CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: **2011-2012 CITY MANAGER'S BUDGET REQUEST AND 2012-2016 FIVE-YEAR FORECAST**

DATE: February 28, 2011

INFORMATION

EXECUTIVE SUMMARY

In compliance with City Charter Section 1204, and the City Council's adopted budget process, this document provides both the recommended 2011-2012 City Manager's Budget Request (Budget Balancing Strategy Guidelines) and the 2012-2016 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program. Following are the major highlights of this report:

- A substantial General Fund Base Budget shortfall of $105.4 million is projected for 2011-2012. This shortfall reflects the estimated cost of delivering existing services as well as the services for which the City has already committed, such as the operation of new facilities. The revised shortfall estimate is well above the already very large shortfall of $69.9 million projected in the Preliminary 2011-2012 General Fund Forecast, which was released in November 2010, but is slightly below the updated estimate of $109.3 million that was provided in January 2011 due to a slight improvement in revenues.

- Approximately 75% of the 2011-2012 General Fund shortfall is attributed to increased expenditures, with increased retirement contributions accounting for the majority of the shortfall. The remaining shortfall represents the portion of the 2010-2011 Adopted Budget solved with one-time solutions and decreased revenues as shown in the following chart.

2011-2012 General Shortfall Component (Ongoing)	$ in Millions
Carry-Over from 2010-2011 Adopted Budget	**($ 20.5)**
Major Expenditure Changes	
- Retirement Contribution Increases (Police ($25.4 million), Fire ($18.4 million), Federated ($14.6 million)	(58.4)
- 2011-2012 Committed Additions (capital projects scheduled to come on-line)	(6.7)
- Health and Other Fringe Increases (Health, Dental, Unemployment)	(6.4)
- Public Safety Vehicle Replacement Increases	(4.7)
- Salary Step/Performance Increases	(3.3)
- Other Adjustments	0.2
Sub-Total Expenditure Changes	**($79.3)**
Decreased Revenue Estimates	**($5.6)**
Total 2011-2012 Projected General Fund Shortfall	**($105.4)**

- In 2011-2012, the City will face its tenth consecutive fiscal year of General Fund budget shortfalls. Over the past nine years, the City has addressed General Fund budget shortfalls totaling $565.2 million and eliminated approximately 1,600 positions, with staffing now at 1994-1995 levels. While the City addressed a record General Fund shortfall of $118.5 million in 2010-2011, the budgetary challenges facing the organization in 2011-2012 are expected to be even more severe given the budget balancing actions that have already been implemented. The magnitude of this shortfall as well as the continuing budget gaps expected over the Forecast period are sobering and require fundamental changes to cost and revenue structures to bring the General Fund budget into balance.

- Over the Forecast period, General Fund budget shortfalls are projected for each year and total $183.8 million over the next five years. Increased City retirement contributions coupled with slow economic growth are the primary drivers for the enormous General Fund budget gap facing the City during the Forecast period.

- For 2011-2012, General Fund retirement costs total $192.9 million, or 21.4% of the total base expenditure budget. Based on Federated and Police and Fire Retirement Boards' actions regarding the interest earnings assumptions and the methodology for setting the City Annual Required Contribution, the City's annual required contribution amount for 2011-2012 is fixed at $192.3 million ($54.0 million to the Federated Retirement System, $86.4 million to the Police Retirement Plan, and $51.9 million to the Fire Retirement Plan). The remaining retirement costs are associated with the part-time benefited employees and the Mayor and City Council who do not participate in the City's retirement plans. For comparison purposes only, at this time, the contribution rate for the Federated Retirement Plan increased from 29.59% for 2010-2011 to 37.5% for 2011-2012; the contribution rate for the Police Retirement Plan increased from 44.58% for 2010-2011 to 60.47% for 2011-2012; and the contribution rate for the Fire Retirement Plan increased from 44.16% for 2010-2011 to 67.76% for 2011-2012. During the Forecast period, General Fund retirement costs will increase by approximately $112 million from $192.9 million for 2011-2012 to $304.5 million for 2015-2016, representing an increase of 58%. By 2015-2016, retirement contributions are projected to account for 28.1% of the total base expenditure budget. It is important to note that the City's annual required contribution amount for two Retirement Plans is not final. The contribution amount to the Police and Fire Retirement Plan will be updated, as appropriate, pending the Police and Fire Retirement Board's consideration of the actuarial valuation for Retiree Health Care, which is expected for the March Board meeting.

- The City retirement contribution rates assume the current staffing level of the Forecast and were calculated to meet the fixed required contribution amounts. However, in order to close the $105.4 million General Fund shortfall in 2011-2012, it will be necessary to reduce staffing levels. As positions are eliminated and compensation costs are reduced, it will be necessary to increase the retirement contribution rates for the remaining positions to generate the fixed retirement contributions.

- Since the release of the Preliminary 2011-2012 General Fund Forecast in November, the projected shortfall for 2011-2012 increased by $35.5 million due to increased expenditures ($39.4 million), partially offset by higher revenue projections ($3.9 million). The $36.9

million increase in retirement contributions (from $21.5 million to $58.4 million) account for the majority of this change.

- The Forecast incorporates service reductions or eliminations totaling approximately $23.1 million and the elimination of 223 positions effective July 1, 2011 that were approved as part of the 2010-2011 Adopted Budget.

- The only salary increases in this Forecast are salary step increases related to eligible non-management employees and management pay for performance allocations, with an estimated General Fund cost of $3.3 million ($2.2 million excluding associated retirement costs) in 2011-2012. There are no cost-of-living salary increases assumed in 2011-2012 or in the out years of the Forecast for any employee groups, reflecting the fact that there are no negotiated agreements covering this period. The consideration of salary adjustments is being treated as a resource allocation policy decision. At current rates, each 1% of salary increase granted to all employees would increase the General Fund cost in 2011-2012 dollars by $6.3 million ($4.4 million excluding associated retirement costs). This figure does not include any potentially higher future retirement costs due to higher salaries.

- It is important to note that this Forecast does not reflect: the impact of unanticipated compensation changes resulting from negotiations or arbitration awards, where applicable, with the City's various employee bargaining groups; impacts from San Jose Redevelopment Agency (SJRA) general budget balancing actions or potentially more severe budget impacts associated with the proposed elimination of redevelopment agencies per Governor Brown's budget proposal; additional impacts to the City's contribution to the retirement system from changes in actuarial assumptions and methodologies that may be approved by the Retirement Boards in upcoming years or from pension reform efforts that are currently underway; revenue from the Marijuana Business Tax that is effective March 1, 2011 (a revenue estimate will be developed once actual collections are received and a baseline can be established); funding for unmet/deferred infrastructure and maintenance needs; and one-time revenue sources or one-time expenditure needs. In addition, any gaps between revenues and expenditures in the Planning, Building, Public Works or Fire Development Fee Programs are not reflected. It is assumed that these programs will be adjusted to recover 100% of their costs.

- As is customary in the Forecast, two alternative forecasts have been developed to model the range of financial scenarios possible under varying economic conditions. "Optimistic" and "Pessimistic" Cases have been created to model economic scenarios considered possible, but less likely to occur than the "Base Case". In 2011-2012, the projected deficits range from $97.0 million to $109.1 million, with the Base Case totaling $105.4 million.

- In approaching the 2011-2012 budget, the Administration proposes the use of the budget balancing strategy guidelines (2011-2012 City Manager's Budget Request) outlined in this memorandum. The City Council priorities identified in prior policy sessions will also guide the City's balancing strategy efforts. The Administration recommends City Council approval of the proposed City Manager's Budget Request (Budget Balancing Strategy Guidelines), with any desired revisions, as part of the Mayor's March Budget Message review process.

- When the estimated ongoing unmet/deferred infrastructure and maintenance needs of $8.6 million are added to the Base General Fund shortfall (excluding one-time costs of $446 million), the City's General Fund Structural Deficit is expected to total $114.0 million in 2011-2012 and reach $226.7 million over the Forecast period. Given the severity of the General Fund base budget shortfall and the significant changes that will be necessary to balance this budget, the General Fund Structural Deficit Elimination Plan, which was last updated in February 2009, has not been revised as part of this document. The plan is still a relevant guide for eliminating the structural deficit and several strategies outlined in the General Fund Structural Deficit Elimination Plan are being pursued as part of the 2011-2012 budget process. This plan will be updated after the extensive budget actions necessary to balance the current budget are approved to provide a revised starting point to address this deficit.

- Also detailed in this document, construction-related Capital Program revenues remain relatively flat from the estimates provided in the 2011-2015 Adopted Capital Improvement Program reflecting minimal improvements in the current environment. There is a projected increase of 4% over the last Forecast, from $172.1 million in the 2011-2015 Forecast to $178.5 million in the 2012-2016 Forecast.

- While this Forecast focuses on the General Fund and key revenues that support the City's Capital Improvement Program, many City funds will be negatively impacted by escalating costs and, in some cases, weak revenue growth. This is particularly the case for the Airport funds, which are expected to face severe financial challenges over the next several years. Increased costs may necessitate rate increases in those funds supported by rate-payers to maintain existing service levels.

BACKGROUND

In compliance with City Charter Section 1204, and the City Council's adopted budget process, this document provides both the recommended 2011-2012 City Manager's Budget Request (Budget Balancing Strategy Guidelines) and the 2012-2016 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program. The City Manager's Budget Request and Five-Year Forecast are key components of the City's annual budget process, and critical steps in the development of both the City's annual Operating and Capital Budgets and the Five-Year Capital Improvement Program (CIP).

The City Manager's Budget Request includes budget balancing strategy guidelines that the Administration recommends be used in developing the 2011-2012 Proposed Budget. These guidelines are predicated on the most current projections for expenditure requirements and available revenue in the coming fiscal year. As the City's anticipated fiscal status for 2011-2012 is an integral part of the Administration's proposed approach to preparing the 2011-2012 budget, a detailed discussion of the key economic, revenue, and expenditure assumptions for 2011-2012, and the subsequent four years, is provided as part of this document.

ANALYSIS

This overview includes the following: a discussion of the 2011-2012 City Manager's Budget Request, including a description of the proposed budget balancing guidelines; an overview of the 2012-2016 General Fund Five-Year Forecast and Revenue Projections; a summary of the Capital Revenue Forecast; and a description of the next steps in the 2011-2012 budget process.

2011-2012 CITY MANAGER'S BUDGET REQUEST

This document provides a set of budget balancing strategy guidelines (these encompass the 2011-2012 City Manager's Budget Request) recommended by the City Administration for use in preparing the 2011-2012 budgets for the General Fund and selected Capital Funds. The proposed guidelines contained in the 2011-2012 City Manager's Budget Request have been formulated in the context of projections for substantial General Fund shortfalls throughout the Forecast period. With moderate revenue growth and significant increases in projected retirement costs, expenditure levels of existing General Fund services are expected to exceed revenue sources in all years of this Forecast. With the exception of salary step increases related to eligible non-management employees and management pay for performance, there are no salary increases assumed in this Forecast reflecting the fact that there are no negotiated agreements covering this period. Approval of any negotiated salary or benefit increases, without any offsetting increase in revenues or reduction in costs, will have the effect of driving up the City's shortfall. 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 City's many service delivery priorities and the large shortfalls projected.

This forecast updates the November 2010 Preliminary General Fund Forecast that projected a $69.9 million shortfall next year. The updated projections indicate an even larger General Fund base shortfall of $105.4 million in 2011-2012. Over the five-year forecast period, the General Fund base shortfalls are expected to total $183.8 million. In accordance with the City Charter, the City is required to address these shortfalls each year in order to develop a balanced budget. The base shortfall figures, however, do not include the ongoing unmet/deferred infrastructure and maintenance needs of $8.6 million that are included in the broader General Fund Structural Deficit definition. Once those ongoing costs are added (excluding the one-time backlog of $446 million), the General Fund structural budget deficit climbs to $226.7 million over the next five years. These additional costs, while not required to be addressed in the annual budget, represent a long-term unfunded need.

Projections for the selected Capital Improvement Program (CIP) revenues included in this Forecast remain relatively flat from the last Forecast. For the Construction and Conveyance (C&C) Tax, which supports a number of capital programs, it is anticipated that collections will increase slightly by 2% over the forecast period but remain at a level that is less than half of the revenue collected at the peak in 2005-2006. For the major development-related capital budget revenues (which primarily support the Traffic Capital Budget), there is expected to be a 5% increase over the last forecast period for the Building and Structure Construction Tax and an 11% increase over the last period for the Construction Excise Tax.

As noted above, the Administration proposes the use of the budget balancing strategy guidelines (2011-2012 City Manager's Budget Request) outlined on the following page to approach the 2011-2012 budget development process. As part of the 2011-2012 Mayor's March Budget Message, the Administration requests confirmation of these guidelines, with any desired revisions. These guidelines incorporate both short-term and long-term approaches to budget balancing efforts and reflect the City's sound fiscal principles.

The Proposed Budget Balancing Strategy Guidelines are similar to those adopted by the Mayor and City Council last year as part of the 2010-2011 Mayor's March Budget Message. A few modifications, however, have been incorporated into the proposed strategies to address City Council direction and to continue to position the City to address the significant General Fund shortfalls projected over the Forecast period. For example, Budget Balancing Strategy Guideline #4 reflects the current City Council goals related to personal services cost savings and replaces Budget Balancing Strategy #11 included last year. A new Budget Balancing Strategy #11 has been added to reflect the goal to identify City policy changes that would enable/facilitate service delivery changes or other budget balancing strategies.

One budget balancing strategy has been eliminated based on changing direction. Last year, there was a strategy to address the projected General Fund shortfall targeted equally in the following three areas: one-third from employee wage and benefit concessions, one-third from revenues; and one-third from one-time revenues, alternative service delivery proposals and efficiencies in operations, with any remaining gaps covered by service reductions and eliminations.

In addition to the Budget Balancing Strategy Guidelines, City Council priorities and goals identified in prior policy sessions will guide the City's budget balancing efforts. Input from the community through community surveys, various City Councilmember and stakeholder outreach activities, and the San José Neighborhood Association/Youth Commission 2011-2012 Priority Setting Session will serve as an important tool in this process. In January 2010, the Administration also released the 2010-2011 Base Budget Program Dictionary, which provided a listing and basic description of over 350 discrete direct service programs delivered by the City as reflected in the 2010-2011 Base Budget, including program cost, staff, and associated resources managed. These programs were then prioritized as part of a pilot Program Prioritization effort and the results were distributed as a reference document for the February 16, 2010 City Council/Senior Staff Study Session on the 2010-2011 Budget Planning. The results of these efforts will continue to serve as a valuable analytical tool in developing budget proposals for the 2011-2012 budget process.

2011-2012 Budget Balancing Strategy Guidelines

1. Develop a budget that balances the City's delivery of the most essential services to the community with the resources available.
2. Every effort should be made to resolve the projected budget deficit with ongoing revenue and expenditure solutions to ensure no negative impact on future budgets to maintain the City's high standards of fiscal integrity and financial management.
3. Focus on protecting vital core City services for both the short- and long-term. Analyze all existing services and target service reductions or eliminations in those areas that are least essential. To the extent possible, use the Department Program Dictionary and results from the Program Prioritization process to assist in identifying alternative service delivery opportunities and services that should be reduced or eliminated.
4. Explore personal services cost savings, subject to the meet and confer process where applicable. Per November 18, 2010 City Council direction, continue prior direction of March 2010 for 10% total compensation reduction for Fiscal Year 2011-2012 with modifications: 1) entire 10% ongoing; 2) roll back any general wage increases received in FY 2010-2011; 3) include City Auditor's recommendations for healthcare cost containment, including increase cost sharing, increase co-pays, reduce health and dental in-lieu, and eliminate dual coverage; and 4) in addition to the 10% total compensation reduction, achieve additional reforms in the areas of retirement (pension and retiree healthcare), sick leave payouts, and compensation structure (eliminate automatic step increases and modify step structure and overtime eligibility).
5. Focus on business process redesign to improve employee productivity and the quality, flexibility, and cost-effectiveness of business practices (e.g., streamlining and simplifying City operations) through engagement of employees and use of technology.
6. Analyze non-personal/equipment/other costs, including contractual services, for cost savings opportunities. Contracts should be evaluated for their necessity to support City operations and to identify negotiation options to lower costs.
7. Explore alternative service delivery models (e.g., partnerships with the non-profit, public, or private sector for out- or in-sourcing services) to ensure no service overlap, reduce and/or share costs, and use our resources more efficiently and effectively. The City Council Policy on Service Delivery Evaluation will serve to provide a decision-making framework for evaluating a variety of service delivery models.
8. Engage the community and employees for generation of budget balancing ideas.
9. Explore redirecting and/or expanding existing revenue sources and/or adding new revenue sources for addressing both the General Fund structural deficit and unfunded needs as outlined in the General Fund Structural Deficit Elimination Plan and related updates to the Plan.
10. Establish a fee structure to assure that operating costs are fully covered by fee revenue and explore opportunities to establish new fees for services, where appropriate.
11. Identify City policy changes that would enable/facilitate service delivery changes or other budget balancing strategies.
12. Make every effort, if operationally feasible, to eliminate vacant positions, rather than filled positions, to minimize the number of employee layoffs. As programs are reduced or eliminated, ensure that management and administration are reduced as appropriate.
13. Defer any new program commitments and initiatives or program expansions, unless those program stimulate the local economy, job creation, new revenues, have a significant return on investment for the General Fund, and/or are funded through redeployment of existing resources.
14. Use the General Plan as a primary long-term fiscal planning tool and link ability to provide City services to development policy decisions.

In light of the current forecasted budgetary situation, the Administration directed each of the six current City Service Areas (CSAs) (Community and Economic Development, Environmental and Utility Services, Neighborhood Services, Public Safety, Transportation and Aviation Services, and Strategic Support) to develop 2011-2012 budget proposals using these guidelines. For planning purposes, General Fund budget reduction targets were set at 10% of General Fund Base Budget amounts for the Public Safety CSA and 28.8% for the remaining five CSAs (adjusted for reimbursement-related costs and costs beyond the control of the CSA). For City Council appointees, the reduction target was set at 14.4%. These targets were set at levels to generate approximately $90 million in General Fund proposals. Based on the revised General Fund shortfall figure of $105.4 for 2011-2012 and the changes in retirement contribution methodologies (as explained in detail in Section I of this document under Expenditure Forecast) that reduce the amount of savings that can be generated from each proposal that eliminates positions, additional budget proposals will be necessary to close the budget gap.

The Mayor is scheduled to issue a proposed March Budget Message on March 11, 2011, which will then be discussed, amended if necessary, and adopted by the City Council. The contents of that Message will provide specific guidance for the preparation of the City Manager's 2011-2012 Proposed Capital and Operating Budgets currently scheduled to be submitted on April 20, 2011 and May 2, 2011, respectively. As required by City Charter, those Proposed Budgets will contain comprehensive plans for how the City organization will address the highest priority needs of the community while maintaining the fiscal integrity of the City. Given the magnitude of the shortfall, significant service reductions and eliminations are expected to be necessary.

After the release of the Proposed Budgets, there will be a series of Proposed Budget Study Sessions and Public Hearings to discuss the budget proposals and the associated impacts on performance measures and service delivery. The Administration will also work with the City Council to provide informational meetings on the Proposed Budget in each City Council District in late March through May 2011. Additional input by the City Council and community will be incorporated into the budget through these Proposed Budget Study Sessions, Public Hearings, and the Mayor's June Budget Message during the months of May and June 2011.

2012-2016 FIVE-YEAR FORECAST AND REVENUE PROJECTIONS

The 2012-2016 Five-Year Forecast and Revenue Projections portion of this document is divided into five sections.

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

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

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

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

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

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

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

Two appendices are also included in this document. The first appendix, prepared by the Planning, Building and Code Enforcement Department, documents the basis for that department's five-year projections for construction activity. The second appendix provides descriptions of the City's major General Fund revenue categories.

<u>2012-2016 Five-Year General Fund Forecast</u>

The following table displays the projected General Fund revenues and expenditures over the next five years and the total cumulative shortfall. In addition to the cumulative shortfall, the incremental shortfall (assuming each preceding deficit is solved completely with ongoing solutions in the year it appears) for each year of the forecast is included. Because it is the City's goal to solve each deficit with ongoing solutions, the incremental shortfall figure is useful in that it shows the additional shortfall and/or surplus attributed to a particular fiscal year. If those shortfalls are not solved with ongoing solutions, however, the remaining budget gap will carry over to the following year. For instance, the 2011-2012 General Fund shortfall includes a $20.5 million carry-over shortfall from the 2010-2011 Adopted Budget.

2012-2016 GENERAL FUND FIVE-YEAR FORECAST
BASE BUDGET SHORTFALL* ($ in Millions)

	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016
Projected Revenues	$797.9	$818.8	$846.6	$874.7	$899.1
Projected Expenditures	$903.3	$967.3	$1,020.2	$1,058.3	$1,082.8
Total Cumulative Shortfall	($105.4)	($148.5)	($173.6)	($183.6)	($183.7)
Total Incremental Shortfall	**($105.4)**	**($43.1)**	**($25.1)**	**($10.0)**	**($0.1)**

* Does not assume cost-of-living salary increases; additional impacts associated with the San Jose Redevelopment Agency; additional impacts from changes in actuarial assumptions and methodologies that may be approved by the Retirement Boards in future years that could substantially increase the City's required contributions or, conversely, that reduce the City's required contributions as a result of pension reform efforts that are currently underway; revenue from Marijuana Business Tax; unmet/deferred infrastructure and maintenance needs; or one-time revenues/expenses.

The incremental changes in this Forecast range from a deficit of $105.4 million in 2011-2012 to a deficit of $0.1 million in 2015-2016. Consistent with prior forecasts, expenditure growth continues to outpace revenue growth. Given the decreasing level of precision to be expected in the later years of a multi-year forecast, the significance of the projections in the out-years is not so much in terms of their absolute amounts, but rather in the relative size of the decrease or increase from the prior year. This information should be used to provide a multi-year perspective to budgetary decision-making, rather than as a precise prediction of what will occur.

The fiscal outlook for the City reflected in this Forecast is worse when compared to both the Preliminary 2011-2012 General Fund Forecast released in November 2010 and particularly the final 2011-2015 General Fund Forecast that was issued in February 2010.

The 2011-2012 General Fund shortfall of $105.4 million is primarily the result of expenditure changes ($79.3 million), with the remaining gap due to lower revenue estimates ($5.6 million) and the carryover of a shortfall from the 2010-2011 Adopted Budget ($20.5 million) as a result of the use of one-time solutions to address a portion of the budget shortfall in that year.

On the expenditure side, several upward and downward adjustments have been incorporated into this Forecast. The most significant expenditure change is the projected increase in the City's retirement contributions assumed for 2011-2012 ($58.4 million). It is important to note that the City's annual required contribution amount to the two Retirement Plans is not final. The contribution amount to the Police and Fire Retirement Plan will be updated as necessary pending the Police and Fire Retirement Board's consideration of the actuarial valuation for Retiree Health Care, which is expected for the March Board meeting.

Other expenditure adjustments resulting in a net increase of $20.9 million in 2011-2012 have been factored into the Forecast, the largest of which include the inclusion of Committed Additions that reflect the cost of new or renovated facilities scheduled to come on-line in 2011-2012, public safety vehicle replacement cost increases, health, dental and unemployment rate increases, and salary step and pay for performance increases.

Lower General Fund revenues account for approximately $5.6 million of the General Fund shortfall. With 2010-2011 revenue performance falling below original expectations in a number of the categories combined with a loss of a portion of San Jose Redevelopment Agency reimbursements as directed by the City Council (November 2, 2010) as part of the approval of the *Mayor's Budget Message: Fiscal Year 2010-2011 Redevelopment Agency Capital and Operating Budget*, there are several revenue categories that have been adjusted downwards for 2011-2012. The Preliminary 2011-2012 General Fund Forecast issued in November 2010 incorporated downward revenue adjustments of $9.5 million from the estimates developed in February 2010, updated for 2010-2011 Adopted Budget actions, based on actual 2009-2010 collections and performance through the first quarter of 2010-2011. This final Forecast includes a slight ($3.9 million) improvement to those revenue estimates presented in November, therefore, the drop in revenue now totals $5.6 million as compared to ongoing revenue performance assumed in the 2010-2011 Adopted Budget.

The categories with the largest declines are: Revenue from Local Agencies (-$7.2 million), due primarily to reduced reimbursements from the Redevelopment Agency of the City of San José; Utility Tax (-$4.3 million), due to lower Telephone and Gas Utility Tax; Cardroom Tax (-$3.6 million) based on lower actual 2010-2011 collections; and Revenue from the State (-$2.4 million) based on lower airplane in-lieu revenue and the elimination of the State Public Library Grant revenue per the Governor's 2011-2012 Proposed Budget. These declines were partially offset by upward adjustments, including a large increase to the Sales Tax estimate ($10.1 million) based on higher actual collections in 2009-2010 and the first quarter of 2010-2011 and an increase to the overhead revenue estimate ($1.3 million) based on the 2011-2012 overhead rates.

The four out-years of the General Fund Forecast continue to show significant budget shortfalls due primarily to escalating City retirement contributions. As depicted in the table below, during the Forecast period, General Fund retirement costs for the three pension plans (as well as retirement costs for part-time benefited employees and the Mayor and City Council who do not participate in the Federated Retirement Plan or the Police and Fire Retirement Plan) will increase by approximately $112 million from $192.9 million ($256.2 million all funds) for 2011-2012 to $304.5 million ($400.7 million all funds) for 2015-2016, representing an increase of 58%. For 2015-2016, projected Retirement costs would represent 28% of the General Fund. The table below details the General Fund's annual Retirement contribution (in $ millions) for employees for the three Retirement Plans as well as the cumulative retirement costs for the Forecast period.

2012-2016 GENERAL FUND RETIREMENT CONTRIBUTIONS ($ in Millions)

Retirement Plan	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016	Total
Federated Retirement Plan	$ 54.0	$65.1	$78.1	$84.7	$87.3	**$369.2**
Police Retirement Plan	$86.4	$106.6	$121.6	$131.3	$135.4	**$581.3**
Fire Retirement Plan	$51.9	$63.9	$72.8	$78.6	$81.1	**$348.3**
Other Retirement Costs	$0.6	$0.6	$0.6	$0.7	$0.7	**$3.2**
Total	**$192.9**	**$236.2**	**$273.1**	**$295.3**	**$304.5**	**$1,302.0**

It is important to note that the projected General Fund shortfall for 2011-2012 does not factor in impacts from the four Development Fee Programs (Building, Fire, Planning, and Public Works). These programs are designed to be 100% cost recovery and have been programmed to have a neutral impact on the Forecast by adjusting the revenue and costs to be equal. In the Building and Public Works Fee Programs, revenues are sufficient to cover the Base Budget costs. In the Planning and Fire Fee Programs, however, small budget gaps are currently projected for 2011-2012. Sufficient Fee Program Reserves are available in each of these programs to address these small variances.

The 2011-2012 budget shortfall of $105.4 million also does not include the service reductions and eliminations that are effective July 1, 2011 as approved by the City Council through the 2010-2011 budget process. These service reductions/eliminations are identified in the table below. The associated costs and positions have been removed from the 2011-2012 Base Budget.

MAJOR SERVICE REDUCTIONS EFFECTIVE JULY 2011

Service	Positions	Savings
Police Patrol Staffing Reduction	(62.00)	($ 9,167,000)
Satellite/Neighborhood Centers Closure	(38.47)	(3,190,000)
One Fire Engine Company Elimination	(13.00)	(2,381,000)
Branch Library Hours Reduction (4-5 hours)	(21.67)	(1,789,000)
Senior Nutrition Program Elimination	(25.86)	(1,164,000)
Park Ranger Program Reduction	(8.98)	(752,000)
Sexual Assaults Investigation Unit Staffing Reduction	(3.00)	(581,000)
Dr. Martin Luther King, Jr. Library Service Reduction	(5.63)	(549,000)
City Attorney Staffing Reduction	(3.00)	(437,000)
PRNS Special Events Staffing Reduction	(6.67)	(425,000)
Police Horse Mounted Unit Elimination	(1.00)	(282,000)
Building Fee Program Reduction	(10.50)	(236,000)
General Code Enforcement Program Reduction	(2.00)	(229,000)
Strong Neighborhoods Initiative Staffing Reduction	(6.00)	(652,000)
Workers' Compensation Claims Staffing Reduction	(2.00)	(218,000)
Anti-Graffiti Program Reduction	(2.00)	(211,000)
Development Services Program Manager Elimination	(1.00)	(175,000)
Info. Tech. Business Application Mgmt Reduction	(1.00)	(136,000)
Arts Express (K-12 Arts) Program Elimination	(1.00)	(131,000)
STAND Gang Intervention Program Reduction	(1.63)	(125,000)
Special TI/ITI Development Program Reduction	(2.00)	(106,000)
Almaden Lake Park Aquatics Program Elimination	(3.22)	(70,000)
Lake Cunningham Marina Closure	(1.51)	(60,000)
Total	**(223.14)**	**($23,066,000)**

* Based on 2010-2011 costs excluding the impact of employee concessions; reflects net costs that factor in offsetting revenue (i.e., Building and Fire Fee Programs)

General Fund Committed Additions

Cost estimates for a number of specific "Committed Additions" that address previous City Council direction are included in this Forecast in the years that they are projected to be required. The Committed Additions category, summarized in the chart below, reflects projected additional operating and maintenance costs for new or renovated capital projects in the 2011-2015 Adopted Capital Improvement Program. The costs of the additions total $6.7 million in 2011-2012 and increase to $14.1 million by the end of the Forecast period.

2012-2016 GENERAL FUND COMMITTED ADDITIONS

	2011-2012	2012-2013	2013-2014	2014-2014	2015-2016
New Parks and Recreation Facilities Maintenance & Operations	$421,000	$933,000	$1,032,000	$1,226,000	$1,723,000
New Traffic Infrastructure Assets Maintenance & Operations	60,000	142,000	216,000	268,000	331,000
Measure O (Library) Maintenance & Operations	3,082,000	3,801,000	4,778,000	4,878,000	4,974,000
Measure P (Parks) Maintenance & Operations	666,000	772,000	877,000	990,000	992,000
Measure O (Public Safety) Maintenance & Operations: Fire	0	2,272,000	3,027,000	3,247,000	3,378,000
Measure O (Public Safety) Maintenance & Operations: Police	2,490,000	2,538,000	2,588,000	2,639,000	2,692,000
Total	**$6,719,000**	**$10,458,000**	**$12,518,000**	**$13,248,000**	**$14,090,000**

Some of the larger facilities expected to come on-line during this forecast period include Emma Prusch – Back Acreage, Hitachi Turnkey Parks, Bascom Library and Community Center, Educational Park Branch Library, Seven Trees Branch Library, Southeast Branch Library, Soccer Complex, Softball Complex, Fire Station 37 (Willow Glen), and the South San José Police Substation. A detailed listing of all capital project operating and maintenance costs included in this 2012-2016 General Fund Forecast can be found in the Committed Additions Section of this document.

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

General Fund Capital Operating and Maintenance/Budget Principle #8 requires City Council certification that funding will be made available in the General Fund for capital projects with an estimated operating budget impact greater than $100,000 at the time of taking beneficial use of the facility or project. Capital projects with operating and maintenance costs over $100,000 and previously certified are included in the approved Capital Improvement Program in Chart B in Section III. There are no potential projects where operating and maintenance funding has not yet been certified. Certification for potential new projects or modifications to existing projects identified after the release of this Forecast that have not been approved by the City Council may be recommended for certification as part of the 2012-2016 Proposed Capital Improvement Program. If certified by the City Council, the operating and maintenance costs associated with these facilities would then be included in subsequent General Fund Five-Year Forecast documents.

Alternative Forecast Scenarios

In order to model the range of budgetary scenarios possible under varying economic conditions, two alternative forecasts have been developed in addition to the "Base Case". "Optimistic" and "Pessimistic" cases have been created to model economic scenarios considered possible, but less likely to occur than the "Base Case". These alternatives are presented to provide a framework that gives perspective to the Base Case. The Base Case Forecast is still considered, however, the most likely scenario and is being used for planning purposes for the 2011-2012 Proposed Operating Budget. It should be noted that the expenditure assumptions remain constant in each of these alternative scenarios.

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 and drives greater job creation which, in turn, supports significant increases in housing prices, promotes more development activity, and results in higher inflation than 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.

By the end of the five-year period, revenues under this scenario would be $50.3 million higher than in the Base Case. In the Optimistic Case, the City would experience annual deficits ranging from $16.2 million to $97.0 million in the first three years of the Forecast, but would have surpluses of $1.4 million and $14.8 million in the last two years, assuming the deficits in the previous years were solved with ongoing solutions.

The Pessimistic Case alternatively assumes that a combination of adverse factors interact to impede the tenuous recovery underlying the Base Case. Under this scenario, high inflation, trade barriers, and contraction of state and local government spending restrain job growth, discourage development activity, and hold down housing prices. In this scenario, the City's revenues, particularly Property Tax and Sales Tax, would continue to be severely impacted. By the end of the five-year period, revenues under this scenario would be $30.5 million lower than in the Base Case. In the Pessimistic Case, there are annual deficits in each year of the Forecast ranging from $109.1 million in 2011-2012 to $7.9 million in 2015-2016.

Revenues/Expenditures Not Reflected in Forecast Model

It is important to note that there are a number of significant factors that may well impact the City's General Fund condition during the five-year period that are not reflected in this forecast model. These include the following:

- *Negotiated Labor Agreements:* As discussed previously, there are no cost-of-living salary increases assumed in this Forecast unless there are approved contract agreements with the employee bargaining groups. No contract agreements are in place for any years of the

Forecast period. 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. This Forecast does not assume that any additional costs would result from the outcome of negotiations with any of the City's bargaining units.

- *San Jose Redevelopment Agency Funding:* The Forecast assumes continued San Jose Redevelopment Agency (SJRA) funding for certain City services that support the Agency ($9.8 million) as well as the reimbursement for the Convention Center debt service payment ($15.4 million). Consistent with the budget direction in the City Council approved *Mayor's Budget Message: Fiscal Year 2010-2011 Redevelopment Agency Capital and Operating Budget*, SJRA reimbursement has been removed for the Strong Neighborhoods Initiative Program, Graffiti Removal, and eligible capital projects that enabled the funding of the San Jose B.E.S.T. Program. The Administration was also directed to work with the Mayor's Office and the SJRA to determine the appropriate amount of unavoidable expenses and General Fund reimbursed direct service for 2011-2012 as well as reassess the appropriate funding level for all discretionary programs previously reimbursed by the SJRA. Any corresponding budget proposals based on these discussions will be brought forward for City Council consideration as part of the 2011-2012 Proposed Operating and Capital Budgets.

- *City Contributions to the Retirement System:* The Forecast does not assume additional changes to actuarial assumptions and methodologies that may be approved by the Retirement Boards in future years. For instance, the Retirement Boards may approve additional reductions to the interest earnings assumptions that will increase the City's required contributions. The actuaries may also change assumptions such as the average lifespan of a retired City employee that may also significantly impact the required contributions to fund the Retirement Plans. Conversely, the Forecast does not assume potential benefits from pension reform efforts that are currently underway.

- *Marijuana Business Tax Revenue:* On November 2, 2010, San José voters approved Measure U which allows the City of San José to tax all marijuana businesses. This action allowed the City to move forward on establishing the Marijuana Business Tax (San José Municipal Code Chapter 4.66). Effective March 1, 2011, the tax rate has been set at 7% of gross receipts. No revenue estimate has been included in this Forecast as the City has not yet been able to establish a baseline for collections. A revenue estimate will be established and included in the 2011-2012 Budget based on actual performance.

- *Unmet/Deferred Infrastructure and Maintenance Needs:* The ongoing General Fund unmet/deferred infrastructure and maintenance needs are estimated at $43.1 million annually. To reach this level over a five-year period, increasing contributions totaling $8.6 million would be needed. This figure does not include the one-time backlog of approximately $821 million, of which $446 million is in the General Fund.

- *One-Time Revenues/Expenses:* Because the Forecast compares ongoing revenues and expenditures, it does not factor in one-time funding sources or one-time expenditure needs.

General Fund Structural Deficit Elimination Plan

Given the severity of the General Fund budget shortfall for 2011-2012 and the significant changes that will be necessary to balance this budget, the General Fund Structural Deficit Elimination Plan, which was last updated in February 2009, has not been revised as part of this document. This plan will be updated after the extensive budget actions necessary to balance the current budget are approved to provide a revised starting point to address the structural deficit. It should be noted that a number of the strategies outlined in the General Fund Structural Deficit Elimination Plan are being pursued as part of the 2011-2012 budget process. Many of the other ideas will be pursued over a longer time period. For instance, proposed tax measures that require voter approval are expected to be brought over a multi-year period after appropriate outreach and polling regarding these various ideas. In addition, several of the proposals to reduce the rate of increase in personnel costs are subject to meet and confer and will be pursued as part of the contract negotiation process with the City's bargaining units.

The projected General Fund Structural Deficit has been updated to reflect revised revenue and expenditure projections in the 2012-2016 General Fund Forecast and unmet/deferred infrastructure and maintenance needs costs. Based on these revised projections, the General Fund structural deficit is expected to total approximately $226.7 million over a five-year period as shown in the table below:

2012-2016 GENERAL FUND STRUCTURAL DEFICIT PROJECTION (FEBRUARY 2011)
($ in Millions)

	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016	Total
Projected Base Incremental Shortfall*	($105.4)	($43.1)	($25.1)	($10.0)	($0.1)	($183.7)
Unmet/Deferred Infrastructure & Maintenance Needs**	($8.6)	($8.6)	($8.6)	($8.6)	($8.6)	($43.0)
Total Incremental Deficit	**($114.0)**	**($51.7)**	**($33.7)**	**($18.6)**	**($8.7)**	**($226.7)**
Total Cumulative Deficit	**($114.0)**	**($165.7)**	**($199.4)**	**($218.0)**	**($226.7)**	**($226.7)**

* Does not assume cost-of-living salary increases; additional impacts associated with the San Jose Redevelopment Agency; additional impacts from changes in actuarial assumptions and methodologies that may be approved by the Retirement Boards in future years that could substantially increase the City's required contributions or, conversely, that reduce the City's required contributions as a result of pension reform efforts that are currently underway; revenue from Marijuana Business Tax; unmet/deferred infrastructure and maintenance needs; or one-time revenues/expenses.

** Assumes a five-year ramp-up period to reach the annual ongoing funding requirement in the General Fund of $43.1 million identified in May 2010; does not address one-time needs of $446 million in the General Fund ($821 million all funds).

Capital Revenue Forecast

Section Five of this report describes the 2012-2016 Capital Budget Revenue Forecast that will be used to formulate several major elements of the Capital Improvement Program (CIP). As in past years, the construction-related revenue estimates included in this report are derived from construction activity projections provided by the Planning, Building and Code Enforcement (PBCE) Department and an analysis of actual collection patterns. The projections and their basis are described in a report prepared by the PBCE Department, which is included as Appendix A of this document (Development Activity Highlights and Five-Year Forecast [2012-2016]). This activity forecast includes a review of specific projects that are in progress as well as a general prediction of expected levels of new construction.

The following table compares the estimates for the economically sensitive capital revenue categories included in this Five-Year Forecast with those included in the 2011-2015 Adopted CIP. As can be seen, there are minimal improvements in the current economic environment.

CAPITAL FORECAST COMPARISON SUMMARY
($ in Thousands)

	2011-2015 CIP	2012-2016 Forecast	Difference	% Change
Construction and Conveyance Tax	$ 107,000	$ 109,000	$ 2,000	2%
Building and Structure Construction Tax	27,500	29,000	1,500	5%
Construction Excise Tax	33,000	36,500	3,500	11%
Municipal Water System Fees	1,510	600	(910)	(60%)
Residential Construction Tax	345	200	(145)	(42%)
Sanitary Sewer Connection Fee	2,100	2,700	600	29%
Storm Drainage Connection Fee	650	530	(120)	(18%)
TOTAL	**$ 172,105**	**$ 178,530**	**$ 6,425**	**4%**

Real estate activity (primarily housing resales) determines the collection level of one of the major capital revenue sources, the Construction and Conveyance (C&C) Tax. As projected in the 2011-2015 Forecast, the bottoming and stabilizing of these revenues from the extreme distress in both the national and local real estate markets have seen collections level off from the sharp declines over the previous years. Construction and Conveyance (C&C) Tax revenues are currently expected to meet or slightly exceed budgeted estimates for 2010-2011 by year-end. As a result, in this Forecast, this category is projected to generate $109 million over the next five years, an increase of $2 million from the estimates assumed in the 2011-2015 Adopted Capital Improvement Program (CIP). The average annual collection level of $21.8 million projected in the 2012-2016 Forecast is, however, well below the actual collection levels in recent years that reached a peak of $49 million in 2005-2006.

The remaining economically sensitive capital revenue categories are directly linked to development activity. Based on projections provided by the Planning, Building and Code Enforcement Department, construction activity valuation is projected to experience a dramatic, short term spike in 2010-2011 ($750 million for 2010-2011 or a 41% increase compared to $529 million in 2009-2010). This level of activity is unsustainable and primarily reflects two new developments in the North San José area. Activity is expected to return back to moderate levels and is projected to drop back down to $600 million in 2011-2012 and 2012-2013 and recover to $675 million in 2014-2015 and 2015-2016. These assumptions are reduced from the levels presented in the 2011-2015 Forecast where activity was expected to drop to $575 million in 2009-2010 and recover to $675 million in 2012-2013 before flattening out in 2013-2014 and 2014-2015 at $725 million. Due to a marked slowdown in residential construction since that time, 2007-2008 experienced a 9% decline, then an additional 26% decline in 2008-2009 and a further decline of 19% in 2009-2010 with total valuation of $529 million.

Based on the construction activity estimates and a review of revenue collection patterns, a minimal increase in construction-related taxes and fees of $6 million, or 4%, is expected when comparing the 2012-2016 Forecast to the 2011-2015 Adopted CIP estimates.

NEXT STEPS IN THE 2011-2012 BUDGET PROCESS

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

March 2011

- 2011-2012 Mayor's March Budget Message Released with Public Hearing; Amended/Approved by City Council

April 2011

- 2011-2012 Proposed Capital Budget and 2012-2016 Capital Improvement Program Released

March-May 2011

- Community Budget Meetings in Each City Council District

May 2011

- 2011-2012 Proposed Operating Budget and 2011-2012 Proposed Fees and Charges Released
- City Council Study Sessions and Initial Public Hearing on 2011-2012 Proposed Operating Budget, 2012-2016 Proposed Capital Budget and Capital Improvement Program, and 2011-2012 Proposed Fees and Charges

June 2011

- 2011-2012 Mayor's June Budget Message Released with Final Public Hearing; Amended/Approved by City Council
- 2011-2012 Operating Budget, 2011-2012 Capital Budget and 2012-2016 Capital Improvement Program, and 2011-2012 Fees and Charges adopted by City Council

CONCLUSION

This document compares the projected revenues and expenditures for the General Fund over the next five years as well as provides estimates for some of the key revenues that support the City's Capital Improvement Program. Over the past nine years, the City has addressed General Fund budget shortfalls totaling $565.2 million and eliminated approximately 1,600 positions City-wide, with staffing now at 1994-1995 levels. In 2011-2012, the City will face its tenth consecutive fiscal year of General Fund budget shortfalls. While the City addressed a record General Fund shortfall of $118.5 million in 2010-2011, the budget gap of $105.4 million in 2011-2012 is expected to be even more severe given the budget balancing actions that have already been implemented and the limitations on reducing the City's retirement contributions.

Unfortunately, the huge budget shortfall projected for 2011-2012 is followed by deficits in the remaining years of the Forecast due primarily to the anticipated increases in retirement costs coupled with low revenue growth. While this Forecast focuses primarily on the General Fund, other City funds will be impacted by escalating costs, primarily due to increased contributions to the City's Retirement Plans.

The revenue and expenditure projections for the 2011-2012 fiscal year will continue to be refined over the next couple of months as additional information becomes available. This is particularly important in the areas of Sales Tax and Property Tax. Sales Tax data for the second quarter of 2010-2011, which covers the 2010 holiday period will be received in March 2011. Based on this additional data, any necessary adjustments will be incorporated into the 2011-2012 Proposed Operating Budget. Similarly, as additional Property Tax data becomes available, it may be necessary to adjust the 2011-2012 revenue estimates.

Fundamental changes to the City's revenue and cost structures as well as the complement of services delivered are needed to create a financially sustainable way to meet the most critical needs of our community. This transition will be extremely difficult as we continue to redefine, restructure, and resize the services this City can afford to provide to its residents. Given the scope of the fiscal challenges that the City faces, it is important that we remain committed to sound fiscal policies.

Debra Figone
City Manager