

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT

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### Overview

This document provides three alternative Five-Year Forecast scenarios for General Fund revenues and expenditures: Base Case, Optimistic Case, and Pessimistic Case. The Administration recommends that the Base Case, considered the most likely projection, be used for the development of the 2010-2011 Proposed Operating Budget. Given the uncertainties inherent in any five-year forecast, however, two alternative case forecasts for the General Fund are also provided. These scenarios attempt to model the potential impact of more optimistic and pessimistic views of the future economic environment. Given the continuing severity of the economic downturn, it is even more difficult than usual to predict economic performance in the coming year and certainly over the next five years.

- ❑ **Base Case** – The Base Case Forecast is built on the assumption of a slow recovery from the deep global recession. The unemployment rate drops slowly during the next several years in the face of sluggish job growth, with only a modest recovery in the housing market and low levels of inflation. In the Base Case forecast, General Fund revenue collections experience only moderate growth over the forecast period.
- ❑ **Optimistic Case** – The Optimistic Case assumes a quicker and more robust recovery than currently anticipated. When compared to the Base Case scenario, Gross Domestic Product (GDP) increases substantially, more jobs are created, and the unemployment rate is significantly lower. The increased economic activity also results in higher inflation than assumed in the Base Case. The combination of higher employment and higher inflation results in increased collections in the economically sensitive revenue categories, such as Property Tax and Sales Tax.
- ❑ **Pessimistic Case** – The Pessimistic Case, alternatively, attempts to model the potential outcome of a deeper and longer-lasting recession. Under this scenario, job growth is delayed and then recovers more slowly, the unemployment rate stays high longer, and housing prices remain low with sluggish sales activity. In this scenario, the City’s revenues, particularly Property Tax and Sales Tax, would continue to be severely impacted.

### Base Case Forecast

As with all forecasts, this one is based on a series of assumptions regarding the overall economic environment, now and in the future. These assumptions were reached after reviewing the projections included in a number of economic forecasts. The economic conditions and the projected impacts on City revenues will continue to be closely monitored and any new developments will be factored into the City Manager’s 2010-2011 Proposed Operating Budget, scheduled to be published on May 3, 2010.

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

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### **Base Case Forecast** (Cont'd.)

The following is a discussion of both the national and local economic outlooks used to develop the revenue estimates for the Base Case Forecast. Various economic forecasts are reviewed in the development of the revenue estimates, including the national and State economic forecasts produced by the Anderson School of Management at University of California – Los Angeles (UCLA) and the California Department of Finance. The City also uses an economic forecasting consultant to assist in the development of this Forecast, particularly the modeling of the growth in the out years of the Forecast.

### **Current National Conditions**

Reversing four quarters of economic contraction, Gross Domestic Product (GDP) began to grow again during the last two quarters of 2009, with at least part of that growth attributable to the federal stimulus program. However, the key economic indicators are mixed, with GDP growing in the fourth quarter of 2009 at an impressive rate of 5.9%, but with the seasonally-adjusted January unemployment rate of 9.7% remaining close to its October 2009 high of 10.1% and continuing job losses. It may be the case that the economy has turned the corner but, from the perspective of households, the future still remains uncertain.

That uncertainty is evidenced by the disappointing results of The Conference Board Consumer Confidence Index for February 2010. The Index declined sharply in February and, according to Lynn Franco, Director of The Conference Board Consumer Research Center, “Concerns about current business conditions and the job market pushed the Present Situation Index [one component of the Consumer Confidence Index] down to its lowest level in 27 years.... Consumers also remain extremely pessimistic about their income prospects. This combination of earnings and job anxieties is likely to continue to curb spending.”

### **The National Economic Outlook**

The Federal Reserve has a difficult task in the coming year as it attempts to maintain control over the nation’s money supply by scaling back the monetary stimulus provided through most of 2009. A miscalculation could lead to tightening of the credit market which would quickly spread to the rest of the economy. Additionally, many economists feel that the fiscal stimulus package was not sufficiently large and once it is spent the country’s job growth will lose traction and employment will decline.

Assuming the Federal Reserve is successful, GDP is expected to grow in the 2.1%-2.7% range during the forecast period, somewhat below the historical average. Net new jobs will likely not be created until mid- to late-2010, and the unemployment rate is expected to decline into the 8% range only near the end of the forecast period.

The determinants of inflation – employment, manufacturing capacity utilization, and energy prices – are all projected to remain relatively low during the forecast period. Inflation is expected to remain within a range of 2.1%-3.1%.

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

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### Base Case Forecast (Cont'd.)

#### The National Economic Outlook (Cont'd.)

Although the prime rate and the 30-year mortgage rate are expected to increase through the forecast, a recent Federal Reserve statement noted that "...economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

#### Current Santa Clara County Economic Conditions

The 2009-2010 Adopted Budget revenue estimates were built on the assumption that the deep global recession would continue to impact national and local economic performance through 2009 and into 2010. Those impacts included high unemployment, depressed home values, reduced household consumption, and lower levels of business and construction activity. Through the first half of the fiscal year, those assumptions have been validated by the economic indicators most relevant to the City's fiscal health.

Employment in the San Jose Metropolitan Statistical Area (MSA) remains well below the prior year level. The employment figure for December 2009 (875,700) was 4.0% below the December 2008 employment level of 911,900. Over the past 12 months, the San Jose MSA lost 36,200 jobs, and the trend continues to be negative.

#### Unemployment Rate (Unadjusted)

	Dec. 2008	Nov. 2009	Dec. 2009
San Jose Metropolitan Statistical Area*	7.8%	11.9%	11.5%
State of California	9.1%	12.3%	12.1%
United States	7.1%	9.4%	9.7%

\* San Benito and Santa Clara Counties  
Source: U.S. Bureau of Labor Statistics.

The San Jose MSA continues to experience double-digit unemployment. Although the December 2009 unemployment rate of 11.5% dropped from the November 2009 rate of 11.9%, that decrease was the result of a shrinkage in the labor force rather than any growth in jobs. This figure is significantly higher than the 7.8% rate experienced in December 2008. The December 2009 unemployment rate in

this region is less than the unadjusted unemployment rate for the State, but continues to track above the nation, which currently has an unadjusted unemployment rate of 9.7%.

Through January, permit activity for residential, commercial, and industrial construction was significantly below prior year levels. Only 272 residential permits have been issued so far this fiscal year compared with 1,031 residential permits issued at this time last year, a 74% drop. The total valuation of commercial permits issued so far this year is \$110.1 million, a 28% drop from the prior year valuation of \$152.7 million. The \$76.0 million of industrial permits issued this year shows an even larger drop, 60%, from the prior year valuation of \$189.6 million.

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

### Base Case Forecast (Cont'd.)

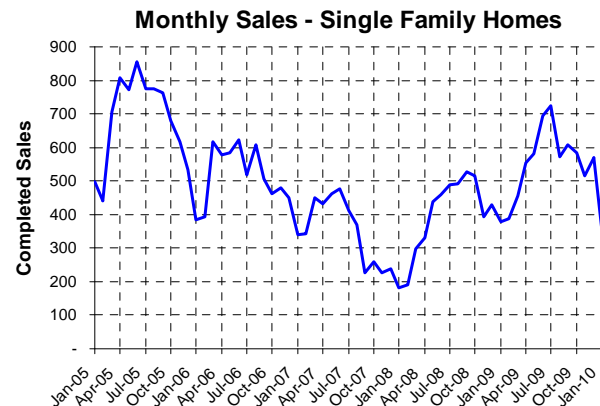
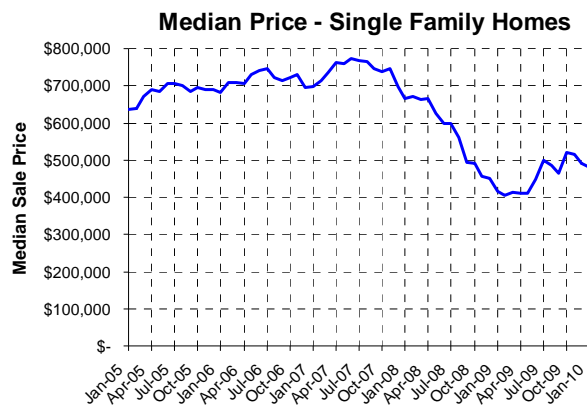
#### **Current Santa Clara County Economic Conditions** (Cont'd.)

This permit activity drives the revenue collection in several construction tax categories and is an indicator of future activity for several other categories, such as the storm and sanitary sewer system fees. Additionally, over the last ten years, the construction industry has provided approximately 5% of the region's jobs; so the reduction in permit activity is expected to contribute to a slow recovery in the local employment market.

More encouraging, the January 2010 median home price of \$481,100 for single family homes within the City is 15.9% above the January 2009 median of \$415,000. January marks the fourth consecutive month in which the median home price has increased from the same month in the prior year. It should be noted, however, that in each of the last three months the median home price has dropped from the previous month, suggesting that the local housing market has not yet stabilized.

Another positive indicator for the local real estate market is the drop in average days-on-market from the high of 90 in June 2009 to 65 in January 2010. Moreover, for the first seven months of 2009-2010, the 3,928 total property transfers (completed sales) for single family homes was the highest number for the same period since January 2006.

The slight improvement in the local residential real estate market indicates that the number of residents willing and able to make a significant long-term investment is increasing – a positive sign for the local economy. The lack of employment growth and slowdown in construction activity, however, should dampen any expectation of a rapid increase in the City's property values, taxable sales, or new residential or commercial development activity.



# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

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### **Base Case Forecast** (Cont'd.)

#### **Santa Clara County Economic Outlook**

Moderate growth in the global and national economies is expected to produce only moderate growth in the local economy through 2014-2015. Over the forecast period, local employment levels are expected to increase at a rate well below the historical norm and the unemployment rate will remain high.

Home prices are expected to rise through the forecast horizon as both employment and incomes gain traction. The improved housing market and inflation levels above 2% are anticipated to support modest improvements in Property Tax revenues through the last four years of the forecast. Because Proposition 8 adjustments reflect assessed value as of the January 1 lien date prior to the fiscal year in which Property Taxes are levied, the 2010-2011 Property Tax receipts are not expected to benefit from this improvement.

The recovery in the residential real-estate sector is expected to be partially offset by declines in the non-residential sector. It is anticipated that commercial values will fall and remain quite soft for the entire forecast period. These lower non-residential valuations will translate into lower Property Tax collections than would otherwise be expected given the recovery in the housing sector. As might be expected, very little additional building will be started and development-related revenues will remain at their current low levels.

Consumer and business spending is expected to increase slowly, but steadily, through the forecast period, and Sales Tax collections are anticipated to follow. For households, increasing employment, income, and wealth (primarily in home value) should contribute to increased consumption. Those positive consumption factors will possibly be partially offset, however, by a persistently higher household savings rate as workers both attempt to compensate for investment losses experienced over the past few years and remain worried about the long term prospects for the economy, their employment status, and their retirement savings. Business-to-business spending is expected to increase as credit markets stabilize and businesses re-capitalize after several years of deferred investment. The extent to which local "green" technology and alternative energy businesses will contribute to this Sales Tax growth has yet to be determined but, as a world leader in technology innovation, it is likely that those contributions will eventually be significant.

While not as closely tied to the economy as Property Tax and Sales Tax revenues, Utility Tax and Franchise Fee revenues will also benefit from the economic growth projected through the forecast period. Moreover, with all of the very expensive alternative electric energy initiatives mandated by the State of California, and expected additions soon by the federal government, electricity prices will almost certainly increase. Conversely, natural gas prices will likely decline due to substantial supplies and reductions in demand due to conservation efforts; however, these declines will not offset the rise in electricity prices. As a whole, Utility Tax and Franchise Fee revenues are expected to increase through the forecast period.

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

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### **Base Case Forecast** (Cont'd.)

#### **Santa Clara County Economic Outlook** (Cont'd.)

In summary, the lingering effects of the economic recession are expected to continue to impact the City's economic performance in 2010-2011 and beyond. The deep decline in the City's revenue collections over the past year coupled with the slow growth projected over the next five years produces annual revenues which are not expected to achieve the 2007-2008 level until the final year of the Forecast.

### **Optimistic and Pessimistic Scenarios**

As discussed above, all forecasts are burdened with a large degree of uncertainty, which increases going further into the future. As a result, in addition to the Base Case, two alternate, but plausible, revenue forecast scenarios are also presented in this document: an Optimistic Case and a Pessimistic Case. These alternatives were developed to display the range of possible outcomes over the next five years under varying economic conditions. The Base Case is, however, still considered the most likely outcome. Following is a discussion of these scenarios.

#### ***Optimistic Case***

In the Optimistic Case, the recent surprisingly strong GDP growth continues and drives higher than anticipated job creation. In addition to reducing the unemployment rate, a rapid economic expansion would support significant increases in housing prices, promote more development activity, and ultimately result in higher inflation than in the Base Case.

With higher inflation, interest rates, particularly mortgage rates, will increase. For this scenario however, it is assumed that the increases in interest rates are not sufficient to derail the recovery. Interest rates are currently very low and there is sufficient room on the upside for them to increase in this scenario without unduly harming the recovery.

The real estate market improves significantly in this scenario. Both the quantity of home sales and the housing prices rise at a quicker rate than in the Base Case, resulting in higher Property Tax receipts. The number of homes reassessed downwards for Property Tax purposes under the Proposition 8 requirements also declines. In addition, the Proposition 13 mandated inflation adjustment reaches the maximum of 2% in all of the forecast years. With these adjustments, Property Taxes rise above the Base Scenario in all of the forecast years.

Under the Optimistic Case, general increases in inflation, employment, and consumer attitudes promote increased spending, which generate Sales Tax for the City. Development activity is also expected to improve. Higher energy prices increase Utility Taxes and Franchise Fees as well. By the end of the Forecast period, revenues are \$48.4 million above the Base Case.

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

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### **Optimistic and Pessimistic Scenarios** (Cont'd.)

#### ***Pessimistic Case***

The Pessimistic Case is one in which the economic stimulus efforts are insufficient to produce a sustainable recovery. This scenario would have a longer lasting negative impact on City revenues.

The threat of a double dip recession is very real. The Federal Reserve has a tremendously difficult task in the coming year as it attempts to maintain control over the nation's money supply. The Federal Reserve has to carefully begin to scale back the monetary stimulus provided through most of 2009. A miscalculation could lead to renewed problems in the financial sector which would quickly spread to the rest of the economy. Many economists feel that the fiscal stimulus package was not sufficiently large and once it is spent, the country's job growth will lose traction and employment will decline. This "double dip" scenario forms the basis of the Pessimistic Case in which employment growth and inflation are much lower than the Base Case.

In the Pessimistic Case, home prices continue to fall and the downward property reassessments under Proposition 8 continue to severely impact Property Tax collections. In addition, low inflation means that the Proposition 13 inflation adjustments remain below the 2% level.

Sales Tax receipts are also significantly lower in this scenario. The very high unemployment rates and very low consumer confidence combine with falling prices to reduce Sales Taxes. The other economically sensitive revenues are also expected to fall in this scenario. The per-unit Gasoline Tax revenues rise, however, because the forecast for lower oil prices results in higher expected gasoline consumption. By the end of the Forecast period, total revenues are \$58.7 million below the Base Case.

### **Impact of Forecasted Economic Conditions on Revenue Collections**

The economic conditions discussed above are the primary drivers for the economically sensitive revenues, with the most significant impacts in the Sales Tax and Property Tax categories. Performance in other areas, however, is primarily driven by other factors. For example, the Utility Tax and Franchise Fee categories are more heavily impacted by utility rate changes and energy prices. Collections from local, State, and federal agencies are primarily driven by the grant and reimbursement funding available from these agencies. As a result, these General Fund revenues experience no significant net gain or loss in times of an economic expansion or slowdown, respectively. Because these revenue sources do not track directly with the performance of the economy, the growth in these areas, even in times of economic strength, can dampen the City's overall revenue growth. Conversely, in an economic slowdown, these categories can act as a buffer, easing the impact of declines in the economically sensitive revenue categories.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST

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An in-depth analysis of the General Fund revenue categories was completed to develop the 2010-2011 revenue estimates included in this Forecast. Over 450 revenue sources were examined to estimate the outcome in 2009-2010 and, building upon those projections, to develop the 2010-2011 revenue estimates. These estimates are based on the Base Case economic scenario described in this section. These revenue estimates will be closely examined and updated again during the preparation of the 2010-2011 Proposed Operating Budget that will be released on May 3, 2010.

As displayed in the Forecast, revenues (exclusive of Beginning Fund Balance) are shown to increase from \$747.9 million in 2010-2011 to \$850.6 million in 2014-2015, for an average growth rate of 3.27% per year. This is above the average growth rate presented in the February 2009 Forecast (2.84%). The higher growth rate in this Forecast is due primarily to the return of modest economic growth after the severe economic downturn that has reduced many of the City's revenues to levels not seen in many years.

Understanding the basis for the revenue estimates included in this Forecast requires a discussion of the assumptions used for estimating each of the revenue categories. The following discussion focuses on estimates used for the 2010-2011 General Fund Forecast.

### Property Tax

Property Tax receipts of \$201.2 million are projected for 2009-2010, which represents a decline of 4.6% from the prior year. This decline reflects decreases in both the Secured and SB 813 (property resales) categories. In 2010-2011, collections are expected to drop an additional 1.1% to \$199.1 million. Additional information about each of the Property Tax sub-categories is provided below.

Secured Property Taxes account for approximately 90% of the revenues in this category. In 2009-2010, Secured Property Tax receipts are expected to drop to \$185.3 million, a decrease of 3.7% from the prior year. This decline marks one of the worst performances in the City's history for this revenue category. For the 2009-2010 property tax assessment roll, over 52,000 properties received a downward adjustment from the County Assessor based on the decline in property tax values. In 2010-2011, Secured Property Tax receipts, which will be based on real estate activity through January 1, 2010, are expected to decline an additional 1%. This projected drop is related to two factors: the drop in the California Consumer Price Index (CCPI) and the anticipated drop in commercial valuation. Under Proposition 13, assessed values of all real property adjust with the CCPI, with a 2% limit, unless there is a change in ownership or new construction. The CCPI adjustment for the 2010-2011 tax roll is a decrease of 0.237%. Since Proposition 13 was approved by the voters in 1978, the CPI has exceeded the 2% limit in all but six years and this will be the first time the CCPI will actually be negative. In addition to the drop in the CCPI, it is anticipated that the valuation for commercial property will drop in 2010-2011. The impact of these reassessments is not yet known. In the residential property area, property valuation is expected to remain relatively flat. In calendar year 2009, residential real estate continued to experience declines at the start of the year but showed some improvement in the last few months of 2009. The January 2010 median sales price of \$481,100 for single family homes

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Property Tax** (Cont'd.)

was 15.9% above the January 2009 level of \$415,000. Given the large declines in the residential real estate category already experienced and the improvement at the end of 2009, a further decline in the Secured Property Tax category associated with residential properties beyond the CCPI adjustment is currently not expected in 2010-2011.

It should be noted that final data on the actual tax levy for 2010-2011 is not available as adjustments are made through June 30, 2010. It is anticipated that information on the impacts of the Property Tax reassessments will not be available in time for incorporation into the 2010-2011 Proposed Operating Budget. If necessary, refinements to the Property Tax estimates will be brought forward during the Proposed Budget review process in May and June.

Unsecured Property Taxes are the second largest revenue source in this category. Growth in this category is driven primarily by increases in the value of personal property (e.g. equipment and machinery used by business and industry for manufacturing and production). During the last decade, performance in this category has been extremely volatile with annual growth or declines reaching double-digit levels based primarily on the strength of the local business sector. Based on actual collections, receipts in this category are expected to reach \$11.8 million in 2009-2010, which is slightly above the 2008-2009 collection level of \$11.7 million. Given the continued weakness in the economy and the lag in personal property valuation, collections are expected to decrease 5.0% in 2010-2011 to \$11.2 million.

SB 813 Property Taxes (supplemental taxes) represent payments for taxes owed on recent housing resales. Through January 2010, collections in 2009-2010 have fallen 49.9% from the prior year. Based on this collection trend and the most recent estimate from the County of Santa Clara Controller's Office, receipts in this category are expected to total \$3.0 million in 2009-2010, a drop of 47% from the 2008-2009 level. In 2010-2011, collections are projected to improve from this extremely low collection level with an increase of 10% to \$3.3 million.

The Homeowners Property Tax Relief category is projected at \$1.1 million for 2010-2011, which is consistent with the 2009-2010 revenue estimate.

In the out-years of the Forecast, annual Property Tax performance is expected to range from growth of 2.9% in 2011-2012 to an increase of 4.9% in 2014-2015, resuming moderate annual growth in this category.

### **Sales Tax**

The Sales Tax category includes General Sales Taxes and Proposition 172 Sales Taxes. Overall, collections are expected to decrease 5.5% in 2009-2010 to \$124.7 million. In 2010-2011, growth of 2.0% is expected, bringing the projected revenue to \$127.2 million.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Sales Tax** (Cont'd.)

The forecast for the General Sales Tax revenue estimate assumes collections of \$121.0 million in 2009-2010, a decrease of 5.3% from the 2008-2009 collection level of \$127.8 million. This decline is in addition to the 14.5% decline experienced in 2008-2009.

For 2010-2011, General Sales Tax receipts are expected to experience slight growth of 2%, bringing the estimate to \$123.4 million. It is assumed that the economy will begin a slow recovery and resume modest growth. To put the 2010-2011 estimate into perspective, the projected revenue of \$123.4 million remains \$26.1 million (17.4%) below the \$149.5 million collected in 2007-2008.

The Sales Tax revenue projections for the 2010-2011 fiscal year will continue to be refined over the next couple of months as additional information becomes available. Sales Tax data for the second quarter of 2010-2011, which covers the 2009 holiday period, will be received in March 2010. Based on this additional data, any necessary adjustments will be incorporated into the 2010-2011 Proposed Operating Budget.

Proposition 172 Sales Tax collections (representing the one-half cent tax that is allocated to counties and cities on an ongoing basis for funding public safety programs) are expected to total \$3.7 million in 2009-2010, which represents a decline of 11.4% from the actual 2008-2009 collections of \$4.2 million based on activity through the first seven months of 2009-2010. In 2010-2011, collections are projected to increase 2% to \$3.8 million.

Through the remaining years of the Forecast, Sales Tax performance is expected to improve, with annual growth ranging from 3.8% to 4.2%. Even with four years of projected growth, the estimated 2014-2015 Sales Tax revenue of \$149.1 million remains below the 2007-2008 collection level of \$154.0 million.

### **Transient Occupancy Tax**

It is currently estimated that Transient Occupancy Tax receipts for 2009-2010 will total \$6.6 million, reflecting a decline of 15.9% from the 2008-2009 collection level. When this projected drop in revenue is added to the 18.5% decline experienced in 2008-2009, total receipts in 2009-2010 are expected to be 31.5% (\$3.0 million) below the \$9.6 million collected in 2007-2008.

In 2010-2011, slight growth of 2.0% from the 2009-2010 estimate is anticipated, bringing the estimate to \$6.7 million. In the remaining years of the Forecast, annual Transient Occupancy Tax performance is expected to range from a decline of 3.2% in 2011-2012 to growth of 14.2% in 2013-2014. These revenue growth factors were based on a study performed by an independent consultant, Horwath HTL, and incorporate the anticipated construction-period impacts from the Convention Center expansion project as well as a slow economic recovery. It is important to note that at the end of the five-year forecast period, collections are expected to total \$8.3 million, which is still 13.1% below the 2007-2008 collection level.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Franchise Fees**

Franchise Fees are collected in the Electricity, Gas, Cable, Tow, Commercial Solid Waste, Water, and Nitrogen Gas Pipeline categories. Overall, collections are projected at \$38.5 million in 2009-2010, a decrease of 6.2% from the 2008-2009 actual receipts of \$41.1 million. The projected decline in 2009-2010 is due to lower collections anticipated in the Gas, Electric, and Commercial Solid Waste categories. In the Gas Franchise Fee category, the drop in gas rates during calendar year 2009 will result in lower collections in 2009-2010. In the Electric Franchise Fee category, a one-time Pacific Gas and Electric Company (PG&E) electricity rebate is expected to impact collections in 2009-2010. In the Commercial Solid Waste category, the lingering effects of the severe economic downturn have negatively impacted collections; increased recycling may also account for some of this decline.

In 2010-2011, Franchise Fees are expected to increase 5.6% to \$40.7 million due primarily to growth in the Electricity (7.5%) and Gas (22.2%) Franchise Fee categories. The increase in the Electricity category reflects anticipated rate increases as well as the assumption that a rebate will not be implemented in 2010-2011. The Gas Franchise Fee category is also expected to increase based on projected increases in gas prices in calendar year 2010. The estimated changes in gas prices are based on Gas Rate Forecast information provided by PG&E. Cable Franchise Fees are also expected to increase 2% in 2010-2011. The remaining categories are expected to remain at the 2009-2010 estimated level for 2010-2011.

In the out years of the Forecast, Franchise Fee revenues are anticipated to increase from 3.9% to 4.6% annually.

### **Utility Tax**

Utility Taxes are imposed on electricity, gas, water, and telephone usage. Collections in 2009-2010 are anticipated to total \$88.7 million, representing an increase of 3.5% from the 2008-2009 collection level. This increase from the prior year is due entirely to the growth in the Telephone Utility Tax category, which is expected to end the year 12.6% above the 2008-2009 level based on current collection trends. Collections in this category reflect the implementation of Measure K that was approved by voters in November 2008 and became effective in April 2009. This measure lowered the Telephone Utility Tax rate by 10% and modernized the tax base. Based on actual receipts, the modernization of the tax base, which included adding international and interstate calls as well as toll free numbers and fax machines, appears to have more than offset the decline in revenues associated with the 10% reduction in the tax rate. The other Utility Tax categories are expected to remain at or slightly below the 2008-2009 collection level in 2009-2010.

In 2010-2011, Utility Tax collections are projected to increase 4.7% to \$92.9 million. In the Electricity category, a 4.1% increase is projected in 2010-2011 based on estimated rate increases and the assumption that the 2009-2010 one-time rebate will not be repeated in 2010-2011. In the Gas Utility Tax category, it is assumed that collections will increase 15.0% based on the assumption that Gas rates will increase in 2010. Gas Rate Forecast information provided by

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Utility Tax** (Cont'd.)

PG&E was used to inform the development of this estimate. Water Utility Tax receipts are also expected to increase 6.5% based on anticipated rate increases. In the Telephone Utility category, growth of 2.0% is projected in 2010-2011.

In the out years of the Forecast, growth ranging from 4.4% to 5.0% annually is expected in the Utility Tax category.

### **Telephone Tax**

In November 2008, voters approved a ballot measure that replaced the Emergency Communication System Support (ECSS) Fee with a Telephone Tax. The tax was set at a rate 10% below the ECSS Fee. Based on current collection trends, receipts in this category are expected to total \$20.7 million in both 2009-2010 and 2010-2011. In the out years of the Forecast, minimal growth of 1% annually is projected for this category.

### **Business Tax**

This category includes General Business Tax, Disposal Facility Tax, and Cardroom Tax. In 2009-2010 General Business Tax proceeds are expected to reach only \$11.0 million, which is well below the Adopted Budget estimate of \$12.6 million. The severe economic downturn has reduced the number of businesses and staffing levels, and increased the number of hardship exemptions, both of which have directly impacted Business Tax receipts. In 2010-2011, collections are projected to increase by 2.0% to \$11.2 million.

In the Disposal Facility Tax category, collections are estimated at \$11.6 million in 2009-2010 based on current collection trends. This reflects a decline of 4.4% from the 2008-2009 collection level. Receipts are expected to remain at \$11.6 million in 2010-2011 as an increase in economic activity is expected to offset any reductions associated with waste diversion.

Based on current performance, collections in the Cardroom Tax category are estimated at \$12.7 million in 2009-2010, a decrease of 7.0% from the 2008-2009 collection level. Receipts are expected to remain at \$12.7 million for 2010-2011.

In the remaining years of the Forecast, the Business Tax category is expected to experience very minimal growth of less than 1% per year.

### **Other Licenses and Permits and Departmental Charges**

The Other Licenses and Permits and Departmental Charges categories contain fees and charges collected by various departments. The most significant revenue sources are development-related fees. Revenue collection levels are projected based on City Council-approved cost-recovery policies with the goal of a net-zero impact on the General Fund.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Other Licenses and Permits and Departmental Charges** (Cont'd.)

For 2010-2011, the development-related revenues are expected to be very weak, continuing the dismal performance experienced in 2009-2010. In cases where the development-related costs are projected to exceed revenues, the impacted departments will be submitting proposals to reduce costs and/or increase fees to bring projected revenues and expenditures back in line for a net-zero General Fund impact. For 2010-2011, the Building, Planning, Public Works, and Fire Fee Program revenues are projected to be below the base costs, which will require budget actions to bring these programs in balance.

For the non-development-related fees and charges, the 2010-2011 estimates are based on current collection trends. In the out years of the forecast, both the Other Licenses and Permits and Departmental Charges categories are expected to experience growth ranging from 3.0% to 4.0% over the remaining years of the Forecast. The growth rates in the out years are tied to the expected increases in costs which the fees are designed to recover, including increased retirement and health costs. It should be noted that cost-of-living salary adjustments have not been factored into the out years of the Forecast. There are currently no negotiated agreements for that period.

### **Fines, Forfeitures and Penalties**

In 2009-2010, the Fines, Forfeitures and Penalties category is expected to generate \$16.2 million. The largest component of this revenue category is Parking Fines, which are currently expected to generate approximately \$10.0 million in 2009-2010. In 2010-2011, a total of \$16.7 million is projected in the Fines, Forfeitures, and Penalties category. This includes \$10.5 million from Parking Fines, which are expected to increase over the 2009-2010 collection level. That increase is based on the assumptions that overall economic conditions will improve and result in increased parking activity, and that additional productivity will be realized in 2010-2011 as less time will be allocated to training new staff than in 2009-2010. In the out years of the Forecast, growth ranging from 1.25% to 1.80% is projected annually.

### **Money and Property**

This category consists of interest income and revenue associated with the rental of City-owned property. The 2010-2011 estimate for interest earnings in the General Fund assumes an average interest rate of only 1.50%, applied to an average cash balance of approximately \$75 million for a total collection level of only \$1.1 million. This forecast reflects a significant decline in both the average cash balance (down from \$180 million) and the average interest rate yield (down from 2.06%) adopted in 2009-2010. The primary factors that have contributed to the low cash balance include prepaying in a lump-sum the employer portion of retirement contributions at the beginning of the fiscal year (\$102.7 million paid in July 2009) and lower levels of earmarked reserves (reserves that had been set aside in previous years for specific purposes were used for those purposes or liquidated). The lower interest yield projection, which was provided by the Finance Department, reflects the impact of current economic conditions.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### Money and Property (Cont'd.)

An additional \$1.8 million is expected to be generated from the remaining sources in this category, including insurance recovery for damage to City property, and rental of facilities. In the out years of the Forecast, increases ranging from 1.9% to 4.1% are projected.

### Revenue from Local Agencies

In 2010-2011, revenue of \$47.8 million is projected from other local agencies, such as the San Jose Redevelopment Agency (SJRA), the Central Fire District, and the County of Santa Clara. The largest portion of the Revenue from Local Agencies category consists of reimbursements from the SJRA. The SJRA reimburses the General Fund for the Convention Center lease payment that is projected at \$15.0 million for 2010-2011. In addition, estimated SJRA reimbursements for City service costs for 2010-2011 of \$20.3 million are based on the assumption that ongoing support will remain consistent with levels included in the 2009-2010 modified budget. During 2009-2010, SJRA reimbursement was reduced for the City Hall rent payment and the cost of two SJRA civil service staff. Given the fiscal challenges facing the SJRA, it is likely that funding budgeted for City support services will be reduced in 2010-2011. The proposed funding levels for 2010-2011 will be refined and updated based on discussions with the SJRA. Any corresponding budget proposals based on these discussions will be brought forward for City Council consideration as part of the 2010-2011 Proposed Operating and Capital Budgets.

The City also receives reimbursement from the Central Fire District for the County areas covered by the San José Fire Department. These payments are based on the property tax assessments for fire services collected in those areas, which are passed on to the City. For 2009-2010, Central Fire District payments are expected to end the year at \$5.9 million, reflecting a significant drop from 2008-2009. In 2010-2011, collections are expected to drop to \$5.6 million. This assumes a 5% drop in Property Tax receipts due to a general decline in the assessed value of the covered areas as well as annexations of County pockets into the City.

In 2010-2011, payments from the County of Santa Clara for the first responder advanced life support program (Paramedic Program) are assumed to total \$1.8 million based on the annual adjustments specified in the contract with the County. In addition, the City is expected to receive \$1.3 million from the County for the Adult Day Care and Senior Nutrition programs. Payments of \$1.9 million from other local agencies are expected to reimburse the City for the Police Department CAL-ID program.

In the remaining years of the Forecast, the Revenue from Local Agencies category is projected to increase annually by 0.8% to 2.3%, based on scheduled payments and retirement and benefit cost adjustments for staff reimbursements.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### Revenue from the State of California

The Revenue from the State of California category includes the Motor Vehicle In-Lieu and Aircraft In-Lieu payments, State grant revenues, and other State reimbursements. In 2009-2010, Motor Vehicle In-Lieu collections are expected to reach only \$2.8 million, a significant drop from the \$4.0 million received in 2008-2009. In 2010-2011, collections are projected to remain at \$2.8 million. The Aircraft In-Lieu payment is estimated at \$4.1 million in 2009-2010, a decline of 14.8% from the 2008-2009 receipts of \$4.9 million. In 2010-2011 collections are expected to remain flat at \$4.1 million.

The following State grants and reimbursements are expected in 2010-2011: Public Library Foundation grant (\$356,000); Waste Tire Enforcement grant (\$159,000); Abandoned Vehicles Abatement Program (\$600,000); Auto Theft reimbursement (\$370,000); and Highway Maintenance Charges reimbursement (\$287,000).

Annual growth of approximately 2.0% is projected in the out years of the Forecast.

### Revenue from the Federal Government

The Revenue from the Federal Government category consists of grant revenues. Three grants are anticipated in 2010-2011: Senior Companion Program (\$130,000); Striving Toward Achievement with New Direction (STAND) (\$125,000); and Retired and Senior Volunteer Program (RSVP) (\$92,000). No growth is projected in the out years of the Forecast.

### Other Revenue

The Other Revenue category consists of miscellaneous revenues received from a variety of sources, including proceeds from the Sale of Surplus Property, cost reimbursements for the Investment Program, and Arena Rental, Suite, Parking, and Naming revenues. In 2010-2011, this category is expected to generate \$13.6 million.

Revenue estimates assume continuation of current year activity levels with revisions, where appropriate, for 2010-2011 costs or agreements. In 2010-2011, the proceeds from the Sale of Surplus Property category has been set at \$1.8 million. The cost reimbursement for the Investment Program is estimated at \$2.7 million based on the current allocation of staff to this function. In addition, \$4.6 million is projected from Arena Rental, Suite, Parking, and Naming revenues.

Increases ranging from 1.6% to 1.8% are projected for each of the out years except 2013-2014. In 2013-2014, no change is projected based on the scheduled elimination of the Arena Parking revenue.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Gas Tax**

The Gas Tax estimate assumes that collections in 2009-2010 will increase 1.3% to \$16.3 million based on current tracking levels this year. In 2010-2011, an additional 2% increase is projected, bringing collections to \$16.6 million. These collection levels remain below historical tracking patterns for this category. Several factors may be impacting collections in this category, including volatile gas prices, the lingering impacts of the economic downturn, and a move to more energy efficient automobiles. In the out years of the Forecast, collections are expected to increase 0.5% annually.

### **Overhead Reimbursements**

The Overhead Reimbursements category includes overhead reimbursements from both operating and capital funds. In 2010-2011, a total of \$36.0 million is projected. This estimate is based on 2010-2011 overhead rates prepared by the Finance Department applied against the projected 2010-2011 salaries for those positions for which an overhead rate is applied. The overhead revenue estimate has been decreased to reflect the potential loss of overhead associated with positions that are likely to be eliminated in the 2010-2011 Budget, including positions at the Airport, the Convention Center, and those assigned to Capital funded programs.

In the remaining years of the Forecast, annual changes ranging from a decline of 3.7% in 2011-2012 to increases of 0.9% in 2013-2014 and 2014-2015 are assumed reflecting expected changes in those costs which the overhead rate is designed to recover, including increased retirement and health contribution costs. It should be noted that cost-of-living salary adjustments have not been factored into the out years of the Forecast as there are currently no negotiated agreements for that period. Any such salary adjustments, if actually implemented, would adversely affect the operating margin and increase any projected out year shortfalls.

### **Transfers**

The Transfers category is projected at \$24.2 million for 2010-2011. The largest component of this category (\$13.9 million) is a transfer from the Airport Maintenance and Operating Fund to reimburse the General Fund for Airport Crash Fire Rescue and Airport Police costs. In 2010-2011, these reimbursements have been set to cover the base 2010-2011 costs. In the remaining years of the Forecast, annual increases ranging from 4.8% to 7.9% are assumed reflecting expected increases in costs, including increased retirement and health contribution costs. As discussed above, cost-of-living salary adjustments have not been factored into the out years of the Forecast as there are currently no negotiated agreements for that period. Other large transfers programmed for 2010-2011 include the \$4.0 million transfer from the Construction Excise Tax Fund and the \$2.0 million transfer from the Construction and Conveyance Tax Fund associated with park maintenance costs. In addition, this category now includes transfers of interest earnings from various funds to the General Fund. These interest amounts are projected to total \$2.2 million in 2010-2011, including \$1.8 million from the Construction and Conveyance Tax Funds.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Transfers** (Cont'd.)

In 2011-2012, the Transfers category is expected to drop to \$23.9 million, primarily reflecting the scheduled phase-out of \$500,000 of the transfer from the Construction Excise Tax Fund. In the remaining years of the Forecast, annual increases ranging from 3.0% to 4.9% are assumed.

### **Reimbursements for Services**

The Reimbursements for Services category reimburses the City for actual costs associated with the Deferred Compensation Program and the Maintenance Assessment District Funds. These amounts have been set to recover costs in 2010-2011 of \$725,000. In the remaining years of the Forecast, annual increases of 2.0% are expected to recover the projected cost increases, including increased retirement and health contribution costs. As discussed above, cost-of-living salary adjustments have not been factored into the out years of the Forecast as there are currently no negotiated agreements for that period.

### **Beginning Fund Balance**

The \$42.2 million forecast estimate of available 2010-2011 Beginning Fund Balance is based on the following assumptions:

- The 2010-2011 Contingency Reserve, \$29.3 million, is projected at the level necessary to comply with the City Council policy to maintain a 3% Contingency Reserve. The Contingency Reserve, set at 3% of budgeted expenditures (excluding the Contingency reserve itself and the Workers' Compensation/General Liability Reserve), is approximately enough to cover General Fund payroll costs for three weeks. The Contingency Reserve is currently budgeted at \$30.7 million. Amounts necessary to remain in compliance with the Contingency Reserve policy are also included in each of the remaining four years of the Forecast.
- A total of \$12.8 million will be achieved from a combination of excess revenue, expenditure savings, and the liquidation of prior-year carryover encumbrances. This figure is based on a review of actual revenue and expenditure performance in 2009-2010.
- A total of \$60,000 will be provided from the Neighborhood Investment Reserve to support the Spartan Keyes Neighborhood Action Center.

The future year beginning fund balance estimates assume that excess revenues of 1% and expenditure savings of 1.5% - 2% will be generated annually. This would generate fund balance ranging from \$49.4 million in 2011-2012 to \$61.2 million in 2014-2015. The Contingency Reserve assumed to be carried over is adjusted upward based on the Contingency Reserve allocation from the prior year.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST

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An in-depth analysis of the General Fund expenditure categories was completed to develop the 2010-2011 expenditure estimates included in this Forecast. These expenditure estimates will be closely examined and updated again during the preparation of the 2010-2011 Proposed Operating Budget.

As displayed in the Forecast, expenditures are shown to increase from \$906.3 million in 2010-2011 to \$1.09 billion in 2014-2015, for an average growth rate of 4.80% per year. This is above the average growth rate presented in the February 2009 Forecast (3.26%). The higher growth rate in this Forecast is due primarily to changes in the retirement costs for the impacts of investment losses and non-economic assumptions upon the two retirement plans and the continued phase-in of retiree healthcare costs.

It is important to note that the service reductions/eliminations under consideration to address the 2010-2011 General Fund budget shortfall are above and beyond the service reductions/eliminations that are effective July 1, 2010 as approved by the City Council through the 2009-2010 budget process. These service reductions/eliminations are identified in the table below.

Service	Savings	Positions
Six Satellite/Neighborhood Center Closures	\$1,710,000	23.04
Horse Mounted Unit Elimination	1,330,000	8.00
Branch Library Hours Reduction (8 hours less)	1,199,000	16.40
Crime Prevention Unit Reduction *	673,000	6.00
Convention and Visitors' Bureau Subsidy	337,000	
Strong Neighborhoods Initiative Staffing **	321,000	9.94
Central Service Warehouse Concourse	300,000	5.00
Wellness Program Pilot for City Employees	300,000	2.00
Transfer to Convention/Cultural Affairs Fund	250,000	
Community Based Organizations Reduction (additional 8%)	210,000	
Dr. Martin Luther King Jr. Library Service Point Reductions	190,000	2.50
Mexican Heritage Plaza Maintenance and Operations	156,000	
Audit Staffing Reduction	130,000	1.00
Rose Garden Maintenance Reduction	126,000	1.96
Police Management Consolidation	125,000	1.00
Fire Data Management Staffing	119,000	1.00
<b>Total</b>	<b>\$7,476,000</b>	<b>77.84</b>

\* Per City Council approval of the Mayor's June Budget Message for 2009-2010, prior to implementing the Crime Prevention Unit Reduction, the City Manager was to explore and report to the Public Safety, Finance and Strategic Support Committee on alternative service delivery models for City Council consideration. This report was heard and approved in a February 2010 Committee Meeting.

\*\*This reduction includes the reduction of expanded Neighborhoods Initiative Staffing funded in 2009-2010 through a reduction of the Neighborhood Investment Fund Earmarked Reserve.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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Understanding the basis for the expenditure estimates included in this Forecast requires discussion of the assumptions used for estimating each of the expenditure categories. The following discussion focuses on estimates used for the 2010-2011 General Fund Forecast.

### Personal Services

As is our usual practice, the first year (2010-2011) projection for personal services costs in this Forecast has been calculated at a detailed level. An extract of payroll system information as of August 2009 was used as the starting point. This individual position-level information was then reviewed, corrected, and updated by each department to include current vacancies and filled positions, accurate salary step status, as well as any position reallocations. Also, 2009-2010 ongoing position reductions (cost savings) and additions (cost increases) were annualized, and projections for all categories of benefit costs in the coming year were made.

Personal services costs continue to account for approximately three-quarters of the General Fund's total costs. The Personal Services category has been broken down into its three major components (Salaries and Other Compensation, Retirement, and Health and Other Fringe Benefits). Of the \$672.7 million projected personal services total for 2010-2011, \$454.9 million (67.6%) is from Salaries and Other Compensation costs, \$155.5 million (23.1%) is from Retirement costs, and \$62.3 million (9.3%) is from Health and Other Fringe Benefits costs. This display of personal services costs by the three categories is intended to show how these different elements drive rising personnel costs. For example, even without any negotiated salary increases, growth in the other major personnel cost components (scheduled non-management step increases, retirement and health and other fringe benefits) impact personal services and, particularly in recent years, have been responsible for a growing element of the major increases in personnel costs. To provide historical context to the growth in this category, from 2000-2001 to 2009-2010, total average personal services costs grew by 63.7%, with average salary and other compensation increasing 48.2% over this period, while retirement costs increased 131.3% and health and other fringe benefit costs grew by 123%.

For 2010-2011, the total personal services preliminary estimate of \$672.7 million, as displayed in Section Two of this report, represents an increase of approximately 7.2% (\$44.9 million) from the 2009-2010 Adopted Budget level.

Specific factors impacting the elements of the personal services costs in the Forecast for 2010-2011 include:

- The implementation of estimated retirement rates for both the Federated and Police/Fire Retirement Plans, which are \$14.7 million higher than the \$38.2 million assumed in the October Forecast. The projected changes in these contribution rates have resulted in an increase of approximately \$52.9 million in the General Fund for both Federated (\$9.3 million) and Police/Fire (\$43.6 million) Retirement plans costs.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Personal Services (Cont'd.)

The rates set forth in this Forecast should still be considered preliminary, but do reflect the Retirement Department's best current rate projections based on 1) an updated July 2009 actuarial study for the Police/Fire Retirement Plan that reflects revised investment loss estimates as well as non-economic assumption changes (two of the larger components of the changes from the prior actuarial study were for higher than expected salary increases and earlier than expected retirements) updated for 2009 valuation data for Police/Fire and 2) an updated 2009 actuarial study for the Federated Retirement Plan. (It should be noted that the Federated Plan's rate still has to be updated based on 2009 valuation data.) In addition, the second year of an approved five-year plan to phase-in the City's share of the General Fund annual required contribution for retiree health care benefits is included. It is also assumed that the City Council's decision to prepay the City's contributions into the two retirement funds in order to receive a rate discount will continue for 2010-2011. In total, for this Forecast, the City's contribution rates (pension and medical) are presumed to grow from 23.12% in 2009-2010 to 28.70% in 2010-2011 for the Federated Retirement Plan, from 25.92% in 2009-2010 to 43.64% in 2010-2011 for the Police Retirement Plan, and from 27.29% in 2009-2010 to 45.48% in 2010-2011 for the Fire Retirement Plan. It is important to note that all final retirement contribution rates are subject to approval by the two Retirement Boards, which is expected to occur in March 2010. To the extent the final rates approved by the retirement boards vary from these projections, the General Fund costs are expected to change by \$2.4 million for the Police and Fire Retirement Plans and by \$1.7 million for the Federated Retirement Plan for every 100 basis point change.

- Approved salary compensation as negotiated with two of the thirteen bargaining/employee groups, including Municipal Employees' Federation (MEF) and Confidential Employees' Organization (CEO) resulting in an increase of \$2.44 million. All other bargaining/employee groups are assumed to have no salary increases in 2010-2011;
- Salary step increases for current non-management employees (an overall 0.5%, or \$2.5 million salary and benefit growth level for the category);
- Forecasted health rate increase of 10%;
- The impact of actions taken during 2009-2010 to rebalance the Development Fee and Capital Programs with the elimination of 43.50 positions (35 of which were in the General Fund). The Development Fee Program is by City Council policy required to achieve 100% cost recovery. Due to a steep decline in development activity, actions to address a revenue shortfall on an ongoing basis were necessary;
- The elimination of five positions in the Police Department that were reimbursed by Airport funds as approved as part of the 2009-2010 Mid-Year Budget Review; and
- As approved by the City Council as part of the 2009-2010 budget, the elimination or reduction of several programs beginning in 2010-2011, resulting in the elimination of approximately 78 positions.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Personal Services (Cont'd.)

Due to the mechanism used to represent the desired outcome in fee programs, it should be noted that personal services expenditures in this Forecast are understated by an additional \$3.3 million. The \$3.3 million represents the shortfall that would exist in the Development Fee Programs in the Planning, Building and Code Enforcement, Fire and Public Works Departments if all costs were reflected. These fee programs are intended by the City Council to recover 100% of the costs of development review and inspection and, as a result, costs are reflected in this Forecast at the expected revenue collection level. The Public Works, Fire, and Planning and Building Development Fee Programs will be required to develop strategies that will address this \$3.3 million shortfall in the 2010-2011 Proposed Budget.

Not included in the Personal Services category are two large General Fund cost categories that actually are personnel-related: Workers' Compensation Claims Payments and Sick Leave Payments Upon Retirement which are other significant components of the total costs of the City's workforce. These costs are included in the City-Wide Expenses category. In 2010-2011, estimates of \$16.7 million for Workers' Compensation Claims Payments and \$9.3 million for Sick Leave Payments Upon Retirement have been included in this General Fund Forecast.

It is also important to note that the City and the International Association of Firefighters (IAFF), Local 230 whose contract expired June 30, 2009 are proceeding to binding interest arbitration and the City and the Association of Building, Mechanical and Electrical Inspectors (ABMEI) whose contract expired December 10, 2009, are at impasse in negotiations. This forecast does not assume that any additional costs would result from the outcome of those negotiations.

As with past forecasts, personal services costs in years two through five of this Forecast have been projected on a more global basis, using the detailed costs calculated for the first year as a base, and then growing that base by an overall percentage factor representing expected growth from salary and benefit adjustments. For this Forecast, the out years were projected to inflate at a composite rate of approximately 5.0%. This projected rate of growth is well above the 2.8% presumed in the February 2009 Forecast due entirely to the increases in the City's contribution rates for its two retirement plans discussed below.

In the Salaries and Other Compensation category, the last four years of the Forecast continues the assumption of no cost-of-living salary increases for any employees, reflecting the fact that there are no negotiated agreements covering this period. The approval of any negotiated salary or benefit increases in those years, without any offsetting increase in revenues or reduction in costs, will obviously have the effect of driving up the City's shortfall. Each 1% of salary increase granted to all employees would increase the General Fund cost in 2010-2011 dollars by \$5.8 million. In this regard, consideration of salary increases is being treated as a resource allocation policy decision and any decision will be made in the context of what is affordable in light of the City's many service delivery priorities. The only salary-related assumption in the out years of the Forecast continues to be salary step increases related to eligible non-management employees.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### **Personal Services** (Cont'd.)

In the Retirement category, retirement costs are calculated as a percentage of salary costs. New for this Forecast, retirement costs have been adjusted in each out year to reflect rates as projected by each Plan's actuary. In the past, retirement rates were adjusted every two years after actuary studies were completed and due to the volatility of retirement rates, no specific predictions for the retirement rate contribution adjustments were assumed in the out years of the Forecast. Due to steep declines in the U.S. financial markets negatively impacting performance in the two retirement systems as well as non-economic factors, the rates are projected to increase significantly by 2014-2015. During the Forecast period, rates in the Federated Retirement Plan are proposed to increase to 28.70% in 2010-2011 (from 23.12% in 2009-2010) and up to 43.42% in 2014-2015. Even greater increases are projected in the Police/Fire Retirement Plan with rates increasing to 43.64% and 45.48% for Police and Fire, respectively (from 25.92% and 28.34%) and up to a staggering 72.05% in 2014-2015. As a result, in 2014-2015, projected retirement costs (at \$271.4 million) would represent almost 25% of the General Fund up from the 2009-2010 Adopted Budget level of 11%.

In the Health and Other Fringe category in the out years of the Forecast, there are annual rate increase assumptions for the City's share of Health (10%) and Dental (4%) benefits.

### **Non-Personal/Equipment**

Non-personal/equipment expenditures for the first year of the Forecast have also been calculated at a detailed level and total \$86.8 million in 2010-2011. The process utilized by the Budget Office includes adjusting each department's current year budget to eliminate one-time cost allocations, annualizing all partial-year reductions or additions approved for 2009-2010, and including projected adjustments for specific large non-personal/equipment allocations (e.g., utilities, leases, contracted services, and Police Department vehicle replacement) as described later in greater detail. The resulting 2010-2011 estimates represent a decrease (\$3,480,000) from the current year level. Departmental gas and electricity funding for 2010-2011 has been slightly adjusted in this Forecast to reflect approved gas and electricity rates and projected consumption from new or expanded City facilities.

Other specific adjustments included in the 2010-2011 non-personal/equipment base include a decrease for the scheduled replacement of police vehicles (\$890,000), a decrease for vehicle maintenance and operating costs (\$605,000) and contractually required cost of living increases to major contracts. For the out years of the Forecast, a growth rate of 2.0% has been assumed from the 2010-2011 non-personal/equipment base level in each of the four years. This projection is unchanged from that assumed in recent forecasts.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### **Other Expenditures**

The General Fund **Capital Projects** category includes debt service payments for Central Service Yard – Phase I (\$1,676,000 in 2010-2011). These payments remain relatively flat in the out years. Also included in this category is the continuation of allocations for Arena repairs (\$100,000), unanticipated maintenance of City facilities (\$200,000), and fuel tanks and methane monitoring control and replacement (\$450,000).

The **City-Wide Expenses** program in the first year of the Forecast (2010-2011) represents a net reduction of \$32.4 million from the 2009-2010 level. This large reduction reflects the combined impact of deleting rebudgeted expenditures in 2009-2010 (\$29.8 million) and other one-time items (\$2.5 million). This category also includes funding for debt service payments for several City facilities. The payments for the Convention Center which is reimbursed by the Redevelopment Agency and Airport West Property have been adjusted by a net increase of \$383,000 to reflect the latest payment schedules. Workers' Compensation Claims payments in this Forecast range from \$16.7 million in 2010-2011 to \$23.6 million in 2014-2015. Sick Leave Payments Upon Retirement expenditures included in this Forecast range from \$9.3 million in 2010-2011 to \$9.9 million in 2014-2015.

The **Earmarked Reserves** category includes a reserve for the Comprehensive General Plan Update (\$200,000) and is entirely offset by revenues collected from a surcharge on development permits.

The Forecast does not include a number of Earmarked Reserves that may remain unspent in 2009-2010, and would be recommended for rebudget to 2010-2011. Some of the larger current Earmarked Reserves include the Development Fee Program Reserves, Workers' Compensation/General Liability Catastrophic Reserve, GASB 43/45 Liability (Retiree Healthcare) Reserve, Enhanced Parks Maintenance Reserve, Salary and Benefits Reserve, Future Capital Projects (FF&E) Reserve, Neighborhood Investment Fund Reserve, Retirement Pre-Payment Reserve, and Economic Uncertainty Reserve.

As in previous years, the **Equipment** category includes a general equipment reserve of \$100,000 for subsequent allocation in the 2010-2011 Proposed Budget. Similarly, \$250,000 is assumed annually for computer equipment and automation projects also for subsequent allocation during the Proposed Budget process.

The **Transfers** category includes funding to cover a portion of the debt service payments for the Hayes Mansion Conference Center (\$5.9 million per year) and Rancho del Pueblo and Los Lagos Golf Courses (\$1.1 million per year) and payments in accordance with the San José Arena Management (\$1.5 million per year in years one and two) for Arena repairs and capital enhancements. All of the debt service and maintenance and operations costs for the Hayes Mansion Conference Center and golf courses are funded in the Community Facilities Revenue and Municipal Golf Course Funds, however, revenues in those funds are not projected to be sufficient to completely cover these costs. The transfer for the Hayes Mansion Conference Center has been increased by \$1.8 million since the last forecast. This is primarily due to

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### **Other Expenditures** (Cont'd.)

economic conditions that continue to negatively affect tourism and the hotel industry. The payments for Arena repairs and capital enhancements are in compliance with the San José Arena Management Agreement Extension from 2009-2018. The first year of the Forecast (2010-2011) is the third year of these required payments, as assumed in prior forecasts. In 2012-2013, an additional \$1.25 million is necessary to pay for the City's share of the \$16.5 million of improvements at the Arena, as approved by the City Council in May 2007. In addition, revenue offset payments for the final two years of the Camden Lifetime Activities Center debt service (\$102,000 in 2011-2012 and \$202,000 in 2012-2013), Fiber Optics loan repayment, and various Maintenance Assessment Districts for the General Fund's share of landscape services in those areas are included.

A **Vehicle Replacement/General Fleet** allocation (\$0.9 million in 2010-2011) is included to fund a vehicle replacement schedule for the General Fleet (\$600,000) and for the retrofit of diesel powered vehicles. This is a reduction of \$1.0 million from the previous forecast to reflect a budget action taken in 2009-2010 on an ongoing basis for the replacement of vehicles in the General Fleet. State regulations necessitate the City to replace the City's diesel-powered vehicles throughout the forecast period, in order to comply with new regulations to reduce the use of fossil fuels and the release of harmful emissions. In this Forecast, costs range from \$287,000 in 2010-2011 to \$255,000 in 2014-2015.

In 2010-2011, **Vehicle Replacement/Police Fleet** funding is carried in the Non-Personal/Equipment category (\$2.9 million). Due to the large variation in funding levels necessary to fund the replacement of Police vehicles over the five-year period, the incremental costs necessary to ensure that replacement schedules for the marked, covert, and unmarked Police fleet are met are shown as a separate line item. In this Forecast, they range from an increased need resulting in additional costs of \$971,000 in 2011-2012 to a reduced need resulting in savings of \$1,446,000 in 2014-2015.

### **Contingency Reserve**

Per City Council policy, the 2010-2011 Contingency Reserve is projected at the level necessary to comply with the City Council policy to maintain a 3% Contingency Reserve (\$29.3 million). This amount would be sufficient to cover approximately one pay period of payroll costs. Amounts necessary to remain in compliance with that policy are also included in each of the remaining four years of the Forecast.

### **Committed Additions to the Base General Fund Forecast**

In this Forecast, projected additions to the base expenditure level have been included as **Committed Additions**. Although all are subject to further review during the budget process, Committed Additions are additional expenditures to which the City is considered to be committed by prior City Council action, such as the costs related to maintaining and operating

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### **Committed Additions to the Base General Fund Forecast** (Cont'd.)

capital projects previously approved by the City Council. The Forecast Base Case, considered most likely to occur, includes ongoing program costs plus committed additions.

The following Committed Additions, totaling \$7.5 million, are included in the 2011-2015 Forecast. These Committed Additions, as well as a discussion of General Fund Capital Operating and Maintenance/Budget Principle #8, are explained in more detail in a later section of this document.

The hiring of **Additional Police Officers**, as directed by the City Council as part of the approval of the 2008-2009 Mayor's June Budget Message has been included in the forecast. The addition of 25 Police Officers in 2010-2011 and 2011-2012 is included. The cost of these positions is projected at \$1.6 million in 2010-2011 and is expected to increase to \$9.5 million by 2014-2015.

**County Pocket Annexation** costs (\$180,000 in all five years) that would be required by the Department of Transportation have been included to maintain the approximately 40 miles of public streets and related infrastructure that will be annexed into the City from Unincorporated areas within the City of San José's Urban Service Area.

**New Parks and Recreation Facilities Maintenance and Operations** costs (\$828,000 in 2010-2011) are included at the levels necessary to support the additional costs of maintaining and operating new or expanded park facilities that were included in the City's latest Five-Year Capital Improvement Program and those that are being developed by other agencies. Examples of projects include Edenvale Community Center in 2010-2011 and Hitachi Park in 2011-2012.

Increased costs from scheduled **New Traffic Infrastructure Assets Maintenance and Operations** (\$111,000 in 2010-2011) are included as a committed addition.

The approved bond measures from the elections of November 2000 and March 2002 will result in new and expanded library (**Measure O**), park (**Measure P**), and police and fire (**Measure O**) facilities and will require significant additional **Maintenance and Operations** funding (\$4,752,000 in 2010-2011). Some of the new facilities scheduled to open during this forecast period include: the South San José Police Substation, Fire Station 37 (Silver Creek/Yerba Buena Road), Seven Trees Community Center and Library, Southeast Branch Library, Soccer Complex, and Bascom Library and Community Center.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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

Budget Principle #8 states that Capital Improvement Projects shall not proceed for projects with annual operating and maintenance costs exceeding \$100,000 without City Council certification that funding will be made available in the applicable year of the cost impact. Consistent with that direction, this Forecast includes a detailed list and discussion of capital projects that were previously certified by the City Council with annual operating and maintenance costs in the General Fund greater than \$100,000. Funding for these projects have been included as part of approved Capital Improvement Programs or Redevelopment Agency Budgets. The majority of these costs are associated with the voter-approved General Obligation bonds for Park, Library, and Public Safety facilities. The operating and maintenance costs for these facilities are included in the figures presented in this Preliminary General Fund Forecast. In addition, one additional potential project (Vietnamese Heritage Garden) where funding has not yet been certified has been identified. This project is under very preliminary development and if approved, is anticipated to have an annualized operating and maintenance impact of \$198,000 by 2014-2015. Consistent with the direction approved as part of Budget Principle #8, for purposes of this Forecast, the operating and maintenance cost for this project is not included as part of the General Fund Five-Year Forecast "Committed Additions" category. Certification for this project and other identified projects that have not been certified by the City Council may be sought as part of the 2011-2015 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.

# ELEMENTS OF THE GENERAL FUND FORECAST

## OPERATING MARGIN

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The Base Case with Committed Additions General Fund Forecast projects a shortfall in the first year (2010-2011) of \$116.2 million. This is higher than both the October 2009 Preliminary Forecast shortfall estimate of \$96.4 million and the February 2009 Forecast shortfall of \$36.7 million for 2010-2011.

Base Case expenditures, including committed additions, increase from \$906.3 million in 2010-2011 to \$1.1 billion in 2014-2015, for an average growth rate each year of approximately 4.8%. This rate of expenditure growth outpaces the average increase in General Fund sources (including Beginning Fund Balance) of 3.6%. The sources of revenue total \$790.1 million in 2010-2011, and grow to \$911.8 million in 2014-2015.

The following table shows how the projected shortfall has changed in the most recent forecasts. The incremental shortfall assumes each preceding deficit is solved completely with ongoing solutions in the year it appears. Each of the four out years of the Forecast is shown in the table, along with a comparison with the increments projected for those years in the February 2009 Forecast and the preliminary 2010-2011 update provided to the City Council in October 2009. It is important to note that in October 2009, only the first year of the forecast (2010-2011) was provided.

<b>2011-2015 General Fund Forecast Changes in Operating Margin (\$ in Millions)</b>					
	<u>2010-2011*</u>	<u>2011-2012*</u>	<u>2012-2013*</u>	<u>2013-2014*</u>	<u>2014-2015*</u>
<b>February 2009*</b> Incremental Surplus/(Shortfall)	(\$36.74)	(\$4.92)	\$6.49	\$10.11	N/A
<b>June 2009</b> Incremental Surplus/(Shortfall)	(\$54.83)	(\$38.70)	(\$36.00)	(\$38.70)	N/A
<b>Revised Forecast</b>	<b>(\$91.57)</b>	<b>(\$43.62)</b>	<b>(\$29.51)</b>	<b>(\$28.59)</b>	<b>N/A</b>
<b>October 2009</b> Incremental Surplus/(Shortfall)	<b>(\$96.42)</b>	N/A	N/A	N/A	N/A
<b>February 2010</b> Incremental Surplus/(Shortfall)	<b>(\$116.16)</b>	<b>(\$20.18)</b>	<b>(\$17.98)</b>	<b>(\$21.50)</b>	<b>(\$5.77)</b>

\* Funding for cost-of-living (COLA) salary increases not factored into the Forecast unless there is an approved contract agreement. For this Forecast, 2% COLAs are assumed for the Municipal Employees' Federation and Confidential Employees' Organization in 2010-2011 only. The Forecast includes committed additions previously agreed upon by Council, such as addition of 25 officers in 2010-2011 and 2011-2012 (50 total) and operating and maintenance funding for capital projects coming online.

## ELEMENTS OF THE GENERAL FUND FORECAST

### OPERATING MARGIN (CONT'D.)

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In the February 2009 Forecast, an incremental shortfall of \$36.74 million for 2010-2011 was projected. This figure was based on the assumption that the entire 2009-2010 shortfall would be solved with ongoing actions. Although the 2009-2010 Adopted Budget was balanced with 96% in ongoing solutions, 4% was one-time and carried forward to the next year. The carryover impact of those one-time measures (\$3.1 million) is reflected in the June 2009 incremental shortfall line item. In addition, the June 2009 shortfall for 2010-2011 was increased by \$51.70 million to reflect the potential impact of the estimated increase in the Police/Fire and Federated Plans pension contributions due to a reported significant retirement portfolio loss in spring 2009. These increases of \$54.8 million when combined with the previous shortfall anticipated for 2010-2011, resulted in a deficit of approximately \$91.6 million projected for 2010-2011.

In October 2009, staff prepared a 2010-2011 Preliminary General Fund Forecast incorporating the final 2008-2009 actual performance and the first three months of activity in 2009-2010. In that Preliminary Forecast, the General Fund deficit for 2010-2011 was increased to \$96.4 million. This increase in the projected deficit was the net result of a number of upward and downward adjustments to the City's many General Fund revenue and expenditure categories. The most significant changes included: net downward adjustments to a number of the economically sensitive revenue estimates and the 2009-2010 Ending Fund Balance/2010-2011 Beginning Fund Balance assumption; downward adjustments to the revenue and expenditure estimates for the Development Fee Programs; increased cost assumptions for the retirement contributions necessary in 2010-2011 (a total of \$51.7 million in retirement contributions was assumed); and lower base costs resulting from the analysis of actual expenditure trends and updated debt service costs. For complete details of the 2010-2011 Preliminary General Fund Forecast, refer to the memorandum issued on October 30, 2009.

For the February 2010 General Fund Forecast, staff completed an in-depth review of anticipated revenues and expenditures for 2010-2011 and the remaining four years of the forecast period. Based on this updated information, a 2010-2011 General Fund shortfall of \$116.2 million is now projected, a net increase of \$19.8 million from the October 2009 figure. This increase was the result of upward expenditure adjustments of \$11.6 million and net revenue reductions of \$8.2 million.

When compared to the Preliminary Forecast, the projected increase in expenditures for 2010-2011 was the result of increased pension costs for both retirement plans (Police/Fire and Federated) (up \$14.7 million) partially offset by lower expenditure estimates in other areas (down \$3.1 million), including the impact of actions taken during 2009-2010 in the development fee programs to align costs with projected revenues and the elimination of five sworn positions in the Police Department for Airport related services; and lower utility and fuel costs. Other expenditure adjustments were based on a more in-depth review of base costs.

The downward adjustment of \$8.2 million to the General Fund revenue estimates primarily reflects the continued impact of the economic downturn on the City's revenues. Several of the revenue estimates were revised downwards, including Business Tax, reimbursement from the Airport Funds for Police services (mostly offset by expenditure reductions), interest earnings, parking fines, Telephone Line Tax, development fee program estimates, Central Fire District

## ELEMENTS OF THE GENERAL FUND FORECAST

### OPERATING MARGIN (CONT'D.)

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reimbursements, Property Tax, Cardroom Tax, Franchise Fees, and Sales Tax. The Utility Tax revenue estimate, however, was increased due to the strong performance in the Telephone Utility Tax category.

The second year of the Forecast (2011-2012) also has a sizeable General Fund deficit of \$20.2 million. Economic performance is expected to show some improvement by 2011-2012, with expected revenue growth of 3.28%. Property Tax is expected to resume growth (2.88%) and Sales Tax is expected to increase 3.76%. The projected expenditure growth in 2011-2012 of 5.1%, however, significantly outpaces the modest revenue growth. This overall expenditure growth is driven by personal services increases projected at 4.3% due, in large part, to changes in the retirement costs for the impacts of investment losses and non-economic assumptions upon the plan and the continued phase-in of retiree healthcare costs; and by changes in Committed Additions. The variances in the three out years range from deficits of \$21.5 million in 2013-2014 to \$5.8 million in 2014-2015.

It is important to note that there are no cost-of-living salary increases assumed in this Forecast unless there is an approved contract agreement with the employee bargaining group. In this Forecast, the only salary adjustments include a 2% cost-of-living salary increase in 2010-2011 for employees represented by the Municipal Employees' Federation (MEF) and Confidential Employees' Organization (CEO) (\$2.4 million) as approved in their contract agreement with the City as well as overall scheduled non-management step increases (\$2.5 million) for eligible employees, which represent 0.5% salary growth for 2010-2011. This is a methodology change that was first incorporated into the November 2008 Preliminary General Fund Forecast. With this change, the consideration of salary increases is being treated as a resource allocation policy decision. This decision will need to be made in the context of what is affordable in light of the large projected shortfalls and the many service delivery priorities. At current rates, each 1% increase in salary has a General Fund cost of approximately \$5.8 million.

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