$433,000. However, the most recent County property tax estimate included \$1.8 million of additional excess ERAF funds. If the State is successful in contesting

DISCUSSION (continued):

ERAF distribution of excess funds, the result would be a negative impact on budgeted revenues. Given that the distribution of the excess ERAF funds is a binary outcome, staff is modeling a 50% reduction in ERAF into yearend.

The following table illustrates the growth projections utilized for development of the FY 2020/21 Five-Year Forecast for property tax and corresponding estimated revenues. In addition, the Forecast estimated additional property taxes of \$350,000 in FY 2021/22 and \$700,000 per year thereafter from Phase One development of the North 40 starting in year 2022/23 of the Forecast.

Property Tax	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
Proposed Growth	0%	3%	3%	3%	3%
Estimated Revenues	\$19.1 M	\$19.9 M	\$20.4 M	\$21.0 M	\$20.8 M

Given the continued low supply of housing inventory and the unanticipated residual benefits of remote workers relocating to less urban environments, staff is anticipating continued modest growth in property tax in the coming year and years ahead.

The UCLA Anderson Forecast provided the following assessment of the housing market: “We forecast that housing will remain strong well into 2023. Home builder confidence is at a record, and permits and housing starts continue to increase. Underlying this are five factors.

First, interest rates are likely to remain low for an extended period of time, which will fuel demand for home purchases. Second, without COVID concerns, sellers who were reluctant to put their homes on the market this past year may enter the market and relieve current inventory constraints. This is likely to be a case where supply begets demand, and the increased options induce more people to become buyers.

Third, we’ll have more clarity on whether working from home will be sustainable over the longer-term once pandemic constraints are no longer binding. This clarity is likely to induce additional rounds of people relocating away from urban cores to suburbs and larger homes. Fourth, there’s a demographic bubble of millennials aging into their prime earning and home-buying years. This demographic shift will continue to fuel higher demand for home purchases.

And fifth, as unemployment begins to come down and there’s less economic uncertainty, buyers who were reluctant to enter the market this past year may be more likely to enter to

DISCUSSION (continued):

take advantage of continued low mortgage rates. As for where housing markets will be red-hot, there are a lot of unknowns. Once the economy fully reopens, urban cores will regain some of the amenity value lost during the pandemic, but demographic shifts, with millennials starting families, and continued opportunities to work from home will make the suburbs more attractive.”

The following table illustrate the growth factors recommended for development of the FY 2021/22 Five-Year Forecast.

Property Tax	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
Proposed Growth	2.5%	2.5%	3%	3%	3%

For purposes of the Forecast, the “Base Case” utilizes a growth factor of 2.5% to 3.0% and the “Greater Growth” and “Lower Growth” scenarios utilize a 2% differential from the Base Case. In addition to the growth factor, staff continues to assume \$350,000 additional North 40 revenue in FY 2021/22 and an additional \$700,000 in FY2022/23 due to the project’s construction and sales schedule. Base non-residual excess ERAF revenue is forecasted at \$400,000 annually until further direction received from the County. FY 2022/23 also anticipates an additional \$500,000 RDA residual allocation representing the current allocation calculation of Santa Clara County.

Property Tax (Property Tax & VLF)	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
Greater Growth Scenario	\$18.6	\$20.2	\$21.2	\$22.4	\$23.5
Base Case Modest Growth	\$18.3	\$19.5	\$20.0	\$20.7	\$21.3
Less Growth Scenario	\$17.9	\$18.7	\$18.	\$19.1	\$19.2

Sales Tax

Sales tax is the second largest revenue source for the Town and comprised approximately 12% of total Town projected revenues for FY 2020/21. The table on the next page illustrates the most recent projections from the Town’s sales tax consultant MuniServices relative to the Adopted FY 2020/21 budget and 2019 actuals.

DISCUSSION (continued):

	FY 2019/20 Actual	FY 2020/21 Adopted Budget	January 26, 2021 MuniServices Estimate
Base Sales Tax & District Tax	\$7.5 M	\$8.0 M	\$7.7 M

The current estimate indicates a deviation from budget of approximately \$300,000 (3.75%); however, staff will continue to monitor MuniServices updates into the close of the year and adjust as appropriate. The table below provides the MuniServices forecasted COVID growth factor used for development of the FY 2020/21 Five-Year Forecast.

Base Sales Tax & District Tax	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
MuniServices COVID Scenario	\$8.10	\$8.20	\$8.40	\$8.50	\$8.60

For the FY 2021/22 Five-Year Forecast, staff is utilizing the MuniServices Conservative scenario. The Conservative scenario assumes that approved vaccines become available on a limited basis 2021 Q1, and treatment options will improve. In addition, the scenario assumes more cases and more fatalities, delays in approving and distributing vaccines, problems with vaccines, and partial modified Stay-At-Home orders stay in effect until 08/31/21. The tables below have been segregated between estimates for the base sales tax and the Town's dedicated District Tax to better illustrate the variability between them.

Base Sales Tax	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
Conservative	\$ 7.26	\$7.48	\$7.64	\$7.79	\$7.93
Most Likely	\$7.38	\$7.61	\$7.78	\$7.94	\$8.09
Optimistic	\$7.49	\$7.74	\$7.92	\$8.09	\$8.25

DISCUSSION (continued):

Measure G 1/8 District Tax	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
Conservative	\$1.00	\$1.03	\$1.05	\$1.07	\$1.09
Most Likely	\$1.02	\$1.04	\$1.07	\$1.09	\$1.11
Optimistic	\$1.04	\$1.06	\$1.09	\$1.11	\$1.13

While staff doesn't necessarily concur with some of MuniServices vaccination and Shelter-In-Place duration assumptions, given the significant unknowns related to the pandemic, staff believes it is appropriate to default to the most conservative scenario. The UCLA Andersen Forecast notes "...our assumption is that households will not only resume their consumption of services, but those that accumulated savings during the pandemic will overcompensate for the past year by consuming more services than they normally would. We expect a significant surge in spending on restaurants, recreation, travel, and accommodation..." Again, given the socioeconomic composition of Los Gatos, the Town should benefit from the Report's forecasted trends.

Transient Occupancy Tax

TOT is an important revenue source for the Town and comprised approximately 3.4% of total Town projected revenues of \$2.3 million for FY 2020/21. The following table illustrates TOT year-end collection estimates, the Adopted FY 2020/21 Budget, and FY 2019/20 actuals.

	FY 2019/20 Actual	FY 2020/21 Adopted Budget	Year-end Estimate
TOT	\$1.87 M	\$2.30 M	\$0.7 M

As the table illustrates, to date TOT has experienced the most significant percentage decline relative to Budget. The FY 2020/21 Five-Year Forecast modeled a steep contraction with subsequent rebound for a net 15% reduction in TOT revenues from the prior January 21, 2020 initial forecast projection over the course of the year. However, in addition to the initial Shelter-in-Place (SIP) and Stay-at-Home restrictions instituted on March 17, 2020, on November 28, 2020, Santa Clara County issued new mandatory directives which included that hotels and other lodging facilities will be open only for essential travel and for use to facilitate isolation or

DISCUSSION (continued):

quarantine. Given that the November restrictions remain as of this writing, staff anticipates that the current Health Order will continue to degrade TOT revenues for the remainder of the year resulting in year-over-year (YOY) declines of 69%.

The table below illustrates the growth projections utilized for development of the FY 2020/21 Five-Year Forecast for TOT and corresponding estimated revenues.

TOT	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
Proposed Growth	-5%	0%	0%	0%	0%
Estimated Revenues	\$2.2 M	\$2.2 M	\$2.2 M	\$2.2 M	\$2.2 M

Unlike sales tax forecasts which predict an acceleration of revenues tied to pent up consumer demand, the Town's TOT revenue has historically been primarily driven by business travel. Given the uncertainty around physical business travel resuming at prior levels, as opposed to a continuation of remote work and online meeting forums, staff is recommending modest growth for base case development of the FY 2021/22 Five-Year Forecast. However, given the significant reduction to the revenue base compared to prior revenue history staff is providing a base growth scenario and an additional more optimistic growth scenario.

TOT	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
Base Growth Scenario	30%	20%	5%	5%	5%
Estimated Revenues	\$0.8 M	\$0.9 M	\$1.0 M	\$1.0 M	\$1.1 M
Base Growth Scenario	50%	20%	5%	5%	5%
Estimated Revenues	\$1.1 M	\$1.3 M	\$1.3 M	\$1.4 M	\$1.5 M

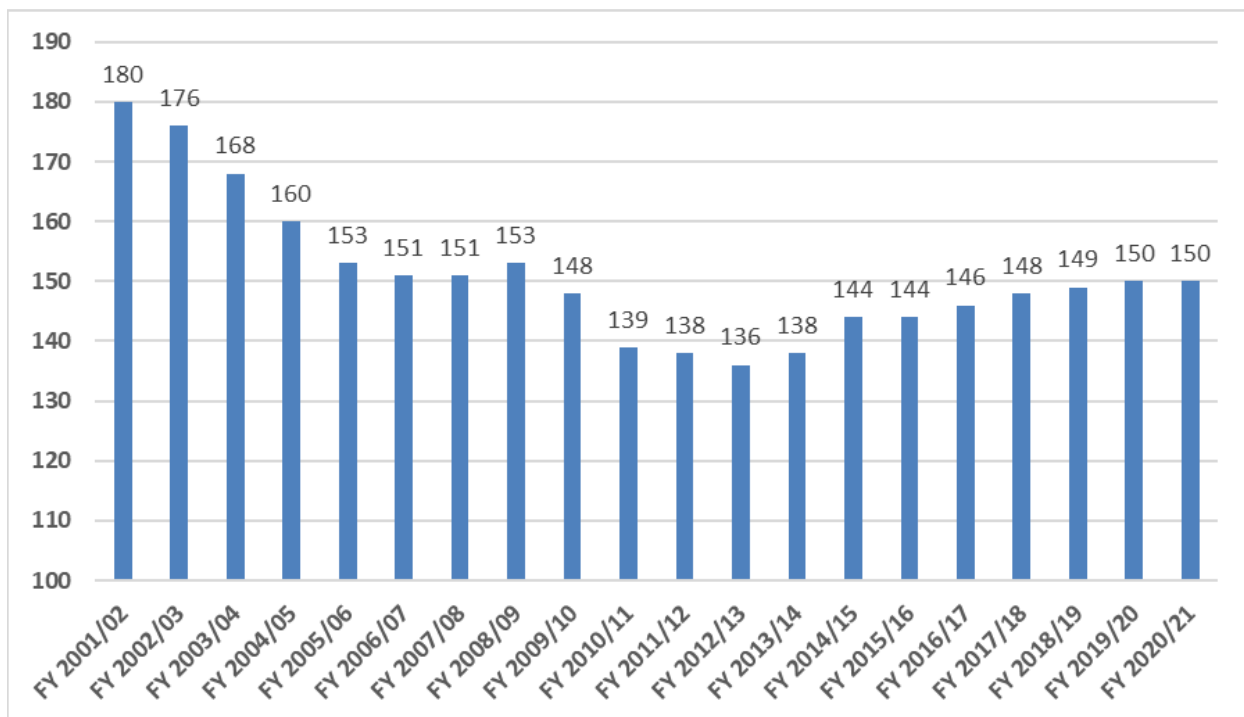
Operating Expense Trends and Five-Year Forecast Scenarios

Forecasts of future operating expenditures take into account 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.

DISCUSSION (continued):

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 unique 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) and the unrepresented Management and Confidential groups.

For FY 2020/21, General Fund Operating expenditures (not including debt payment and transfers out) were programmed at \$47.9 million. The delivery of Town services is highly dependent on labor which comprises 59.5% of budgeted General Fund expenditures and 41% of budgeted total expenditures for FY 2020/21. 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. As the table below illustrates, since 2001 the Town has reduced its full-time employees by 16.7% to 150 FTE employees.



In addition, the Town's bargaining groups have helped manage employee costs as evidenced by participating in wage freezes and unpaid furloughs for several years to assist in achieving balanced budgets after the 2008 recession. It should also be noted that since 2000 the Town's bargaining groups have received salary increases of 51.50% (AFSME), 56.00% (TEA), 56.00%

DISCUSSION (continued):

(Confidential), 61.25% (POA), 46.00% (Management), respectively. This compares to inflation in the San Francisco Statistical Area of 66.84% over the same time period.

Mandated pension payments to CalPERS has 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 OPEB obligations for the Town. To address the escalation in pension costs, previous Councils have allocated additional discretionary pension funding totaling \$12,800,000 million. These additional discretionary payments will ultimately yield an approximate additional \$11,700,000 in contribution savings.

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, prior Council's and the Town's bargaining groups have worked to curb cost escalation in Other Post-Employment Benefits (OPEB). In 2009, the Town initiated prefunding of the retiree healthcare benefit and has since established approximately \$23.5 million in OPEB assets 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. The majority of other expenses are assumed to increase at 3% per annum. Detailed expenditure assumptions and factors can be found in Attachment 5.

DISCUSSION (continued):Salary and Benefits*Salary*

The Town has historically budgeted vacant and non-sworn positions at top step of the range for the position. Sworn and management positions are budgeted at one step higher of current step in anticipation of any merit increases expected to be awarded in the upcoming fiscal year. Based on Council's direction, for FY 2020/21 salaries were budgeted at actual salary plus a one step increase, which was a significant budgeting methodology change from previous practice. This methodology will be continued for the development of FY 2021/22.

For the Forecast, positions are budgeted at the actual rate of pay of employees including benefits as of December 2020. 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 TEA and AFSCME on June 30, 2021. POA's MOU will expire on September 30, 2021. The Management and Confidential groups are unrepresented.

In addition to the economic terms of the MOUs, the Forecast assumes step increases for employees in applicable positions, and merit increases for Management and Confidential employees. As is the Town's practice, no general wage adjustments are included in the Forecast starting in 2021/22 due to the expiration of bargaining group MOUs. The Forecast will be updated accordingly based on labor negotiations with the Town's unions at that time.

(values in millions)

Salaries (Current MOUs)	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
Base Case	\$19.7	\$19.7	\$19.9	\$20.1	\$20.2

Pension and Other Benefits

For purposes of the Forecast, staff utilizes data provided by CalPERS in the annual actuarial valuations and then in consultation with the Town's Actuary (Bartel Associates) and CalPERS updates the projections to include data not included. Given that actuarial valuations lag by

DISCUSSION (continued):

about a year the CalPERS 2019 valuation would not have captured the 4.7% CalPERS investment return for FY 2019/20, the current CalPERS investment return year to date, or the Town's \$3.5 million additional discretionary payment from July 2020. The following table illustrates the forecast for pension and other benefits. The projections for the Town's OPEB payments are derived from Bartel Associates.

Pension & Other Benefits	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
Base Case	\$11.4	\$11.4	\$11.2	\$11.5	\$11.8

As we move closer to the final development of the Proposed FY 2021/22 Operating Budget, staff will generate an updated pension forecast utilizing an investment return which more closely approximates CalPERS returns at that time versus the plans current 7.0% assumed return. Any update will not impact the initial years of the forecast due to lags in actuarial reporting but will be exhibited starting in the third year of the forecast.

Given that investment returns have one of the largest impacts contribution variability CalPERS provides projected employer Unfunded Actuarial Liability (UAL) contributions under alternate investment returns. As the table below illustrates returns higher than the expected return of 7% result in lower UAL contributions and returns lower than 7% result in higher UAL contributions.

UAL Town Contributions	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
(Misc & Safety)					
Greater Investment Return Scenario (12%)	N/A	\$5,004,000	\$4,971,000	\$4,751,000	\$3,860,000
Base Investment Return Case (7%)	\$4,756,698	\$5,172,000	\$5,476,000	\$5,783,000	\$5,626,000
Less Investment Return Scenario (1%)	N/A	\$5,392,000	\$6,138,000	\$7,110,000	\$7,838,000

CalPERS Actuarial Valuations as of June 30, 2019

For the year ending June 30, 2019, the Public Employees Retirement Fund (PERF) returned 6.7%. The table below illustrates the historic investment returns for five years, ten years, twenty years, and thirty years.

DISCUSSION (continued):

CalPERS Compound Annual Rates of Return	5 Years	10 Years	20 Years	30 Years
Geometric Return	5.8%	9.1%	5.8%	8.1%

Five-Year Financial Forecast Alternative Scenarios

The tables below present the “Base Case” forecast contrasted against the two alternative scenarios of “Greater Growth” and “Lower Growth.” As illustrated in the tables, even modest changes to the “Base Case” forecast can result in either additional surpluses or deficits during the forecast period.

(values in millions)

Original 5 Year Forecast “Base Case”	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
Total Revenues, Transfers & Use of Reserves	\$42.7	\$44.2	\$45.1	\$46.1	\$47.2
Total Expenses & Allocations	\$44.7	\$44.6	\$45.1	\$45.9	\$46.9
Original Surplus/Deficit	(\$2.0)	(\$0.4)	\$0.0	\$0.2	\$0.3

Alternative Scenario “Greater Growth”	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
Total Revenues & Transfers	\$43.4	\$45.4	\$46.7	\$48.3	\$50.0
Total Expenses & Allocations	\$44.7	\$44.6	\$45.1	\$45.9	\$46.9
New Surplus/Deficit	(\$1.3)	\$0.8	\$1.6	\$2.4	\$3.1

DISCUSSION (continued):

Alternative Scenario "Lower Growth"	2021/22 Forecast (\$M)	2022/23 Forecast (\$M)	2023/24 Forecast (\$M)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)
Total Revenues & Transfers	\$42.0	\$43.2	\$43.6	\$44.2	\$44.9
Total Expenses & Allocations	\$44.7	\$44.6	\$45.1	\$45.9	\$46.9
New Surplus/Deficit	(\$2.7)	(\$1.4)	(\$1.5)	(\$1.7)	(\$2.0)

CONCLUSION:

The Town Council should review and discuss the elements and assumptions of the initial Five-Year Forecast and other budget considerations. While the "Base Case" Forecast estimates deficits at this time, it is based on assumptions that are subject to change given the significant unknowns related to COVID and as shown with the alternative growth scenarios. As the Forecast is not a budget, there are no specific budget balancing recommendations being proposed at this time. The Town Manager will bring forward for Council consideration in May a balanced proposed FY 2021/22 budget.

At this time, the preparation of the FY 2021/22 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. This is considered a "status quo" approach with no major new initiatives or staffing. Key budget principles include:

- Develop and recommend a balanced budget that maintains service levels;
- Position for multi-year recession
- Continue to make progress on Strategic Priorities identified by the Town Council; and
- Identify opportunities to enhance service delivery through new revenue sources, technology, and open government.

Staff looks forward to answering the Town Council's questions and receiving any direction for the preparation of the proposed FY2021/22 Operating and Capital Budgets that results from the discussion. The Council may also discuss budget assumptions. For reference, the current status of the Town's Capital Improvement projects are contained in Attachment 6. The Draft FY 2021/22 Operating and Capital Budgets will be available in May with the budget hearing tentatively scheduled for May 18, 2021.

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SUBJECT: FY 2021/22 Initial Five-Year Forecast

DATE: February 10, 2021

COORDINATION:

This Report was prepared by the Town Manager's Office in coordination with the Finance Department.

ENVIRONMENTAL ASSESSMENT:

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

Attachments:

1. Annual Budget Process
2. Base Case Five-Year Forecast
3. UCLA Anderson School 2020/23 Economic Forecast
4. Forecast Revenue Assumptions
5. Forecast Expense Assumptions
6. Capital Improvement Project Status