

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Debra Figone

**SUBJECT: 2007-2008 MID-YEAR
BUDGET REVIEW REPORT**

DATE: January 29, 2008

RECOMMENDATIONS

1. Approval of the 2007-2008 Mid-Year Budget Review Report.
2. Adoption of related Appropriation Ordinance and Funding Sources Resolution amendments in various funds as detailed in Section III (Appropriation/Clean-Up Adjustment Actions) in the 2007-2008 Mid-Year Budget Review.
3. Approval of the addition of 2.5 positions in the Parks, Recreation and Neighborhood Services Department and the elimination of 6.0 positions in the Planning, Building and Code Enforcement Department as described in Section III of the 2007-2008 Mid-Year Review document.

OUTCOME

The Mid-Year Budget Review document is designed to provide an understanding of the City's financial condition during the first six months of 2007-2008. Approval of the budget actions included in the Mid-Year Budget Review will address current year funding needs, fund various grant-supported activities, and process technical adjustments and corrections.

EXECUTIVE SUMMARY

Through December, the City's overall finances remain sound, with revenues generally tracking at or slightly above estimated levels and expenditures remaining within budgeted levels. If current trends continue, it is anticipated that upward adjustments to various revenue categories will be possible by year-end. In addition, a number of departments are expected to end 2007-2008 with savings, as was the case in 2006-2007. The expenditure savings are the result of cost control measures, such as the hiring freeze, that have generated savings in recent years as well as the difficulty in filling vacant positions.

On an overall basis, it is anticipated that approximately \$25 million from a combination of excess revenue and expenditure savings will be available at the end of the fiscal year. This is consistent with the estimated Ending Fund Balance projections that were used in developing the 2009-2013 Preliminary General Fund Forecast that was issued in November 2007.

While the City's financial performance in the current year remains on track, the deteriorating economic conditions are expected to impact the City's revenues to a larger extent than anticipated when the Preliminary 2009-2013 General Fund Forecast was developed in November 2007. The revenue estimates for this year will be updated again as part of the final 2009-2013 General Fund Forecast and Revenue Projections document due to be released in February. This forecast will serve as the starting point for developing the revenue estimates for 2008-2009.

As has been the practice in recent years, Mid-Year Budget adjustments are recommended in the General Fund as well as a number of special and capital funds. These recommendations implement technical adjustments based on updated information and, in a limited number of instances, to address funding issues in the current year. Across all funds, the number of new projects for City Council consideration has been restricted to only those very few items that are critical, have their own funding source, or implement City Council direction. In general, new and ongoing funding requests are brought forward during the annual budget process to ensure that these items are being considered with all other City Council priorities and potential funding needs.

In the General Fund, proposed adjustments result in a net decrease of \$780,000 in both revenues and expenditures. This reflects an increase of \$1.9 million related to various grant and reimbursement-related expenditures, offset by a decrease of \$2.7 million to the Building and Public Works Development Fee Programs based on lower revenue collections in the current year. In addition, there are several net zero expenditure adjustments recommended, including actions to allocate reserve funding and to implement City Council direction. One of the largest adjustments includes the shift of \$1.1 million from the General Fund South San José Police Substation project to replenish the Future Capital Projects (FF&E) Reserve. Associated actions are recommended in the Public Safety Bond Fund to shift funding from the Public Art allocation to the South San José Police Substation project to ensure full funding of this project. A separate memorandum on the options to restore funding for public art at the Police Substation will be released and available for review as part of this Mid-Year Budget Review on the February 12th City Council Agenda. Budget actions are also recommended to add \$600,000 to the Comprehensive General Plan Update to address additional and increased costs for the Environmental Impact Report and Transportation elements. Other recommended actions include the use of the Officeholder Accounts Earmarked Reserve to fund new Council District Constituent Outreach appropriations. A no cost item is proposed to add 1.5 positions to form a Volunteer Coordination Unit to support and enhance parks maintenance efforts. This pilot program is expected to increase involvement in volunteer services and would be funded by the existing Public-Private Parks Maintenance Partnership appropriation.

BACKGROUND

The annual adopted budget is a financial plan predicated on the best information available at the time it is prepared. As with any budget, however, changing conditions may create the need to modify the original plan. Through its budget policies, the City Council has, therefore, designated mid-year as the appropriate time to perform a comprehensive review of the current year's budget, and the Mid-Year Budget Review as the appropriate vehicle for consideration of

any revisions to the budget. In compliance with that process and the adopted budget schedule, this document is hereby presented to Council. It contains a comprehensive review of the status of the City's 2007-2008 Capital and Operating budgets. This review, although concentrating heavily on the status of the General Fund, also provides information of several operating and capital funds. City Council review of this report is agendaized for the February 12, 2008 Council meeting.

The Mid-Year Review document includes the following sections:

- **Transmittal Memorandum** – An overall summary of the contents of the Mid-Year Budget Review Report.
- **Section I: Operating Budget Status Report** – A review of the General Fund revenues and expenditures through Mid-Year and a review of selected special funds that have revenue and/or expenditure variances from the modified budget or other issues of interest.
- **Section II: Capital Budget Programs Status Report** – A review of the financial status of each Capital Budget Program.
- **Section III: Budget Augmentations/Reductions and Clean-up Adjustments** – A summary of the proposed budget augmentations/reductions in the General Fund and special/capital funds. A summary of clean-up adjustments in a number of funds is also included to provide technical appropriation and revenue estimate adjustments.
- **Section IV: Appendices** – Financial results, prepared by the Finance Department, for all budgeted fund groups for the first six months of the year.

ANALYSIS

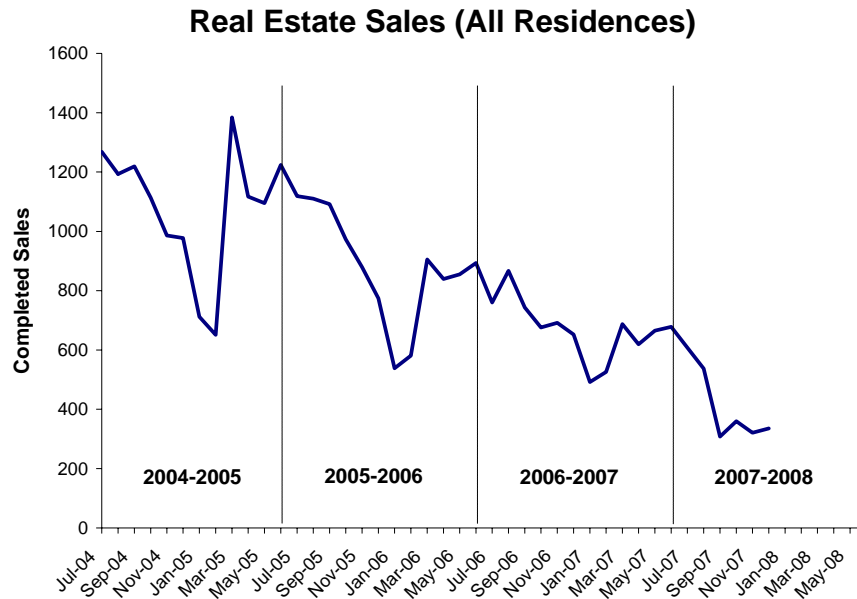
The Analysis section includes the following: an overview of the current economic environment; a discussion of General Fund performance through December; a summary of proposed General Fund budget revisions included in the Mid-Year Budget Review document; the status of selected special funds; and an overview of capital budget programs.

THE CITY AND THE ECONOMIC ENVIRONMENT

When the 2007-2008 Adopted Budget was prepared, it was assumed that only modest economic growth would be experienced during the fiscal year. It was also assumed that the impacts of the slowing housing market would continue to hamper growth in this region, along with the State and the nation.

As expected, the economic indicators through the first half of the fiscal year, particularly the housing-related ones, were not positive. As the year has progressed, however, the economic news has gotten progressively worse, with increasing volatility in the stock market, continued fallout from the sub-prime mortgage crisis, the weakness in the dollar, and an increasing number of economists pointing to the likelihood of a recession.

As shown in the following chart, the number of housing sales in San José dropped significantly in 2006-2007 and is continuing to fall with a 44% decline through December of this fiscal year.

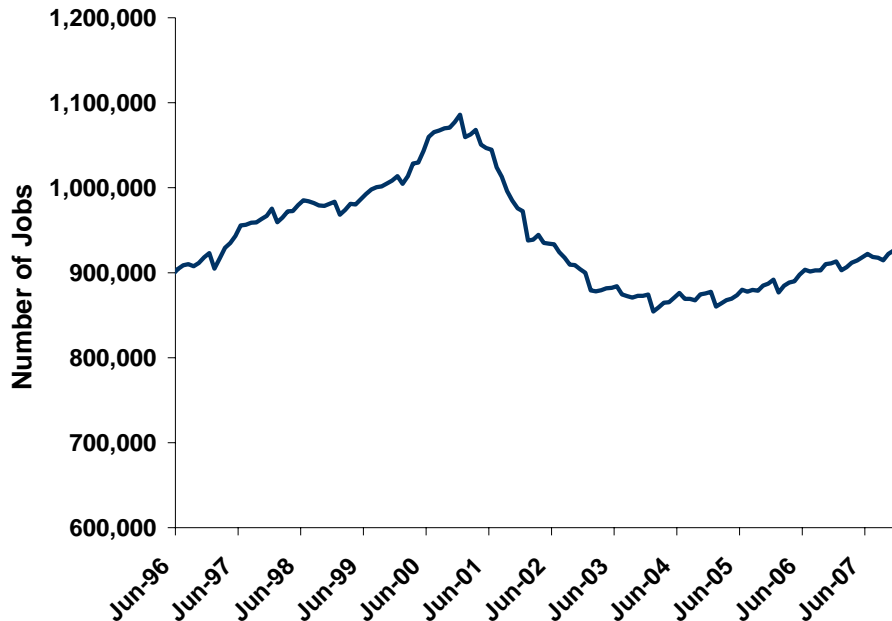


It is expected that the housing market will continue to experience weak performance through 2007-2008 and into next fiscal year. This will most directly impact Construction and Conveyance Tax receipts and the SB 813 Property Tax receipts, which already declined 15% and 21%, respectively, in 2006-2007. As anticipated, Construction and Conveyance Tax receipts are down 26% through the first half of this fiscal year. The significant slowdown in this area is also expected to negatively impact Sales Tax collections with the downward spending in construction materials and the reduction of consumer spending, as the “wealth effect” associated with housing appreciation diminishes. Over the last year, Sales Tax growth has been minimal, with almost no increase in the most recent quarter after factoring out a large one-time adjustment. The weak Sales Tax performance in the most recent quarter was the result of declines in the Construction (down 3.4%) and the Transportation (down 7.8%) sectors.

Also as anticipated, the major impact on Secured Property Taxes resulting from the current slowdown is not expected to be realized until 2008-2009 and 2009-2010, since current year Secured Property Tax receipts are based on the value of property assessed as of January 1, 2007, with adjustments for roll corrections. While real estate activity had started to slow in 2006, performance during that period was still able to generate relatively strong growth for Property Tax receipts in the current fiscal year. If there are greater than anticipated reductions in home prices, however, there is a risk that a larger than expected number of properties will be reassessed during 2007-2008, which would impact Secured Property Tax receipts.

In the area of job growth, the employment figure for December 2007 (926,400) was 1.4% above the December 2006 figure of 913,400 jobs. This growth rate is tracking slightly below the job growth of 2.1% experienced in 2006-2007. The following table illustrates the changes in the number of jobs by fiscal year from the peak in 2000-2001 of 1.1 million jobs to the December 2007 figure of 926,400 jobs.

**Total Jobs Comparison
San José Metropolitan Statistical Area (Santa Clara County)**



The unemployment figures also continue to inch upwards. The unemployment rate of 5.1% in December 2007 was slightly above the November 2007 figure of 5.0% but was up from 4.1% a year ago. This unemployment rate was below the unadjusted figure for the State of 5.9%, but above the unadjusted figure for the nation of 4.8% in December 2007.

With signs of increasing weakness, local economic conditions will need to be closely monitored and factored into the assessment of the City's performance in 2007-2008 as well as development of the final 2009-2013 General Fund Forecast. (A preliminary forecast was released in November, with a final General Fund Forecast planned to be released in February 2008.)

In the November 2007 Preliminary General Fund Forecast, it was assumed that the national and California economies would experience slower than previously anticipated growth, but would not sink into an actual recession as a result of the continued impact of the housing market slowdown and the lingering impacts of the sub-prime mortgage problems. The likelihood of the economy sinking into a recession, however, has clearly increased since that Forecast was issued. In the out-years of that Forecast, economic growth was expected to improve somewhat as the housing market begins to recover from the current slowdown. These basic assumptions will be revisited in the development of the February Forecast. It is currently anticipated that some of the revenue projections will need to be adjusted downwards based on the current economic conditions.

GENERAL FUND PERFORMANCE

Through December, General Fund revenues and transfers totaled \$287.5 million, or 36.7% of budgeted estimates. This amount was \$9.0 million, or 3.0%, below the amount received last year at this time. This lower collection level, however, was the result of timing differences between collections in the two years. After taking these timing differences into account, a number of the revenue categories are currently tracking ahead of both the prior year and the current budgeted estimates.

As was projected in the November Forecast and recent Monthly Financial Reports, it is anticipated that additional revenue over the budgeted estimates will be available by year-end if current collection trends continue. This higher collection level was taken into consideration in the development of the Preliminary 2009-2013 General Fund Forecast that was issued in November 2007. This Forecast, which still resulted in a projected General Fund shortfall of \$24.8 million in 2008-2009, assumed that approximately \$25 million would be available at the end of 2007-2008 from a combination of excess revenues and expenditure savings for use in 2008-2009. Revenue and expenditure data to date is still generally consistent with those projections.

General Fund expenditures through December totaled \$393.9 million. This represented an increase of \$39.1 million, or 11%, from the December 2006 level of \$354.8 million. Encumbrances totaling \$48.1 million were also \$8.8 million (22%) above the December 2006 level of \$39.3 million. City Departments will be directed to evaluate these encumbrances at the end of the year and liquidate those that are no longer necessary. Expenditures and encumbrances through December of \$442.0 million constituted 46.1% of the total 2007-2008 modified budgeted use of funds amount (excluding reserves) of \$959.4 million. This was in line with the 45.0% experienced in last year's budget at this time. Overall, expenditures are tracking as anticipated and are expected to end the year within budget. Year-end savings are anticipated in both the departmental and non-departmental categories.

Section I of this document provides a detailed discussion of the General Fund revenue and expenditure performance through December.

PROPOSED GENERAL FUND AUGMENTATION/REDUCTION RECOMMENDATIONS

Actions resulting in a net reduction of \$780,000 to the General Fund revenues and expenditures are recommended in this Mid-Year Budget Review. This reflects the net result of an increase of \$1.9 million related to various grant and reimbursement-related expenditures, offset by a decrease of \$2.7 million to the Building and Public Works Development Fee Programs based on lower revenue collections in the current year. In addition, there are a number of net zero expenditure adjustments recommended, including actions to allocate reserves and to implement City Council direction. The budget actions have been limited to technical adjustments and those items that are necessary to address current year problems or to implement City Council direction.

The following chart summarizes these recommended adjustments.

PROPOSED GENERAL FUND ADJUSTMENTS

PROPOSED REVENUE ADJUSTMENTS

- Grants/Reimbursements	\$ 1,895,180
- Development Fee Programs	(2,675,000)
Total Proposed Revenue Adjustments	\$ (779,820)

PROPOSED EXPENDITURE ADJUSTMENTS

- Grants/Reimbursements	\$ 1,895,180
- Required Adjustments	
Expenditure Augmentations	1,783,546
Earmarked Reserves/Expenditure Reductions	(2,083,723)
Sub-Total Required Adjustments	(300,177)
- Previous Council Direction	
Future Capital Projects (FF&E) Reserve Restoration	1,100,000
South San José Police Substation	(1,100,000)
Other Council Direction - Expenditure Augmentations	625,177
Earmarked Reserves/Expenditure Reductions	(325,000)
Sub-Total Previous Council Direction	300,177
- Development Fee Programs	
Expenditure Adjustments	(1,025,000)
Development Fee Reserves	(1,650,000)
- Sub-Total Development Fee Programs	(2,675,000)
Total Proposed Expenditure Adjustments	\$ (779,820)

Following is a brief description of the General Fund expenditure adjustments recommended in this report. Additional information on these adjustments is provided in Section III of this document.

Summary of Proposed Expenditure Adjustments in the General Fund

GRANTS/REIMBURSEMENTS (items supported by various grants or reimbursements)	
<i>Public Safety and Homeland Security Activities</i> – Recognizes and appropriates grants and reimbursements that will be received for police and homeland security activities. They include Police Department overtime for Level Orange security reimbursed by Airport funds (\$977,000) and miscellaneous police (\$281,421) and homeland security (\$23,728) grants.	\$1,282,149
<i>Economic Development and Miscellaneous Activities</i> – Allocates grants and reimbursements received for Pre-Development (\$50,000), gated ticket events (\$12,803), and green vehicle/alternative vehicle education (\$21,000).	\$83,803
<i>Neighborhood Services Activities</i> – Recognizes and appropriates grants and reimbursements for Happy Hollow Marketing (\$107,877), Historic Preservation (\$100,000), San José After School Program (\$95,625), Senior Nutrition (\$45,993), Landfill Enforcement (\$29,433), Senior Companion Program (\$10,800), Census Bureau Addressing (\$5,000), and Library Grant activities (\$2,500).	\$397,228

Summary of Proposed Expenditure Adjustments in the General Fund (Cont'd.)

<i>Benchmarking Study</i> – Recognizes and appropriates a reimbursement to San José as the lead agency (of seven) to complete the Multi-Agency Capital Project Benchmarking Study, which evaluates capital project delivery cost performance and assists with performance improvement.	\$132,000
Total Grants and Reimbursements	\$1,895,180

REQUIRED ADJUSTMENTS (items considered unavoidable and/or prudent to fund)

<i>Airport Police Services</i> – Provides funding to repay the Airport for the overpayment for Police services between 2003-2004 and 2006-2007. Funding was set aside as a reserve in the 2006-2007 Annual Report to account for potential funds that might be due back to the Airport.	\$646,871
<i>Comprehensive General Plan Update</i> – Increases the Comprehensive General Plan Update appropriation for additional and increased costs for the Environmental Impact Report (EIR) and Transportation elements. Addressing global warming and water quality in the EIR were not initially anticipated. San José will be the first major California city that will have to address global warming in its EIR. Clarification of the additional costs associated with sustainability/Green Vision/climate change is also necessary. Finally, recent environmental reports have seen cost increases of 15-40% in basic hourly rates. These consultant cost elements are fully funded by a surcharge on development permits. A “bridge” loan of \$600,000 is necessary and will be repaid as revenues from the developer fees assessed for this purpose are received. It will take approximately three years to repay this loan, with interest.	\$600,000
<i>Sunshine Reforms: Website</i> – Adds funding to complete an audit of the City’s website in response to recommendations included in the Sunshine Reform Task Force Phase II Report. Funding for this purpose was set aside as a reserve in the 2007-2008 Adopted Budget for Sunshine Reform.	\$250,000
<i>Workers’ Compensation State License</i> – Increases the appropriation for the State Workers’ Compensation State License Fee to cover an increase recently announced by the State.	\$140,000
<i>Annexations</i> – Sets aside funding for staff to extend the current phasing of annexation of unincorporated islands of up to 150-acres within the City of San José from three years to five years.	\$56,720
<i>Traffic Signals</i> – Adds funding for equipment to resolve an unanticipated problem with LEDs in traffic signals when service is interrupted by PG&E.	\$50,000
<i>Citation Hearing Officers</i> – Reallocates funding from the Department of Transportation to the Finance Department to reflect the transfer of costs associated with the contractual citation hearing officers for the parking citation appeals process.	\$27,733
<i>Senior Nutrition Program</i> – Adds funding for the non-reimbursed portion of Senior Nutrition Program increases.	\$12,222

Summary of Proposed Expenditure Adjustments in the General Fund (Cont'd.)

Use of Earmarked Reserves/Expenditure Savings – Reduces the following reserves and expenditure appropriations to fund the recommended Required Adjustments: Salaries and Benefits Reserve (\$725,000); Airport Police Services Reserve (646,871); Sunshine Reform Reserve (\$250,000); Workers Compensation Claims (\$140,000); Police Officer’s Professional Liability Insurance (\$120,000); General Liability Insurance (\$117,399); Planning, Building and Code Enforcement Department Personal Services (\$56,720); and Department of Transportation personal services (\$27,733). (\$2,083,723)

Total Required Adjustments (\$300,177)

<p>PREVIOUS COUNCIL DIRECTION (items that have already been approved by City Council and require budget actions to implement)</p>
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Future Capital Projects (FF&E) Reserve – Replenishes a portion of the Future Capital Projects (FF&E) Reserve as approved in concept by Council on December 18, 2007 for the South San José Police Substation Project. This addition is offset by a reduction to the General Fund South San José Police Substation Project (a corresponding increase to the project in the Neighborhood Security Bond Fund, offset by a reduction in the Public Art allocation for Public Safety Bond projects, is also included to ensure full funding for the construction of the Substation). Per City Council direction given on December 18, 2007, it should be noted that a separate memorandum on the options to restore funding for public art at the Police Substation will be released and available for review as part of this Mid-Year Budget Review on the February 12th agenda. \$1,100,000

History San José – Provides additional funding to History San José’s annual operating subsidy. As part of a Council action on December 18, 2007, the City agreed to increase the 2007-2008 annual operating subsidy for History San José. \$300,177

Arts Stabilization Flexible Fund – Establishes an Arts Stabilization Flexible Fund from the uncommitted portion of the Arts Stabilization Loan Fund. As part of a Council action on October 2, 2007, the City agreed to establish this Flexible Fund to help identify and assist local arts organizations to avert potential financial crises. \$200,000

Constituent Outreach – On November 20, 2007, the City council approved the Mayor’s Biennial Ethics Review recommendation to phase out existing and prohibit new Officeholder Accounts. The Mayor had also recommended that as part of the Mid-Year Budget actions, each Council Office be allocated \$10,000 and the Mayor’s Office be allocated \$25,000 to offset some of the expenses associated with holding office that had been previously paid for through the Officeholder Accounts. These new allocations would be funded from the Officeholder Accounts Reserve that had been established in the 2007-2008 Adopted Budget for this purpose. \$125,000

Enhanced Parks Maintenance – Creates a temporary Community Coordinator, a Volunteer Coordinator PT and Non-Personal/Equipment funding for a pilot Volunteer Coordination Unit to support parks maintenance efforts. This pilot is expected to increase volunteer involvement, allowing the City to leverage and shift parks maintenance resources to meet shortfalls in other areas. The annual cost of the pilot program in \$143,000, with a partial year cost of \$48,000 in 2007-2008. The existing Public-Private Parks Maintenance Partnership appropriation would provide the funding for the pilot. \$0

Summary of Proposed Expenditure Adjustments in the General Fund (Cont'd.)

Use of Earmarked Reserves/Expenditure Savings – Reduces the following reserves and expenditure appropriations to fund the recommended Prior Council Direction items: South San José Police Substation (\$1.1 million); Arts Stabilization Loan Fund (\$200,000); and Officeholder Accounts Reserve (\$125,000). (\$1,425,000)

Total Previous Council Direction \$300,177

DEVELOPMENT FEE PROGRAMS (items that support and are funded by the Building, Fire, Planning, and Public Works Development Fee Programs)

Expenditure Adjustments – Decreases the Planning, Building, and Code Enforcement Personal Services appropriation by \$1.0 million and eliminates six vacant positions in the Building Division (two of which are temporary) to offset a reduction in the Building Development Fee Program revenue estimate based on current collection trends. Also decreases the Public Works Personal Services appropriation by a net of \$25,000, which reflects a decrease of \$205,000 to offset the lower Public Works Development Fee Program revenue collections and an increase of \$180,000 that is supported by the Building Fee Reserve to enhance customer service by Public Works staff located on the first floor of the Customer Service Center. (\$1,025,000)

Development Fee Program Reserves – Reduces the Building Fee Program Reserve by \$1,180,000 to offset a reduction in the revenue estimate (\$1.0 million) and to fund additional expenditures in the Public Works Development Fee Program (\$180,000). Also reduces the Public Works Fee Program Reserve by \$470,000 to offset the remainder of the reduction in the revenue estimate. (\$1,650,000)

Total Development Fee Programs (\$2,675,000)

Total Mid-Year General Fund Recommended Adjustments (\$779,820)

STATUS OF SELECTED SPECIAL FUNDS

Airport Operating Funds

The Airport Maintenance and Operation Fund is the primary operating fund that supports Airport operations, including Airport staff, Airport police services, Fire Station 20 aircraft rescue and fire fighting services, interdepartmental charges, and overhead to the General Fund. At mid-year, revenues are tracking above budgeted estimates and are at levels higher than the same period in 2006-2007 due to conservative revenue estimating. Expenditures through December are tracking below estimates, primarily due to continued controlled spending in 2007-2008.

Passenger activity at the Airport experienced mixed results compared to last fiscal year. Passenger traffic, landings and takeoffs exceeded prior year levels and cargo weights and rental car activity trailed prior year levels. Although overall passenger activity growth has been minimal year-to-date, the Airport's fiscal situation remains stable.

Convention and Cultural Affairs Fund

On an overall basis, revenues in the Convention and Cultural Affairs Fund are performing as anticipated. Occupancy is at approximately 75% for actual event time, which is slightly above last year's levels. Expenditures through December in the Convention and Cultural Affairs Fund are tracking slightly below expectations in personal services due to position vacancies. Non-personal/equipment expenditures are tracking slightly above anticipated levels due to the use of contract labor to cover its vacancies. A transfer of personal services savings to the Non-personal/Equipment appropriation in the amount of \$200,000 is recommended in this report to properly align the contract labor costs with the budget.

Transient Occupancy Tax Fund

Revenues in the Transient Occupancy Tax Fund are tracking above budgeted levels. Overall, occupancy rates for the first six months of the fiscal year averaged 58.6%, which is slightly higher than last year's level of 57.4%. Room rates have also increased from last year's average of \$125 to \$138. If this trend continues, revenue would end the year approximately 10% above budget. Expenditures through December in the Transient Occupancy Tax Fund are tracking as anticipated.

STATUS OF CAPITAL BUDGET PROGRAMS

Capital Budget Revenues

Section II of this report contains a detailed update on the financial status of each Capital Program, including a discussion of the major revenue sources. As has been reported in Monthly Financial Reports, the major economically sensitive revenue sources that support the Capital Program are tracking to end the year within adopted estimates. With the continued slowdown of the local real estate market, these revenues will need to be watched closely and downward adjustments, if necessary, will be recommended at year-end. In addition, it is anticipated that the major non-economically sensitive revenues such as transfers and contributions from other agencies that support many of the capital programs will perform as projected.

The Building and Structure Construction Taxes and the Construction Excise Taxes that support the Traffic Capital Program are currently expected to meet the budgeted estimates by year-end. Through December, Building and Structure Construction Taxes totaled \$5.8 million, which represents an increase of 2.1% through the first six months of last year and 57% of the current budgeted estimate of \$10.2 million. Construction Excise Tax collections through December totaled \$8.7 million, up 11.4% from last year and 59% of the budgeted estimate. It should be noted, however, that with the continuation of the housing slowdown, the portion of Construction Excise Tax receipts related to the residential sector was down 69% in December 2007 compared to December 2006. Though this decrease has been offset to date by an increase in taxes associated with commercial development (up 135% in December 2007 compared to December 2006), we remain concerned over the long-term impact on these tax collections should a prolonged residential real estate slowdown continue.

As discussed in recent Monthly Financial Reports, Construction and Conveyance Tax (C&C) revenues that support many of the capital programs continue to experience a steep decline, reflecting the greatly reduced level of real estate transactions city-wide. Performance through December represents the worst C&C performance in at least a decade. Through December, C&C taxes totaling \$13.3 million have been received, which represents a decline of 25% from last year. Since nearly 98% of the C&C taxes are comprised of conveyance receipts, property transfers are the main driver in this revenue category. The drop off in December meant that in 18 of the past 20 months revenues have declined compared to the same month in the prior year. A number of factors suggest these revenues have not yet reached bottom. The drops in recent months have been much worse. Receipts dropped 52% in October, 21% in November, and 44% in December compared to the same month in the prior year. The number of property transfers for all types of residences in the first half of 2007-2008 declined by 44% and the number of days on the market for completed sales continues to rise steadily.

Given the current economic conditions in this region, a fall off in the housing market that drives the C&C Tax collections had been anticipated for the last couple of years. As a significant decline had been projected when the budget was developed, even at the reduced levels, these revenues are still expected to meet the budgeted estimate by year-end but will need to be watched carefully. The 2007-2008 budget estimate of \$27 million allows for a decline of 35% compared to 2006-2007 actual performance. Adjustments to the current year revenue estimates will be brought forward at the end of the fiscal year, if necessary, based on actual collections.

Capital Program Adjustments

A series of recommended Appropriation Ordinance and Funding Sources Resolution amendments to the Adopted Capital Budget are included in Section III of this report. Following is a summary of the most significant adjustments:

- In the *Airport Capital Program*, adjustments to revenues (\$36.2 million) to reflect actual bond proceeds issued to support the Airport Terminal Area Improvement projects and an additional transfer from the new \$5.00 Customer Facility Charge that became effective January 1, 2008 to support the Consolidated Rental Car Garage (\$2.2 million) are recommended. In addition, a limited number of augmentations are proposed, including the North Concourse Building project (\$6.5 million) and the Public Parking Garage (\$1.7 million). Lastly, the receipt of a grant and corresponding appropriation of funds to enhance the Compressed Natural Gas Fueling Station (\$747,000) are recommended.
- In the *Library Capital Program*, project savings from the Almaden (\$200,000), Edenvale (\$750,000), and Santa Teresa (\$2.0 million) branch libraries are recommended to be reallocated to the Contingency Reserve (\$2.95 million). Funding is also recommended to be reallocated for New Branch Opening Day Collections (\$4.5 million) from a reserve in the Construction and Conveyance Tax Fund.
- In the *Parking Capital Program*, additional funding is recommended for the Convention Center Deck Repair (\$310,000) project.

- In the *Parks and Community Facilities Development Capital Program* the reallocation of funds to the Happy Hollow Park and Zoo project, as approved in concept by the City Council during the construction award of the zoo and attractions phase (\$3.9 million from City-wide C&C Fund and the Parks and Recreation Bond Projects Fund) is recommended. Other major changes in this program include funding for Rosemary Garden Park Improvements (\$50,000) and Flickinger Park (\$107,000) in the Park Trust Fund; and Pools and Fountains (\$101,000) in the Parks Central C&C Fund. In addition, grant funded projects included in this document include Alma Community Center Improvements (\$285,000) in District 7 C&C Fund; Vietnamese Cultural Heritage Garden Improvements (\$297,000) in the City-Wide C&C Fund. Lastly, the reallocation of funds from the Calpine Open Space reserve to the District 2 Community Center reserve (\$500,000) is recommended for funds recently received from Calpine.
- In the *Public Safety Capital Program*, the reallocation of \$1.1 million in the Public Art-Police Bond Projects appropriation to the South San José Police Substation is recommended. As authorized by the City Council on December 18, 2007, this action would replenish the General Fund Future Capital Projects (FF&E) Reserve by reallocating funding in the Neighborhood Security Bond Fund from public art to the South San José Police Substation project. A corresponding decrease to this project in the General Fund is recommended to allow for the reserve to be replenished. It should be noted that a separate memorandum on the options to restore funding for public art at the Police Substation will be released and available for review as part of this Mid-Year Budget Review on the February 12th Agenda.
- In the *Traffic Capital Program*, the appropriation of project funding and associated revenue for the Route 101/Blossom Hill project (\$1.75 million) is recommended. In addition, augmentations for the Seismic Bridge Retrofit Julian Street (\$650,000), William Street (\$330,000), and Southwest Expressway (\$83,000) projects are recommended in the Building and Structure Tax Fund.
- In the *Water Pollution Control Capital Program*, funding is recommended to be reallocated from the Fuel Cell Cogeneration project to the Alternative Disinfection (\$4.0 million) and M5, Ring Buss and Cable Replacement (\$1.8 million) projects to fund other high priority projects. In addition, the Dissolved Air Flotation Pressure Retention Tanks and Valve project (\$650,000) is recommended to be accelerated from 2010-2011. Lastly, an adjustment (\$2.6 million) to the WPCP Reliability Improvement project is recommended to address an accounting error in which an encumbrance was mistakenly liquidated and redistributed in the previous year.

LOOKING FORWARD

MODIFICATIONS TO COST CONTROL MEASURES

For the past five years, the City has implemented various cost control measures as initially directed by the Mayor's Proposed Budget Strategy memorandum as approved by the City Council on February 4, 2003. These cost control measures are applied to hiring, as well as

several expenditures categories, including technology purchases, marketing/outreach, vehicle acquisition, and office and space renovations, regardless of the funding source. Requests to unfreeze positions and purchase items subject to the cost control measures are reviewed by the City Manager's Office and the respective departments, as appropriate.

Given the length of time these cost control measures have remained in place, it seems an appropriate time to reevaluate these measures and identify streamlining opportunities. Based on a review of the current cost control measures, changes will be implemented that will decrease some of the City Manager's Office oversight and delegate authority to departments to control these spending items given the continued fiscal condition of the City. While all expenditures covered by the current cost control measures would continue to be reviewed by the department directors, expenditure thresholds would be developed to determine those items that require additional review and approval by the City Manager's Office, or designated department.

It is important to note, however, that no changes to the current hiring freeze and review process are contemplated at this time. All exemptions for position hiring (with the exception of sworn Police Department and Fire Department positions, public safety dispatcher positions, parking and traffic control positions and unbenefited part-time positions that are automatically exempt from the hiring freeze) will remain under the control of the Assistant City Manager and Budget Office Director. This policy has been very effective in generating savings during the year and minimizing layoffs as the City has reduced positions over the last several years and should remain in place until significant progress has been made in resolving the City's structural deficit problem.

NEXT STEPS IN THE 2008-2009 BUDGET DEVELOPMENT PROCESS

Planning efforts are well underway on the development of the 2008-2009 Proposed Operating and Capital Budgets. The 2009-2013 General Fund Forecast serves as a starting point in the budget development process as it compares the projected revenues and expenditures for the upcoming five-year period. As reported to the City Council in November, the Preliminary 2009-2013 General Fund Forecast showed a General Fund deficit of \$24.8 million in 2007-2008 and \$75.4 million over the next four years. In late February, the Administration will bring forward an updated 2009-2013 General Fund Forecast that will take into consideration the actual performance through the first half of 2007-2008 and revised revenue and expenditure assumptions based on the current economic environment. The deteriorating economic conditions are expected to negatively impact the revenue estimates that were initially developed in November 2007.

The Mayor's March Budget Message, as reviewed and approved by the City Council, will serve as a guiding document for the Administration in its development of the 2008-2009 Proposed Budget. It is anticipated that Mayor's March Budget Message will incorporate feedback from the Community Budget Survey, Neighborhood Association/Youth Commission Priority Setting Session, City Council/City Management Team Strategic Planning Retreat, and any direction

provided by the Mayor's Budget Shortfall Advisory Group as approved by the City Council in resolving the General Fund structural budget deficit.

PUBLIC OUTREACH/INTEREST

- ✓ **Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater.
- Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City.
- Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach.

This document is posted on the City's website for February 12, 2008 Council agenda. Additional outreach efforts have been conducted for certain projects by various City departments.

CONCLUSION

Through the mid-point of the year, the City's finances remain in sound condition, with revenues generally tracking at or slightly above estimated levels and expenditures remaining within the budgeted allocations. While the City's financial performance in the current year remains on track, the deteriorating economic conditions are expected to impact the City's revenues in the coming fiscal year to a larger extent than anticipated when the Preliminary 2009-2013 General Fund Forecast was developed in November 2007. The revenue estimates for 2007-2008 will serve as the starting point for developing the estimates for 2008-2009. The estimates for 2008-2009 and the remaining years of the forecast will be updated as part of the final 2009-2013 General Fund Forecast due to be released in February.

The Mid-Year Budget actions recommended in this document are intended to address current year issues, implement City Council direction, and to fund grant or reimbursement-related activities. Any new and ongoing funding requests will be brought forward during the annual budget process to ensure that these items are being considered with all other City Council priorities and potential funding needs.

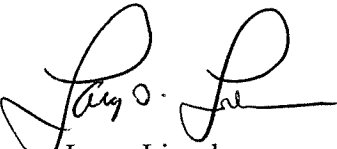
As always, the Administration will continue to closely monitor the City's current year financial status and report to the City Council any and all significant developments through the regular Bi-Monthly Financial Reports.


Debra Figone
City Manager

Certification of Funds

I hereby certify that there will be available for appropriation in the designated funds and in the amounts as listed below in fiscal year 2007-2008 monies in excess of those heretofore appropriated therefrom:

Airport Capital Improvement Fund	\$ 527,000
Airport Customer Facility & Transportation Fund	2,247,000
Airport Fiscal Agent Fund	42,700,000
Airport Maintenance and Operations Fund	79,700
Airport Revenue Bond Improvement Fund	38,447,000
Benefit Fund	1,812,000
Building and Structure Construction Tax Fund	1,750,000
Community Facilities District #12 (Basking Ridge) Fund	222,000
Construction & Conveyance Tax – Council District 7	285,000
Construction & Conveyance Tax – Council District 9	220,000
Construction & Conveyance Tax – City-Wide	297,000
Dental Insurance Fund	58,000
Gift Trust Fund	169,784
Home Investment Partnership Program Fund	642,563
Maintenance Assessment District Fund #10	70
Multi-Source Housing Fund	4,197,250
Redevelopment Agency Capital Projects (City Side)	25,000
Supplemental Law Enforcement Services Fund	36,000


Larry Lisenbee
Budget Director