CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: **2013-2014 CITY MANAGER'S BUDGET REQUEST AND 2014-2018 FIVE-YEAR FORECAST**

DATE: February 28, 2013

INFORMATION

EXECUTIVE SUMMARY

In compliance with City Charter Section 1204, and the City Council's Adopted Budget process, this document provides both the recommended 2013-2014 City Manager's Budget Request (Budget Balancing Strategy Guidelines) and the 2014-2018 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program. Following are the major highlights of this report:

- As shown in the chart below, a small General Fund shortfall of $5.5 million is projected for 2013-2014. This projection is derived by comparing the estimated revenues with the cost of delivering existing services as well as the services for which the City has already committed, such as the operation of new facilities or other capital projects scheduled to come on-line next year. In the remaining years of the Forecast, small General Fund shortfalls and a surplus are projected, ranging from -$13.7 million to $2.0 million annually. These margins are extremely narrow when put into context of the size of the projected General Fund budget, ranging from -0.8% to 0.1% of the projected annual budget (revenues and expenditures). Over the five-year period, a total shortfall of $27.9 million is anticipated, or approximately $5.6 million annually. This average shortfall figure equates to only 0.3% of the projected General Fund annual budget. In the development of the Forecast, an Employee Compensation Planning Reserve has been factored into the expenditures, which is a change in practice from recent Forecasts as discussed later in this Executive Summary. In recommending the Employee Compensation Planning Reserve, the Administration is also recommending to resolve the $5.5 million shortfall and thus balance the budget through means that would not reduce or eliminate services to the community. Excluding that Reserve, General Fund surpluses would be generated in four of the five fiscal years, including a $5.6 million surplus in 2013-2014.

2014-2018 General Fund Forecast
Incremental General Fund Surplus/(Shortfall)

2013-2014	2014-2015	2015-2016	2016-2017	2017-2018
($5.5 M)	($13.7 M)	$2.0	($4.7 M)	($6.0 M)

- This Forecast reflects the Administration's best estimates on the projected revenues and expenditures over the next five years based on the information currently available. It does not, however, incorporate several elements that would impact the General Fund over the Forecast period, including: 1) impacts associated with the implementation of the remaining elements of the Fiscal Reform Plan (cost savings, such as retirement reform, and additional revenues); 2) tax increment funding for the Successor Agency to the Redevelopment Agency, a public entity, regarding the outcome of litigation with the County of Santa Clara related to the PERS Levy; 3) costs associated with fully funding the annual required contributions for police and fire retiree healthcare; 4) costs associated with services that were funded on a one-time basis in 2012-2013; 5) costs associated with the restoration of key services to January 1, 2011 levels; 6) costs associated with unmet/deferred infrastructure and maintenance needs; and 7) one time revenue sources or expenditure needs, including the $29.4 million in one-time funding that is currently in the 2013-2014 Future Deficit Reserve. The Forecast also does not factor in the potential impact associated with the sunsetting of the Library Parcel Tax in 2014, which is budgeted in a special fund. If this Tax is not renewed, there will be significant service delivery impacts for the Library, which relies on this tax revenue to support both operations and the capital program, including the purchase of library materials. The Forecast does assume that the Police and Fire Retirement Plan Board will approve the elimination of the Supplemental Retiree Benefit Reserve (SRBR) for the 2013-2014 City retirement contribution amount and rates.

- The City's budget has started to stabilize with very small General Fund shortfalls and a surplus projected over the forecast period. The difficult budget balancing actions implemented over the past several years have played a critical role in bringing revenues and expenditures into close alignment in this Forecast. These actions included a combination of significant service and position reductions, employee total compensation reductions, increased employee benefit cost sharing, changes to service delivery models across the organization, and increasing revenues, including four voter-approved tax measures, to address a decade of cumulative General Fund budget shortfalls totaling $680 million that required the elimination of approximately 2,000 positions. The three-year period from 2009-2010 through 2011-2012 was the most difficult with the deepest service cuts, position eliminations and layoffs, and compensation reductions. In-depth planning efforts were undertaken to strategically address these unprecedented budget challenges. The City first developed a General Fund Structural Deficit Elimination Plan in 2008 that outlined cost reduction and revenue strategies to bring the General Fund into structural balance. This document was later updated by the Fiscal Reform Plan that was approved by the City Council in May, 2011. The Fiscal Reform Plan presented a strategy to achieve long-term financial stability, restore key City services to January 1, 2011 levels (fire, police, libraries, community centers, and street maintenance), and open facilities that had been recently completed or were under construction. This plan identified cost reduction strategies, primarily retirement-related, and revenue strategies, primarily Sales Tax and Business Tax measures, that would generate additional resources to meet these goals.

- The chart on page 4 compares the 2013-2014 Forecast to the 2012-2013 Adopted Budget. The carry-over from the 2012-2013 Adopted Budget of $9.0 million is the first element and represents the ongoing surplus funds that were not allocated in 2012-2013 in order to address a portion of the projected deficit in 2013-2014, as outlined in the February 2012 Forecast document. The next major comparison element is the change in major revenue sources year-over-year. Ongoing revenues are projected to increase by $21.7 million, driven primarily by an increase in the Sales Tax estimate. When comparing expenditures (the third element), base costs are expected to increase by $25.1 million from 2012-2013 ongoing budget levels, with the largest increase in retirement contribution expenditures. The combined impact of those three elements would have otherwise resulted in a General Fund surplus of $5.6 million. However, a fourth element, an $11.1 million Employee Compensation Planning Reserve, has been incorporated into the 2013-2014 Forecast, which causes the surplus to turn into a projected shortfall of $5.5 million for 2013-2014. As discussed in recent prior Forecasts, employee compensation increases are a City Council resource allocation decision in any given year. Starting in 2009-2010, this cost element was not incorporated into the City's budget planning given the severity of the projected General Fund budget shortfalls. During this period, it was necessary to not only implement salary freezes, but to also significantly reduce total employee compensation, rendering it unfeasible to build in salary increases in the Forecast. Moving forward, it is important to recognize that a meaningful long-term fiscal planning strategy needs to incorporate some level of employee compensation adjustments within the City's ability to afford them. Although adding a small set-aside for potential limited salary adjustments in this Forecast causes the General Fund budget position to be slightly negative, the Administration believes that budget balancing solutions can be identified over the next two months to close the 2013-2014 gap without reducing or eliminating General Fund services to our community, bringing the balance to zero. This reserve allocation, representing only a modest amount of funding, would require City Council labor negotiations direction and discussions with the City's bargaining groups before any form of distribution could be made. How this allocation would be applied, if it remains funded, has not been determined.

2013-2014 General Fund Forecast
Reconciliation from 2012-2013 Adopted Budget

2013-2014 General Fund Forecast Components (Ongoing)	$ in Millions
Carry-Over from 2012-2013 Adopted Budget	**$9.0**
Major Revenue Changes	
- Sales Tax Increase	14.0
- Overhead Reimbursements Increase	4.3
- Property Tax Increase	3.7
- Transient Occupancy Tax Increase	1.9
- Other Revenue Net Decreases	($2.2)
Total Revenue Changes (Increase)	**$21.7**
Major Expenditure Changes	
- Retirement Contributions Increases	18.1
- 2013-2014 Committed Additions (capital projects scheduled to come on-line)	3.9
- Healthcare/Dental Cost Increases	3.3
- Non-Management Step Increases/Management Pay-For-Performance	3.1
- Workers' Compensation Claims Payments	2.3
- Successor Agency to the Redevelopment Agency Transfer	(2.3)
- Debt Service/Capital Projects Funding Shift to Capital Funds	(2.6)
- Other Expenditure Net Decreases	(0.7)
Total Expenditure Changes (Savings)	**$25.1**
Subtotal 2013-2014 Projected General Fund Surplus	**$5.6**
Additional Expenditure Changes	
- Employee Compensation Planning Reserve	$11.1
2013-2014 Projected General Fund Shortfall	**($5.5)**
Budget Balancing Solutions Needed w/o Service Reductions/Eliminations	**$5.5**
Remaining Balance	**$0.0**

- The 2013-2014 projected shortfall of $5.5 million reflects an improvement from the $22.5 million budget shortfall projected for 2013-2014 in the February 2012 Five-Year Forecast. This reduction in the shortfall is the net result of numerous revenue and expenditure changes. Actions taken in the 2012-2013 Adopted Budget and the implementation of fiscal reforms were major contributors to the lower shortfall. As discussed above, in the 2012-2013 Adopted Budget, $9.0 million of ongoing funds were not allocated in 2012-2013 in order to address a portion of the projected deficit in 2013-2014. In addition, reductions in retirement costs associated with the elimination of the SRBR (approved for the Federated Retirement System and pending final approval by the Police and Fire Department Retirement Plan Board) and the implementation of a low cost health plan reduced costs for 2013-2014. Partially offsetting these factors is the inclusion of the Employee Compensation Planning Reserve. In recommending the Employee Compensation Planning Reserve, the Administration is also recommending to resolve the $5.5 million shortfall through means that would not reduce or eliminate services to the community and thus have a balanced budget.

- Retirement costs (pension and retiree healthcare) remain a major cost driver in this Forecast. For 2013-2014, retirement costs are projected to be $211.5 million in the General Fund ($275.8 million all funds) representing a total increase of $24.4 million (13.0%) from the 2012-2013 Modified Budget level of $187.1 million. This increase includes base budget increases ($18.1 million) and those associated with committed additions, non-management step increases, management pay-for-performance, and the Employee Compensation Planning Reserve. The cost reductions in the retirement plans due to the elimination of the SRBR for the Retirement Plans (pending final approval by the Police and Fire Department Retirement Plan Board) and the implementation of a low cost/high deductible healthcare plan were more than offset by a lowering of the interest earnings assumption for the Police and Fire Department Retirement Plan from 7.5% to 7.25% and after economic and demographic assumption changes within the plans. The City Council approved the Federated Retirement System Tier 2 plan, a defined benefit plan for new non-sworn employees, with a lower benefit level than existing employees; and a Tier 3, defined contribution plan, for new Unit 99 employees entering the City, the City's unrepresented employee group. During the forecast period, General Fund retirement contributions will increase by approximately $45.1 million (21.3%) from $211.5 million in 2013-2014 to $256.6 million in 2017-2018. During the same period, the City retirement contributions for all funds will increase by $53.8 million (19.5%) from $275.8 million in 2013-2014 to $329.6 million in 2017-2018. Similarly, the budgetary retirement contribution rates show significant increases for the Federated Retirement System Tier 1 plan and the Police and Fire Department Retirement Plan. For the Federated Retirement System Tier 1 plan, the budgetary retirement contribution rate increases from 60.6% in 2013-2014 to 77.1% in 2017-2018; for the Federated Retirement System Tier 2 plan, the budgetary contribution rate increases only slightly from 18.6% in 2013-2014 to 18.9% in 2017-2018; for the Police Retirement Plan the budgetary retirement contribution rate increases from 73.0% in 2013-2014 to 79.7% in 2017-2018; and for the Fire Retirement Plan, the budgetary retirement contribution rate increases from 72.2% in 2013-2014 to 81.1% in 2017-2018. It should be noted that retirement contribution costs and rates for the Police and Fire Retirement Plans do not reflect full funding of the annual required contribution for retiree healthcare. A Tier 2 Plan for Police and Fire has not yet been agreed to by those bargaining units.

- As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document. For example, General Fund revenues may exceed or fall below expectations based on changes in economic or non-economic conditions. Various cost elements can also vary from year to year. As seen in recent years, retirement costs have been fluctuating and will likely continue to experience upward or downward swings based on actual performance of the retirement funds and changes in actuarial economic and demographic assumptions as approved by the Federated and Police and Fire Retirement Department Boards. Another cost element that is difficult to project is the amount of funding necessary to ensure payment of Successor Agency to the Redevelopment Agency of the City of San José, a public entity (Successor Agency) obligations which the City is contractually obligated to pay (Convention Center Debt Service, 4th Street Parking Garage Debt Service, HUD 108 Loan payments, and ERAF loan payments) as well as administrative costs. The necessary transfer from the General Fund is difficult to calculate given the complexity in determining the Successor Agency revenue streams and the legal questions regarding the order in which the Successor Agency obligations will be addressed by those revenue streams.

Consistent with past practice, as part of the preparation for the 2013-2014 Proposed and Adopted Budgets, the Administration will continue to update the City Council on both the revenue and expenditure estimates as new information becomes available.

- As is customary in the Forecast, two alternative forecasts have been developed to model the range of financial scenarios possible under varying economic conditions. "Optimistic" and "Pessimistic" Cases have been created to model economic scenarios considered possible, but less likely to occur than the "Base Case". In 2013-2014, the Optimistic Case results in a small projected shortfall of only $755,000, while the Pessimistic Case results in a shortfall of $13.6 million.

- In approaching the 2013-2014 budget, the Administration proposes the use of the budget balancing strategy guidelines outlined in this memorandum (2013-2014 City Manager's Budget Request). The Service Restoration Decision Making Framework, the City Council-approved Guiding Principles for Restoring City Service Levels, and the overall City of San José Budget Principles combined with City Council priorities identified in prior policy sessions will also guide the City's budget development efforts. The Administration recommends City Council approval of the proposed 2013-2014 City Manager's Budget Request, with any desired revisions, as part of the Mayor's March Budget Message review and approval process.

- Looking forward, the Administration's goal is to build capacity to meet the City's basic service delivery needs, maintain competitiveness as an employer, and address the significant backlog of unmet/deferred infrastructure and maintenance needs. This will require continued diligence on controlling the City's costs and pursuing increased revenues to support City services. The Fiscal Reform Plan approved by the City Council in May 2011 outlined cost reduction and revenue strategies to help build this capacity. If the remaining elements of this Plan were implemented, significant additional savings or new funding could be generated over the five-year period as outlined in the Fiscal Reform Plan Update section that can be found later in this transmittal memorandum.

- Projections for the selected Capital Improvement Program (CIP) revenues are also included in this document. These revenues total $281 million over the five-year period and are up 23% from the $229 million included in the 2013-2017 Adopted CIP. Significant growth is anticipated for the Construction and Conveyance (C&C) Tax receipts (38% increase) due to the recovering real estate market, while moderate increases for the Building and Structure Construction Tax (10% increase) and the Construction Excise Tax (8% increase) are anticipated, primarily due to expected residential multi-family housing developments in North San José.

BACKGROUND

In compliance with City Charter Section 1204 and the City Council's Adopted Budget process, this document provides both the recommended 2013-2014 City Manager's Budget Request and the 2014-2018 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program. The City Manager's Budget Request and Five-Year Forecast are key components of the City's annual budget process and critical steps in developing the City's annual Operating and Capital Budgets and the Five-Year Capital Improvement Program (CIP).

The City Manager's Budget Request includes budget balancing strategy guidelines that the Administration recommends be used in developing the 2013-2014 Proposed Budget. These guidelines are predicated on the most current projections for expenditure requirements and available revenue in the coming fiscal year. As the City's anticipated fiscal status for 2013-2014 is an integral part of the Administration's proposed approach to preparing the 2013-2014 budget, a detailed discussion of the key economic, revenue, and expenditure assumptions for 2013-2014, and the subsequent four years, is provided as part of this document.

ANALYSIS

This section includes the following: a discussion of the 2013-2014 City Manager's Budget Request; an overview of the 2014-2018 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program; a Fiscal Reform Plan Update; and a description of the next steps in the 2013-2014 budget process.

2013-2014 CITY MANAGER'S BUDGET REQUEST

The City Manager's Budget Request includes a set of general budget balancing strategy guidelines that will be used in the development of the 2013-2014 budgets for the General Fund and selected Capital Funds. These proposed guidelines have been formulated in the context of projections for small General Fund deficits and a surplus over the Forecast period. The over-arching goals of these guidelines are to reach fiscal and operational stability, to deliver the services our community deserves in a cost-effective manner, and to provide for modest employee compensation increase. This includes bringing General Fund revenues and expenditures into balance while maintaining, and in some limited cases, expanding service levels in high priority areas that have been impacted by the budget balancing actions required in recent years. These guidelines will be used with the Service Restoration Decision Making Framework and the City Council-approved Guiding Principles for Restoring City Service Levels and the overall City Council approved City of San José Budget Principles that have been previously presented to the City Council.

In accordance with the City Charter, the City is required to adopt a balanced budget each year, addressing any projected shortfall or allocating any surplus. In 2013-2014, a General Fund shortfall of $5.5 million is projected, representing only 0.3% of the General Fund annual budget (revenues and expenditures). In the out years of the Forecast, General Fund shortfalls and a surplus range from -$13.7 million to $2.0 million annually. These surplus and shortfall amounts are very small when put into context of the size of the projected General Fund budget, ranging from -0.8% of the budget to 0.1% of the projected annual budget. With a projected shortfall of less than 1% of the budget, the Administration does not anticipate major service changes in 2013-2014. However, in order to balance the budget and create capacity to add resources in critical areas, the organization will continue to pursue additional revenues, more efficient and cost-effective ways to provide City services, potential restructuring opportunities, and reductions that do not impact direct service delivery.

Although overall service levels are clearly not at adequate levels for our community, the Administration continues to recommend aligning new ongoing service commitments with ongoing funds to support those additions, to the extent possible. Given the projected shortfall in the second year (2014-2015) of the Forecast of $13.7 million, it would also be prudent to consider a two-year strategy when developing the budget for 2013-2014. This effective strategy was implemented in 2012-2013 and, as a result, the projected ongoing shortfall in 2013-2014 was reduced by $9.0 million and there is a 2013-2014 Future Deficit Reserve that currently totals $29.4 million. The Administration recommends that the one-time funding contained in the 2013-2014 Future Deficit Reserve, as well as any additional one-time funds that become available during the budget development process, be strategically invested, with a portion reserved to address the projected shortfall in 2014-2015. Other potential uses of these one-time funds include the continuation of services that were restored on a one-time basis in 2012-2013, infrastructure and maintenance needs, establishment of a Budget Stabilization Reserve, the pay down of debt, and/or a small number of critical service or organizational needs.

Because of the difficult decisions that have been made over the last few years and a slightly improving economy, revenues and expenditures are in close alignment in this Forecast, with annual variances of less than 1% of the budget. Challenges remain, however, in addressing other funding needs that are not included in the Forecast, some of which would be potentially addressed by the remaining Fiscal Reform Plan strategies that have not yet been implemented or factored into the Forecast. When evaluating the annual General Fund shortfalls or surplus projected in this Forecast, it is important to keep in mind that these figures do not include the following:

- Various cost reduction and revenue strategies identified in the City-Council-approved Fiscal Reform Plan, which are not yet implemented. This Plan outlined cost reduction and revenue strategies to eliminate the General Fund structural deficit, restore selected services to January 1, 2011 levels, and open facilities that have been recently completed or are under construction. A total of at least $85.1 - $122 million could be generated over a five-year period from the remaining cost avoidance ($48.2 million) and revenue ($36.9 - $73.8 million) strategies.

- This Forecast anticipates that there will not be sufficient property tax increment revenue to pay all enforceable obligations of the Successor Agency to the Redevelopment Agency of San Jose, a public entity. If the Successor Agency cannot pay all of its obligations, the City is contractually obligated to assume certain payments of the Successor Agency; therefore, General Fund payments to the Successor Agency are included in all five years of this Forecast. However, it should be noted that the Successor Agency continues to dispute the amount of former Redevelopment Agency tax increment distributed by the County Auditor-Controller. A percentage of tax increment has been withheld by the County of approximately $7.5 million annually to fund the County employee's retirement plan (the PERS levy). Should the Successor Agency succeed in its legal challenge of the County's actions, additional tax increment would be distributed to the Successor Agency, thereby partially offsetting City contractually obligated Successor Agency payments and related General Fund payments.

- The costs associated with fully funding retiree healthcare in the out years of the forecast period for the Police and Fire Retirement Plan and the Federated Retirement System. Per the Memoranda of Agreements (MOAs) with the San Jose Police Officers' Association and the San José Fire Fighters, IAFF Local 230, the City and employee retiree healthcare contribution percentage has a limit which, if reached, results in the meet and confer process. Retiree medical costs are shared 50/50 between City and employees and these MOAs expire on June 30, 2013. Per Cheiron, the Board's actuary, in order to fully fund the annual retirement contribution for police and fire retiree healthcare benefits, the City's annual contribution would be in excess of the current limit of the percentage contribution of 11%.

- The costs to continue services funded on a one-time basis in 2012-2013 totaling $5.2 million in the General Fund ($5.7 million all funds). Services that fall in this category include: the San José BEST Program; Medical Marijuana Program; Economic Development Incentive Fund; City Attorney legal support staffing, Senior Transportation Services; Fiscal Reform Plan staffing; Senior Services and Wellness Program support; City Clerk staffing; Safe Summer Initiative; Independent Police Auditor staffing; Volunteer Engagement; Neighborhood Business Districts; Fair Swim Center Program; and Silver Creek Aquatics Program. Many of these programs and services will likely need to be re-evaluated for continued funding in 2013-2014. This analysis will be conducted during the 2013-2014 budget process and funding recommendations for these programs and services will be included in the 2013-2014 Proposed Operating Budget, as appropriate, and in context of other budgetary needs. A listing of the one-time funded services is included in *Appendix A*.

- The costs to restore service levels in critical service areas, including police, fire, libraries, and community centers as outlined in the Fiscal Reform Plan. The net cost to restore those services to January 1, 2011 levels was previously estimated at $33 million.

- The costs associated with ongoing unmet/deferred infrastructure and maintenance needs that were last calculated in April 2012 at $127 million annually (all funds) are not factored into the Forecast. In addition, there is a one-time backlog of infrastructure needs totaling $811 million (all funds). These figures will be updated and presented to the Transportation and Environment Committee in April 2013.

- One-time revenues that may become available or one-time expenditure needs. This includes the 2013-2014 Future Deficit Reserve of $29.4 million. Because the Forecast compares ongoing revenues and expenditures, it does not factor in one-time funding elements that may be available or required in any given year.

- Impacts associated with the potential elimination of the Library Parcel Tax. The Library Parcel Tax was approved by the voters in 2004 and is scheduled to sunset in 2014. These tax revenues, which are budgeted in a special fund, generate $7.5 million annually that are used to support both library operations and the library capital program, including the purchase of library materials. Without these funds, there will be significant service delivery impacts for the Library.

2013-2014 Budget Balancing Strategy Guidelines

The 2013-2014 Budget Balancing Strategy Guidelines on page 11 provide recommended direction on the general approaches to use in the development of the 2013-2014 Proposed Budget. While these guidelines are similar to those adopted by the Mayor and City Council last year as part of the 2012-2013 Mayor's March Budget Message, they have been modified to increase the focus on rebuilding the organization in a strategic and fiscally responsible manner. For instance, guideline #9 has been added to focus service restorations to meet January 1, 2011 service levels, consistent with previous City Council direction. Guideline #10 has been expanded to incorporate the components of the Service Restoration Decision Making Framework in addition to the City Council-approved Guiding Principles for Restoring City Service Levels. Guideline #11 has been added to recognize the need to start implementing compensation adjustments but in a fiscally responsible manner that does not result in a reduction or elimination of services in the General Fund. As mentioned earlier, a modest Employee Compensation Planning Reserve has been set aside in this Forecast. Due to the improvement in the City's budget position, there is less than a 1% variance between revenues and expenditures in all years of the Forecast. Given these very small budget gaps, the inclusion of this cost component should not result in service reductions and/or eliminations in the General Fund. This reserve allocation, representing only a modest amount of funding, would require City Council labor negotiations direction and discussions with the City's bargaining groups before any form of distribution could be made. How this allocation would be applied, if it remains funded, has not been determined.

There are three guidelines that have been removed, including the direction to explore personal services cost savings. Personal services cost reduction strategies have been previously identified in the City Council approved Fiscal Reform Plan and have either already been implemented or are currently being pursued. The guideline to eliminate vacant positions rather than filled positions to minimize layoffs has also been eliminated. Given the improved financial position of the City and the sizeable number of vacancies available for any employee placements, this item is no longer necessary. The guideline to focus on protecting vital core City services for both the short- and long-term has also been eliminated in recognition of the City's improved financial position that will not require the service reductions that have been necessary in recent years.

2013-2014 Budget Balancing Strategy Guidelines

1. Develop a budget that balances the City's delivery of the most essential services to the community with the resources available.
2. Balance ongoing expenditure needs with ongoing revenues to ensure no negative impact on future budgets and to maintain the City's high standards of fiscal integrity and financial management.
3. Focus on business process redesign in light of the severe staff reductions experienced during the last several years in order to improve employee productivity and the quality, flexibility, and cost-effectiveness of service delivery (e.g., streamlining, simplifying, reorganizing functions, and reallocating resources).
4. Explore alternative service delivery models (e.g., partnerships with the non-profit, public, or private sector for out- or in-sourcing services) to ensure no service overlap, reduce and/or share costs, and use our resources more efficiently and effectively. The City Council Policy on Service Delivery Evaluation provides a decision-making framework for evaluating a variety of alternative service delivery models.
5. Analyze non-personal/equipment/other costs, including contractual services, for cost savings opportunities. Contracts should be evaluated for their necessity to support City operations and to identify negotiation options to lower costs.
6. Explore redirecting and/or expanding existing revenue sources and/or adding new revenue sources.
7. Establish a fee structure to assure that operating costs are fully covered by fee revenue and explore opportunities to establish new fees for services, where appropriate.
8. Identify City policy changes that would enable/facilitate service delivery changes or other budget balancing strategies.
9. As additional resources become available, focus service restorations to meet the baseline January 1, 2011 service levels previously identified by the City Council in the areas of fire, police, library, community centers, street maintenance, and facility openings.
10. In addition to considering the service restorations to meet the baseline January 1, 2011 service levels, take a holistic approach regarding the restoration of services. As outlined in the Guiding Principles for Restoring City Service Levels, allocate additional resources with the following goals in mind: ensure the fiscal soundness of the City; choose investments that achieve significant outcomes; and improve efficiency and effectiveness of service delivery. Using a multi-pronged approach to restoring direct services, take into consideration the following factors: adequate strategic support resources; adequate infrastructure; service delivery method to ensure efficient and effective operations; service delivery goals and current performance status; service sustainability; and staffing resources.
11. Incorporate compensation adjustments in a fiscally responsible manner that does not result in a reduction or elimination of services in the General Fund.
12. Engage employees in department budget proposal idea development.
13. Use the General Plan as a primary long-term fiscal planning tool and link ability to provide City services to development policy decisions.
14. Continue a community-based budget process where the City's residents and businesses are educated and engaged, as well as have the opportunity to provide feedback regarding the City's annual budget.

Framework and Guiding Principles for Restoring City Service Levels

As the City brings the General Fund revenues and expenditures into balance and continues to implement the cost reduction and revenue strategies identified in the Fiscal Reform Plan, there is expected to be some capacity to restore City service levels in the future. One of the goals of the Fiscal Reform Plan is to restore services to January 1, 2011 levels and open facilities that were recently completed or were under construction (see *Appendix A* for Service Restorations Previously Identified by City Council (January 1, 2011 Levels)). As discussed at the August 7, 2012 City Council meeting (Item 3.5 Restoration of Selected General Fund Services to January 1, 2011 Levels) and the 2013-2014 Budget Planning Study Session held on February 11, 2013, it is important that the City take a holistic approach regarding the restoration of services as additional resources become available.

The Service Restoration Decision Making Framework and the City Council-approved Guiding Principles for Restoring City Service Levels (both included in *Appendix A)* provide the broader context that should be considered when analyzing potential service restorations. The Service Restoration Decision Making Framework provides a multi-pronged approach to restoring direct services to the community that takes into consideration various factors, including adequate strategic support resources, adequate infrastructure, service delivery method to ensure efficient and effective operations, service delivery goals and current performance status, service sustainability, and staffing resources. The Guiding Principles for Restoring City Service Levels, which were approved by the City Council as part of the Mayor's March Budget Message for Fiscal Year 2012-2013, provide a solid guide to help the City determine not only the appropriate service levels and most cost-effective method for service delivery, but also the critical areas for investment. The principles extend beyond the January 1, 2011 service restorations to include considerations such as infrastructure maintenance, technology improvements, and alternative service delivery models. These principles fall into three general categories: ensure the fiscal soundness of the City; choose investments that achieve significant outcomes; and improve the efficiency and effectiveness of service delivery.

When considering any additions to the budget, it is important to consider the overall City of San José Budget Principles (also included in *Appendix A*) that were initially developed as part of the General Fund Structural Deficit Elimination Plan work. These principles were approved as part of the City Council's approval of the Mayor's March Budget Message for Fiscal Year 2008-2009, and subsequently amended on September 9, 2008. These principles provide a meaningful framework for maintaining the financial discipline crucial to a large organization like the City of San José.

Incorporating Strategies into the 2013-2014 Budget Process

As noted above, the Administration proposes the use of the general budget balancing strategy guidelines outlined above in the 2013-2014 City Manager's Budget Request combined with the Service Restoration Decision Making Framework, the City Council-approved Guiding Principles for Restoring City Service Levels, and the overall City of San José Budget Principles to approach the 2013-2014 budget development process. In January 2013, the Administration directed the City departments to develop 2013-2014 budget proposals using a draft version of the 2013-2014

Budget Balancing Strategy Guidelines. For planning purposes, General Fund budget reduction targets were set at levels to generate approximately $20 million in General Fund proposals ($15 million from non-public safety departments and $5 million from public safety departments) to address a potential General Fund shortfall. While a much smaller shortfall is projected for 2013-2014 than originally anticipated, the budget balancing strategy guidelines and budget proposals generated from departments will still provide a good starting point for developing the 2013-2014 budget. The Administration will continue to pursue cost reductions and service delivery efficiencies that make sense, but does not anticipate any further direct service reductions in 2013-2014 consistent with the approach in 2012-2013.

As part of the 2013-2014 Mayor's March Budget Message, the Administration requests confirmation of the budget balancing guidelines, with any desired revisions. These guidelines incorporate both short-term and long-term approaches to budget balancing efforts and service level restoration and reflect the City's sound fiscal principles. City Council priorities and goals identified in prior policy sessions will also guide the City's budget balancing efforts. Input from the community through community surveys, various City Councilmember and stakeholder outreach activities, and the 2013-2014 San José Neighborhood Association/Youth Commission Priority Setting Session will also serve as an important tool in this process.

The Mayor is scheduled to issue a proposed March Budget Message on March 8, 2013, which will then be discussed, amended if necessary, and adopted by the City Council. The contents of that Message will provide specific guidance for the preparation of the City Manager's 2013-2014 Proposed Capital and Operating Budgets currently scheduled to be submitted on April 22, 2013 and May 1, 2013, respectively. As required by City Charter, those Proposed Budgets will contain comprehensive plans for how the City organization will address the highest priority needs of the community while maintaining the fiscal integrity of the City.

After the release of the Proposed Budgets, there will be a series of Proposed Budget Study Sessions and Public Hearings to discuss the budget proposals and the associated impacts on performance measures and service delivery. The Administration will also work with the City Council to provide informational meetings on the Proposed Budget in each City Council District in April and May 2013. Additional input by the City Council and community will be incorporated into the budget through these Proposed Budget Study Sessions, Public Hearings, and the Mayor's June Budget Message during the months of May and June 2013.

2014-2018 FIVE-YEAR FORECAST AND REVENUE PROJECTIONS

The 2014-2018 Five-Year Forecast and Revenue Projections portion of this document is divided into five sections.

1. **Elements of the General Fund Forecast** – This section begins with a description of the overall economic outlook and the expected performance of the economy over the five-year period, followed by detailed descriptions of the assumptions made concerning each of the General Fund revenue and expenditure categories. The Elements of the General Fund Forecast section ends with information regarding the projected General Fund operating margin for each of the five years included in the forecast period.

2. **Base General Fund Forecast** – The forecast model is presented in this section. It includes projections for each of the General Fund revenue and expenditure categories. The expenditure summary is divided into two sections:

   - *Base Case without Committed Additions* – This section describes projections associated with existing expenditures only.
   - *Base Case with Committed Additions* – This section describes the existing expenditures (Base Case) along with those expenditures to which the City is committed by previous City Council direction and has less discretion, such as maintenance and operating costs for capital projects scheduled to come on-line during the next five years.

   The Five-Year Forecast discussion is based on the Base Case with Committed Additions scenario, which is considered the most likely scenario for the upcoming year.

3. **Committed Additions to the Base General Fund Forecast** – This section describes the committed additions per previous City Council direction considered in the Forecast, including the financial impact in each year of the Five-Year Forecast. This section also includes a discussion of Budget Principle #8, which pertains to capital projects with General Fund operating and maintenance costs in excess of $100,000.

4. **Alternative Forecast Scenarios** – Because all forecasts are burdened with a large degree of uncertainty, two plausible alternative forecast scenarios are presented – an Optimistic Case and a Pessimistic Case that modify revenue assumptions. These cases are compared with the Base Case, with committed additions, to show the range of growth rates for revenues and the associated operating margins.

5. **Capital Revenue Forecast** – This section describes the estimates for construction and real estate related revenues that are major sources of funding for the City's Five-Year Capital Improvement Program.

6. **Appendices** – Three appendices are also included in this document. *Appendix A* includes the following: 2012-2013 Adopted Budget One-Time Funded Proposals; Service Restorations Previously Identified by City Council (January 1, 2011 Levels); the Service Restoration Decision Making Framework; the City-Council-approved Guiding Principles for Restoring City Service Levels; and the overall City-Council-approved City of San José Budget Principles. *Appendix B* provides descriptions of the City's major General Fund revenue categories. *Appendix C*, prepared by the Planning, Building and Code Enforcement Department, documents the basis for that department's five-year projections for construction activity.

2014-2018 General Fund Forecast

The following table displays the projected General Fund revenues and expenditures over the next five years and the total cumulative shortfall. In addition to the cumulative shortfall, the incremental shortfall or surplus (assuming each preceding shortfall or surplus is addressed completely with ongoing solutions in the year it appears) for each year of the forecast is included. Because it is the City's goal to remain in balance on an ongoing basis, the incremental figure is useful in that it shows the additional shortfall and/or surplus attributed to a particular fiscal year. To the extent that a shortfall is not resolved or a surplus is not expended on an ongoing basis, it is important to understand that the remaining budget gap or surplus will carry over to the following year.

2014-2018 General Fund Five-Year Forecast
($ in Millions)

	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018
Projected Revenues	$852.7	$873.9	$899.7	$930.5	$963.3
Projected Expenditures	$858.2	$893.1	$916.8	$952.4	$991.2
Total Cumulative Surplus/(Shortfall)	($5.5)	($19.2)	($17.1)	($21.9)	($27.9)
Total Incremental Surplus/(Shortfall)	**($5.5)**	**($13.7)**	**$2.0**	**($4.7)**	**($6.0)**

Note: Does not incorporate impacts associated with elements of the Fiscal Reform Plan that are not yet implemented; Tax Increment funding for the Successor Agency to the Redevelopment Agency, a public entity, regarding the outcome of litigation with the County of Santa Clara related to the PERS Levy; costs associated with fully funding the annual required contributions for police and fire retiree healthcare; costs associated with services funded on a one-time basis in 2012-2013; costs associated with restoration of key services to January 1, 2011 levels; costs associated with unmet/deferred infrastructure and maintenance needs; or one-time revenues/expenses.

Assumes that the Police and Fire Retirement Plan Board will approve the elimination of the Supplemental Retiree Benefit Reserve (SRBR) for the 2013-2014 City retirement contribution amount and rates; and includes an Employee Compensation Planning Reserve, which totals $11.1 million in 2013-2014. Without that Reserve, a surplus of $5.6 million is projected for 2013-2014, and surpluses would be generated in all years but 2014-2015.

In the 2014-2018 Forecast, small incremental General Fund shortfalls are anticipated for four of the five years. Similar to last year, overall revenue growth is close to the expenditure growth over the forecast period, with an annual variance of less than 1% of the budget (revenues and expenditures). However, as stated previously, there are significant expenditure components that are not incorporated into the Forecast. The Forecast also does not reflect the Fiscal Reform Plan cost reduction and revenue generation strategies that have not yet been implemented.

Given the decreasing level of precision to be expected in the later years of a multi-year forecast, the significance of the projections in the out years is not so much in terms of their absolute amounts, but rather in the relative size of the decrease or increase from the prior year. This information should be used to provide a multi-year perspective to budgetary decision-making, rather than as a precise prediction of what will occur.

The 2013-2014 projected shortfall of $5.5 million reflects an improvement from the $22.5 million budget shortfall projected for 2013-2014 in the February 2012 Five-Year Forecast. Some of the major drivers of the reduction to the projected shortfall include actions taken in the 2012-2013 Adopted Budget and the implementation of fiscal reforms. In the 2012-2013 Adopted Budget, $9.0 million of ongoing funds were not allocated in 2012-2013 in order to address a portion of the projected deficit in 2013-2014. In addition, changes to the retirement plans such as the elimination of the SRBR (approved for the Federated Retirement System and pending final approval for the Police and Fire Department Retirement Plan) and the implementation of a low cost health plan reduced costs for 2013-2014. Partially offsetting these factors is the inclusion of funding in the Employee Compensation Planning Reserve for modest compensation increases. This reserve allocation, representing only a modest amount of funding, would require City Council labor negotiations direction and discussions with the City's bargaining groups before any form of distribution could be made. How this allocation would be applied, if it remains funded, has not been determined.

When reconciling next year's Forecast to the 2012-2013 Adopted Budget, the projected shortfall of $5.5 million for 2013-2014 is the result of the following: the carryover of unexpended ongoing funds from the 2012-2013 Adopted Budget of $9.0 million, improved revenues of $21.7 million, offset by increased costs of $36.2 million. As discussed previously, a new expenditure component added to this Forecast is the Employee Compensation Planning Reserve of $11.1 million, which allows for modest compensation increases. Without this expenditure component, there would be a projected surplus of $5.6 million. In recommending the Employee Compensation Planning Reserve, the Administration is also recommending to resolve the $5.5 million shortfall and thus balance the budget through means that would not reduce services to the Community. Following is addition detail on the projected changes to General Fund revenues and expenditures.

General Fund revenues are estimated to improve $21.7 million when compared to the ongoing revenue performance assumed in the 2012-2013 Adopted Budget. Revenue performance in 2012-2013 continues to reflect moderate growth and is estimated to at least meet current budgeted levels. Revenue categories that have improved year-over-year include: Sales Tax to reflect improved growth rates ($14.0 million); Overhead Reimbursements based on the revised overhead rates and the personal services costs to which the rates are applied ($4.3 million); Property Tax based on the most recent information provided by the County of Santa Clara ($3.7 million); Transient Occupancy Tax receipts based on current year activity levels ($1.9 million); and miscellaneous categories that have experienced a net decrease based on actual collections experience ($2.1 million).

On the expenditure side, several upward and downward adjustments have been incorporated into this Forecast resulting in a net increase of $36.2 million in 2013-2014. The most significant expenditure changes are the following: increase in retirement contributions based on rates provided by the Retirement Boards ($18.1 million); 2013-2014 Committed Additions ($3.9 million), the most significant of which are expenditures related to the opening of the South San José Police Substation in January 2014 and the annualization of operating costs of four branch libraries scheduled for opening in 2012-2013; healthcare and dental cost increases ($3.3 million); non-management step increases/management pay-for-performance ($3.1 million); increases for workers' compensation claims ($2.3 million); a decreases in the transfer to the Successor Agency to the Redevelopment Agency ($2.3 million); debt service and capital projects funding shifts to Capital Funds ($2.6 million); and other net expenditure decreases ($0.7 million). In addition, an increase related to the establishment of an Employee Compensation Planning Reserve ($11.1 million) is included to account for this funding need.

Given the severity of the projected General Fund budget shortfalls, starting in 2009-2010, employee compensation increases were not incorporated into the City's budget planning. Rather, during this period, it was necessary to implement salary freezes and reduce total employee compensation. Moving forward, it is important to recognize that a meaningful long-term fiscal planning strategy needs to incorporate some level of employee compensation adjustments within the City's ability to afford them. Due to the improvement in the City's budget position, there is less than a 1% variance between revenues and expenditures in all years of the Forecast. Given these very small budget gaps, the inclusion of this cost component should not result in service reductions and/or eliminations in the General Fund.

It is important to note that the Development Fee Programs (Building, Fire, Planning, and Public Works) are designed to be 100% cost recovery and have been programmed to have a neutral impact on the Forecast by adjusting the revenue and costs to be equal. In the Fire and Public Works Fee Programs, revenues are sufficient to cover the Base Budget costs. In the Planning and Building Fee Programs, however, small budget gaps are currently projected for 2013-2014. Sufficient Fee Program Reserves are available in each of these programs to address these small variances and have been programmed into the Forecast.

City Retirement Contributions

Given the major impact of retirement costs on the City's budget in recent years, detailed information is provided on the retirement projections incorporated into this Forecast. Overall, the City Retirement contribution costs are determined by the two Retirement Boards as guided by actuarial recommendations and take into account overall benefit levels, the funding status of each retirement plan, and economic and demographic assumptions. The retirement costs in this Forecast assume the pre-payment of the annual required City contribution for the Federated Retirement System Tier 1 plan and the Police and Fire Department Retirement Plan. As detailed in the table below, General Fund retirement contributions are projected to increase by $24.4 million, or 13.0%, from 2012-2013 to 2013-2014 (by $29.9 million, or 12.2%, in all funds). Over the Forecast period, the General Fund retirement contributions are estimated to increase by $45.1 million, or 21.3% from $211.5 million in 2013-2014 to $256.6 million in 2017-2018. During the same period, the City retirement contribution for all funds will increase by $53.8 million, or 19.5%, from $275.8 million in 2013-2014 to $329.6 million in 2017-2018. Similarly, the budgetary retirement contribution rates show significant increases for the Federated Retirement System Tier 1 plan and the Police and Fire Department Retirement Plan. For the Federated Retirement System Tier 1 Plan, the budgetary retirement contribution rate increases from 60.6% in 2013-2014 to 77.1% in 2017-2018; for the Federated Retirement System Tier 2 Plan, the budgetary contribution rate increases only slightly from 18.6% in 2013-2014 to 18.9% in 2017-2018; for the Police Retirement Plan the budgetary retirement contribution rate increases from 73.0% in 2013-2014 to 79.7% in 2017-2018; and for the Fire Retirement Plan, the budgetary retirement contribution rate increases from 72.2% in 2013-2014 to 81.1% in 2017-2018. It should be noted that retirement contribution costs and rates for the Police and Fire Retirement Plans do not reflect full funding of the annual required contribution for retiree healthcare and that a Tier 2 Plan for Police and Fire has not yet been agreed to by those bargaining units.

2014-2018 City Retirement Contribution Costs
And Budgetary City Retirement Contribution Rates
($ in Millions)

Retirement Plan	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018
Fed. Ret. System Tier 1 – Pension	$56.5	$55.6	$58.5	$59.1	$60.4	$62.9
Fed. Ret. Syst. Tier 1 – Ret. Healthcare	10.0	13.1	12.7	12.4	11.9	11.3
Fed. Retirement Plan Tier 1 - Total	**$66.5**	**$68.7**	**$71.2**	**$71.5**	**$72.3**	**$74.2**
Budgetary Contribution Rates	*50.5%*	*60.6%*	*65.9%*	*68.1%*	*71.6%*	*77.1%*
Fed. Ret. System Tier 2 – Pension	N/A	$1.5	$1.5	$2.0	$2.5	$3.1
Fed. Ret. Syst. Tier 2 – Ret. Healthcare	N/A	2.6	2.7	3.6	4.6	5.7
Fed. Retirement Plan Tier 2 - Total	N/A	**$4.1**	**$4.2**	**$5.6**	**$7.1**	**$8.8**
Budgetary Contribution Rates	N/A	*18.6%*	*18.9%*	*18.9%*	*18.9%*	*18.9%*
Police Retirement Plan – Pension	$66.3	$74.3	$82.0	$83.1	$86.5	$92.2
Police Ret. Plan – Retiree Healthcare	10.5	11.8	12.9	13.2	13.7	14.2
Police Retirement Plan – Total	**$76.8**	**$86.1**	**$94.9**	**$96.3**	**$100.2**	**$106.4**
Budgetary Contribution Rates	*65.7%*	*73.0%*	*78.3%*	*77.3%*	*77.6%*	*79.7%*
Fire Retirement Plan – Pension	$38.9	$46.5	$51.1	$52.1	$54.3	$57.9
Fire Ret. Plan – Retiree Healthcare	4.4	5.5	6.7	7.9	8.4	8.7
Fire Retirement Plan - Total	**$43.3**	**$52.0**	**$57.8**	**$60.0**	**$62.7**	**$66.6**
Budgetary Contribution Rates	*64.0%*	*72.2%*	*78.0%*	*78.4%*	*79.1%*	*81.1%*
Other Retirement Costs	$0.5	$0.6	$0.6	$0.6	$0.6	$0.6
Total General Fund	**$187.1**	**$211.5**	**$228.7**	**$234.0**	**$242.9**	**$256.6**
Total All Funds	**$245.9**	**$275.8**	**$295.1**	**$301.6**	**$312.6**	**$329.6**

Source: 2012-2013 Modified Budget; Cheiron Letters dated January 9, 2013, January 30, 2013, and January 31, 2013 with applied pre-payment discount for Federated Retirement System Tier 1, the Police Retirement Plan, and the Fire Retirement Plan.

In June 2012, the voters approved Measure B, which included the elimination of the SRBR. On December 4, 2012, the City Council approved an ordinance change, which eliminated the SRBR for the Federated Retirement System. On January 29, 2013, the City Council approved an ordinance change, which eliminated the SRBR for the Police and Fire Department Retirement Plan. The SRBR in the respective retirement plans provided for supplemental benefits to retirees which were derived from plan "excess" earnings. When the plans' actual investment returns exceeded the expected returns, a portion of these "excess" returns was transferred into the SRBR for later distribution as a supplemental benefit. This transfer also took place even when the plans were underfunded. Through the elimination of the SRBRs, the City's contribution amount and rate were reduced by a total of $13.4 million in the General Fund and $17.8 million in all funds. It should be noted, though, that the reduction of the City's annual required contribution (ARC) for 2013-2014 due to the City Council's elimination of the SRBR for the Police and Fire Department Retirement Plan is pending approval of the Police and Fire Department Retirement Board. This Forecast assumes that the Board will approve the reduction of the City's 2013-2014 ARC in the amount of $8.6 million due to the elimination of the SRBR.

In June 2012, the City Council approved a low cost/high deductible healthcare plan for employees and retirees effective December 23, 2012. Additionally, effective July 1, 2012, Federated Retirement System members are required to enroll in Medicare A and B supplemental plans at the age of 65. These changes significantly reduced the Federated Retirement System Retiree Healthcare contributions for the City and employees.

With the aforementioned healthcare plan modifications, the 2013-2014 Cheiron projected City and employees combined Federated Retirement System retiree healthcare rate in this Forecast reflects a significant reduction to the 2013-2014 contribution rate that had been included in the February 2012 Forecast. For the City, the 2013-2014 Cheiron projected contribution rate decreased by 4.9 percentage points from 16.8% to 11.9% resulting in a decrease of $6.5 million in the General Fund ($12.5 million all funds).

In 2009, the City and Federated bargaining units reached an agreement to begin a five-year phase-in to fully fund the annual required contribution for retiree healthcare benefits. The last year of the phase-in was 2012-2013 (with a contribution rate of 7.69% for employees and 7.9% for the City) with the full funding of the ARC starting with 2013-2014 (with a contribution rate of 10.74% for employees and 11.93% for the City). It is important to note that in December, as part of ongoing retiree healthcare negotiations, the Administration made a proposal to the Federated Retirement System bargaining groups that included a continuation of the phase-in of the Retiree Healthcare contribution rates because of the significant increase in the contribution rates from 2012-2013 to 2013-2014. If an agreement is reached on that proposal, a further reduction to both the employees' and City retiree healthcare contribution rates for 2013-2014 is anticipated.

Similarly, due to City Council approval of a low cost/high deductible healthcare plan for employees and retirees and Medicare A and B supplemental plans, the Police and Fire Department Retirement Plan's unfunded liability offset by the reduction in the interest earnings assumption for this plan from 7.5% to 7.25% was reduced. This would result in a lowering of the City's and employees' contribution rates, if the annual required contribution for Retiree Healthcare were fully funded. However, per the Memoranda of Agreements (MOAs) with the San Jose Police Officers' Association and the San José Fire Fighters, IAFF Local 230, the City and employee retiree healthcare contribution percentage has a limit which, if reached, results in the meet and confer process. Per Cheiron, the Board's actuary, in order to fully fund the annual retirement contribution for police and fire retiree healthcare benefits, the City's annual contribution would be in excess of the current limit of the percentage contribution of 11%.

In the four out years of the General Fund Forecast, retirement costs (pension and retiree healthcare) remain a major cost driver, although the escalation of costs is less than just two years ago. As part of the February 2011 Five-Year General Fund Forecast, the then projected costs for 2015-2016 were estimated at $400.7 for all funds. For this Five-Year General Fund Forecast, the retirement costs for 2015-2016 are projected to be approximately $301.6 million for all funds. The significant reduction of retirement costs is primarily due to a combination of factors such as the Retirement Boards' actuaries adjustment of pensionable payroll reflective of the ongoing 10% total compensation reductions for all employee groups and the reduction of over 1,000 positions as part of the 2010-2011 and 2011-2012 Adopted Budgets, the elimination of the

SRBR, the implementation of the low cost/high deductible plan, offset by a lowering of the plans' interest earnings assumptions.

General Fund Committed Additions

Cost estimates for a number of specific "Committed Additions" that address previous City Council direction are included in this Forecast in the years that they are projected to be required. The Committed Additions category, summarized in the chart below, reflects projected additional operating and maintenance costs for new or renovated capital projects in the 2013-2017 Adopted Capital Improvement Program or for projects approved by the City Council during 2012-2013. The costs of the additions total $2.0 million in 2013-2014 and increase to approximately $7.7 million by the end of the Forecast period.

2014-2018 General Fund Committed Additions

	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018
New Parks and Recreation Facilities Maintenance & Operations	$51,000	$331,000	$560,000	$795,000	$862,000
New Police Maintenance & Operations	336,000	399,000	413,000	326,000	340,000
New Traffic Infrastructure Assets Maintenance & Operations	31,000	56,000	83,000	108,000	136,000
Measure O (Library) Maintenance & Operations	0	0	648,000	725,000	742,000
Measure P (Parks) Maintenance & Operations	0	0	50,000	87,000	81,000
Measure O (Public Safety) Maintenance & Operations: Fire	0	8,000	24,000	3,026,000	3,146,000
Measure O (Public Safety) Maintenance & Operations: Police	1,616,000	2,253,000	2,303,000	2,355,000	2,405,000
Total	$2,034,000	$3,047,000	$4,081,000	$7,422,000	$7,712,000

Some of the larger facilities expected to come on-line during this forecast period include: the South San José Police Substation, Southeast Branch Library, Softball Complex, and Fire Station 37 (South Willow Glen). A detailed listing of all capital project operating and maintenance costs included in this 2014-2018 General Fund Forecast can be found in the Committed Additions Section of this document.

General Fund Capital Operating and Maintenance Costs/Budget Principle #8

General Fund Capital Operating and Maintenance/Budget Principle #8 requires City Council certification that funding will be made available in the General Fund for capital projects with an estimated operating budget impact greater than $100,000 at the time of taking beneficial use of the facility or project. Capital projects with operating and maintenance costs over $100,000 and previously certified are included in the Capital Improvement Program and displayed in Chart A in Section III. Certification for potential new projects or modifications to existing projects identified after the release of this Forecast that have not been approved by the City Council may be recommended for certification as part of the 2014-2018 Proposed Capital Improvement Program. If certified by the City Council, the operating and maintenance costs associated with these facilities would then be included in subsequent General Fund Five-Year Forecast documents.

Alternative Forecast Scenarios

In order to model the range of budgetary scenarios possible under varying economic conditions, two alternative forecasts have been developed in addition to the "Base Case." "Optimistic" and "Pessimistic" cases have been created to model economic scenarios considered possible, but less likely to occur than the "Base Case." These alternatives are presented to provide a framework that gives perspective to the Base Case. The Base Case Forecast is still considered, however, the most likely scenario and is being used for planning purposes for the 2013-2014 Proposed Operating Budget. It should be noted that the expenditure assumptions remain constant in each of these alternative scenarios.

The Base Case Forecast is built on the assumption of a continued slow recovery from the deep global recession on a national level and a dampening of overall growth due to budgetary pressures at the federal level. At the local level, positive near term growth is expected to continue in the Silicon Valley as a result of the continued strength in the technology industry. Local employment levels are expected to continue to experience moderate growth and the unemployment rate is expected to continue to decrease and ultimately remain around historical normal levels. Home values are anticipated to continue to improve over the five years. In the Base Case Forecast, General Fund revenue collections are anticipated to experience moderate growth over the forecast period.

The Optimistic Case assumes a much faster and more robust recovery than currently anticipated. When compared to the Base Case scenario, the real estate market improves significantly with increases not only in the price of housing, but also the volume of homes sales, out pacing the growth rates assumed in the Base Case. This housing market recovery would also drive growth in employment levels. This vigorous recovery results in increased collections in the economically sensitive revenue categories, such as Property Tax, Sales Tax, and Transient Occupancy Tax. In the Optimistic Case, the City would experience small shortfalls of $755,000 and $7.1 million in the first two years of the Forecast, followed by surpluses in the last three years ranging from $5.8 million to $14.0 million.

The Pessimistic Case assumes that a combination of adverse factors interact to impede the moderate recovery underlying the Base Case and continue a sluggish recovery. Under this scenario, looming impacts in the world economy in areas such as Europe, Japan, and China are anticipated to ripple through to the U.S. economy at a national level as well as at the State and local levels. Housing prices are anticipated to fall both locally and nationally as the Federal Reserve monetary and fiscal policies result in higher inflation, which in turn, results in higher mortgage rates. Higher mortgage rates would negatively impact both home sales and prices. In this scenario, the City's revenues, particularly Property Tax and Sales Tax, would be impacted by an economic slowdown. In the Pessimistic Case, the City would experience shortfalls in all years of the Forecast ranging from $11.6 million to $24.4 million.

Capital Revenue Forecast

Section V of this report describes the Capital Revenue Forecast that will be used to develop several major elements of the 2013-2014 Capital Budget and the 2014-2018 Capital Improvement Program (CIP). As in past years, the construction-related revenue estimates included in this report are derived from construction activity projections provided by the Planning, Building and Code Enforcement (PBCE) Department and an analysis of actual collection patterns. The projections and their basis are described in a report prepared by the PBCE Department, which is included as *Appendix C* of this document (Development Activity Highlights and Five-Year Forecast [2014-2018]). This activity forecast includes a review of specific projects that are in progress as well as a general prediction of expected levels of new construction.

The following table compares the estimates for the economically sensitive capital revenue categories included in this Five-Year Forecast with those included in the 2013-2017 Adopted CIP. As shown below, higher collections are projected in all revenue categories. Based on improved real estate activity, construction activity estimates, and a review of revenue collection patterns, a significant increase in these taxes and fees of $51.7 million, or 23%, is expected when comparing the 2014-2018 Forecast to the 2013-2017 Adopted CIP estimates.

Capital Revenue Forecast Comparison Summary
($ in Thousands)

	2013-2017 CIP	2014-2018 Forecast	Difference	% Change
Construction and Conveyance Tax	$109,000	$150,000	$41,000	38%
Building and Structure Construction Tax	50,000	55,000	5,000	10%
Construction Excise Tax	65,000	70,000	5,000	8%
Municipal Water System Fees	750	750	0	0%
Residential Construction Tax	500	925	425	85%
Sanitary Sewer Connection Fee	3,000	3,250	250	8%
Storm Drainage Connection Fee	700	750	50	7%
TOTAL	**$228,950**	**$280,675**	**$51,725**	**23%**

Real estate activity (primarily housing resales) determines the collection level of one of the major capital revenue sources, the Construction and Conveyance Tax. As the housing market shows continued improvement from the sharp declines experienced after the collapse of the financial market, action was taken as part of the 2012-2013 Mid-Year Budget Review to increase the 2012-2013 Construction and Conveyance Tax revenue estimate from $21.0 million to $30.0 million based on actual collections. This category is projected to generate $150 million over the next five years, which is 38% higher than the estimates assumed in the 2013-2017 Adopted Capital Improvement Program. However, the average annual collection level is still well below the actual collection levels in the mid-2000's that reached a peak of $49 million in 2005-2006.

The remaining economically sensitive capital revenue categories are directly linked to private development activity. Based on projections provided by the Planning, Building and Code

Enforcement Department, construction activity valuation is projected to continue at slightly lower levels than experienced last year: $800 million for 2012-2013, or an 11% decrease compared to $894 million in 2011-2012. This level of activity is expected to drop to $775 million in 2013-2014 and 2014-2015, and then drop slightly again to $750 million for 2016-2017 and 2017-2018. These assumptions show a slight improvement of 12% or $425 million from the levels presented in the 2013-2017 Forecast ($675 million in 2012-2013 through 2014-2015 and increased to $700 million in 2015-2016 and 2016-2017). For the largest categories, modest revenue increases are projected, including a 10% ($5 million) increase to the Building and Structure Construction Tax and an 8% ($5 million) increase to the Construction Excise Tax, due primarily to expected residential multi-family housing developments in North San José.

Fiscal Reform Plan Update

In May 2011, the City Council approved the Fiscal Reform Plan, which contained various cost savings/avoidance and revenue strategies to achieve $216 million in General Fund savings by 2015-2016. The table below provides an update, or score card, for these strategies by identifying the amount of General Fund savings for the fiscal year it was implemented or specific notes regarding the implementation status. For strategies that are not yet implemented, the potential cost savings/avoidance amount or the anticipated revenue amount for the respective fiscal year are depicted below. Please note that the lowering of the retiree pension cost-of-living adjustment from 3% to 1% is not included as the voter approved ballot measure would require a declaration of fiscal and service level emergency.

Fiscal Reform Plan - General Fund Scorecard
($ in Millions)

	Implement. Status	Not Yet Implemented 2013-2014	2014-2015	2015-2016	2016-2017	Total
Cost Reduction Strategies						
10% Total Compensation Reduction	Net $39.6M (2011-2012)					
Workers' Compensation Reform	(1)					TBD
Additional Retirement Contribution (or Opt-In)		$12.0M	$12.0M	$12.1M	$12.1M	$48.2M
Supplemental Retiree Benefit Reserve Elimination	$13.4M (2013-2014)					
Retiree Healthcare Modifications (2)	$6.5M (2013-2014)					
Tier 2 – Federated Ret. System	(3)					
Tier 3 for Unit 99 – Defined Contribution Plan	(4)					
Sick Leave Payments Upon Retirement ($6.0M)	(5)					TBD
Overtime ($1.2M)	(6)					TBD
Organ. Changes/ Efficiencies	(7)					
Subtotal Cost Red. Strategies	***$59.5M***	***$12.0M***	***$12.0M***	***$12.1M***	***$12.1M***	***$48.2M***
Revenue Strategies						
Sales Tax (1/4% - 1/2%)			$9.2M - $18.4M	$27.7M- $55.4M		$36.9M- $73.8M
Business Tax Modernization ($10.0M)						TBD
Disposal Facility Tax/Munic. Water System Tax ($7.5M)						TBD
Subtotal Revenue Strategies			***$9.2M- $18.4M***	***$27.7M- $55.4M***		***$36.9M- $73.8M***
TOTAL	**$59.5M**	**$12.0M**	**$21.2M- $30.4M**	**$39.8M- $67.5M**	**$12.1M**	**$85.1M- $122.0M**

(1) Workers' Compensation Reform includes implementation of the workers' compensation offset as part of Measure B (not yet implemented) and the Workers' Compensation Pilot Program (in progress).

(2) These savings due to the retiree healthcare modifications only include savings for non-sworn employees. Per the Memoranda of Agreements with SJPOA and IAFF, Local 230, the City and employees' retiree healthcare contributions are capped at 11.0% and 10.0%, respectively.

(3) The Tier 2 plan for non-sworn employee groups became effective on September 30, 2012. A Tier 2 Plan for Police and Fire has not yet been agreed to by those bargaining units.

(4) The Tier 3 plan for new employees in Unit 99 is effective on February 4, 2013.

(5) Sick Leave Payments Upon Retirement were eliminated for MEF, CEO, IBEW, OE#3 and for new employees for non-sworn employee groups effective September 30, 2012 (tentative with ALP).

(6) Elimination of overtime pay for management employees (Police Captain, Battalion Chief, and maintenance supervisory positions) requires negotiation with affected Bargaining Groups (SJPOA; IAFF, Local 230; AMSP).

(7) As part of the annual budget process, during the last three years, departments and services were consolidated (e.g., Public Works and General Services), lower cost service models were put in place (e.g., Police sworn civilianization and Parks Maintenance), services were outsourced (e.g., custodial, graffiti eradication, and in-state prisoner transport services), and technologies were implemented in order to gain efficiencies and reduce costs.

Next Steps in the 2013-2014 Budget Process

The next major steps in the budget development process include the following:

March 2013

- 2013-2014 Mayor's March Budget Message Released with Public Hearing; Amended/Approved by City Council

April 2013

- 2013-2014 Proposed Capital Budget and 2014-2018 Capital Improvement Program Released

April-May 2013

- Community Budget Meetings in Each City Council District

May 2013

- 2013-2014 Proposed Operating Budget and 2013-2014 Proposed Fees and Charges Released
- City Council Study Sessions and Initial Public Hearing on 2013-2014 Proposed Operating Budget, 2014-2018 Proposed Capital Budget and Capital Improvement Program, and 2013-2014 Proposed Fees and Charges

June 2013

- 2013-2014 Mayor's June Budget Message Released with Final Public Hearing; Amended/Approved by City Council
- 2013-2014 Operating Budget, 2013-2014 Capital Budget and 2014-2018 Capital Improvement Program, and 2013-2014 Fees and Charges adopted by City Council

CONCLUSION

This document compares the projected revenues and expenditures for the General Fund over the next five years as well as provides estimates for some of the key revenues that support the City's Capital Improvement Program. In 2013-2014, a small General Fund shortfall of $5.5 million is projected, which the Administration seeks to balance without service reductions or eliminations. In the remaining years of the Forecast, small General Fund shortfalls and a surplus ranging from -$13.7 million to $2.0 million annually are projected. These margins are very narrow when put into context of the size of the projected General Fund budget, ranging from -0.8% to 0.1% of the projected annual budget (revenues and expenditures).

As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document and it is important to keep in mind that this Forecast does not reflect several elements that would impact the General Fund over the Forecast period, including: 1) impacts associated with the implementation of the remaining elements of the Fiscal Reform Plan (cost savings, such as retirement reform, and additional revenues); 2) outcome of the PERS Levy litigation with the County of Santa Clara; 3) costs associated with fully funding the annual required contributions for police and fire retiree healthcare; 4) costs associated with services that were funded on a one-time basis in 2012-2013; 5) costs associated with the restoration of key services to January 1, 2011 levels; 6) costs associated with unmet/deferred infrastructure and maintenance needs; and 7) one time revenue sources or expenditure needs. This Forecast also does not factor in the impacts associated with the sunsetting of the Library Parcel Tax in 2014, which is budgeted in a special fund.

The revenue and expenditure projections for 2013-2014 will continue to be refined over the next several months as additional information becomes available. This is particularly important in the areas of Sales Tax and Property Tax. Sales Tax data for the second quarter of 2012-2013, which covers the 2012 holiday period, will be received in March 2013. Based on this additional data, any necessary adjustments will be incorporated into the 2013-2014 Proposed Operating Budget. Similarly, as additional Property Tax data becomes available, it may be necessary to adjust the 2013-2014 revenue estimates.

This document also provides the recommended 2013-2014 City Manager's Budget Request (Budget Balancing Strategy Guidelines) for consideration by the City Council as part of its review of the Mayor's March Budget Message. With a projected shortfall of less than 1% of the budget, the Administration does not anticipate major service changes this year. However, in order to balance the budget and create capacity to add resources in critical areas, the organization will continue to pursue additional revenues, more efficient and cost-effective ways to provide City services, potential restructuring opportunities, and reductions that do not impact direct service delivery.

Even though overall service levels are not at adequate levels for our community, the Administration continues to recommend aligning new ongoing service commitments with ongoing funds to support those additions, to the extent possible. Given the projected shortfall in the second year (2014-2015) of the Forecast of $13.7 million, it would also be prudent to consider a two-year strategy when developing the budget for 2013-2014. The 2013-2014 Future Deficit Reserve of $29.4 million, along with any additional one-time funds identified in the budget development process, provides the resources necessary to implement this two-year strategy and to address critical infrastructure and service delivery needs.

Although the margins are thin, this Forecast is a positive indicator, so far, that the hard work and difficult decisions and sacrifices that have been made over the past few years are paying off. Continued focus and commitment to strategies that will get the City to stable fiscal ground in order to rebuild services and our workforce is required.

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