June 8, 2021

Ms. Mayor and City Council,

As part of our annual efforts, the Budget Advisory and Financial Planning Committee (the "Committee") has completed its brief review of financial projections in the city budget and whether they provide for the long-term financial future of the City. The Committee reviewed the most recent revised fiscal year 21/22 budget and projections, as prepared by Finance Director Michael Szczech and his staff under the guidance of City Administrator Sara Lillevand, and as presented to the Committee on May 25, 2021.

The City's understanding of its financial position, as in previous years, is very thorough. Overall, we believe the assumptions used, and the results presented, to be reasonable and consistent with past practices, which have proven to be appropriately conservative. The presentation from the Finance Director addressed all material revenue sources and expense categories, and discussed potential revenue risks, projected pension costs in detail, Other Post-Employment Benefits (OPEB) funding, equipment replacement, and facilities maintenance.

As we seem to be emerging from the Covid-19 pandemic, the City has weathered its financial impacts admirably and maintains a strong financial condition. Property tax related revenue, which makes up over three-quarters of the City's revenue, has been bolstered by the strong real estate market during the pandemic. The most notable area with declining revenue was the City's recreation programs and facility rentals, but the City was able to reduce program expenses in these areas largely in measure with the revenue reductions. Where lingering uncertainty around some elements of the City's revenues – such as transfer tax revenue – remains, the budget is appropriately conservative and reflects the Finance Director's best estimates. In addition, while the City anticipates receiving approximately $2 million in funding from the American Rescue Plan Act (ARPA), this funding is not included in the FY21-22 budget or 10-year projections given uncertainty surrounding use constraints and timing. The situation continues to be fluid and will require monitoring throughout the year and, with respect to ARPA funds, further review by this Committee pursuant to its charge.

As you know, the Committee believes the objective of long term financial planning for the City is to take steps to ensure that current services are being paid for in the current year, to the extent possible, and that funds for known future requirements (retirement commitments and infrastructure maintenance) are set aside on a current basis. In short, current citizens should pay for the current costs of running the City and not defer those costs to future citizens. Over the past decade, the City has done an excellent job planning for and controlling future costs of retirement commitments. While risks remain, and the cost of funding these commitments is expected to grow significantly over the next decade, the City's established funds for these purposes are projected to be sufficient to address its liabilities.

The Committee believes that the same level of attention should now be given to quantifying and planning for the future costs associated with the City's facilities, streets, and sidewalks – broadly, its infrastructure. Until the full long term costs of maintaining the City's infrastructure are better understood and comprehensively quantified, not only will the City be challenged in prioritizing repair and replacement projects, but it will also be challenged in developing sufficient revenue sources to fund its critical needs. Although progress has been made, there is still work to do on a long-term facilities maintenance plan (including streets, sidewalks, and parks) that incorporates necessary replacement or renovation of aging buildings to meet current standards and to improve operating capacity and efficiency. As you know, the Committee wrote a more complete report last year concerning facilities maintenance and improvements. The Committee continues to believe this is a very high priority.

In reviewing the City's long term projections and considering the current economic situation, the Committee reminds the Council of several things:

- The financial projections seek to maintain, over the long term, an 18% General Fund balance (which, the Committee thinks is prudent). Achieving this target, however, requires that the City eliminate or reduce transfers to the Facilities Maintenance Fund, which addresses ongoing and deferred maintenance of city facilities, and eliminate supplemental funding for street and sidewalk repairs beyond the current budget year. Current projections indicate the Facilities Maintenance Fund will be depleted by FY 27-28. Even without incorporating the yet to be determined costs of major capital projects referenced above, the Facilities Maintenance Fund is inadequately capitalized for the duration of the 10-year projections. This underfunding is not sustainable; it will severely affect repair and replacement expenditures within this decade.
- The Committee supports the conservative approach used to establish the budget for transfer tax revenues given their historic volatility. The Committee also supports the modest increase in projected transfer tax revenue, from the $2.8 million consistently used in the recent past, to $3.2 million annually beginning in FY23. This increased budget amount could still be attained with a recessionary pace of sales and/or drop in sales prices given substantial gains in Piedmont home values over the past decade. The Committee recommends that to the extent actual transfer tax revenue exceeds the conservative estimate, such funds be used to fund the Facilities Maintenance Fund, consistent with prior years.
- The projected pension expenses have increased based on an updated actuarial study completed earlier this year, which assume CalPERS

investment returns decline to 6.0% over the next 20 years. However, future pension costs could still rise should CalPERS investment performance be below target due to a sustained downturn in financial markets.

- The prior funding of the Public Agency Retirement Services (PARS) Fund, supplemented by the proposed capital transfer from the current budget surplus, will provide the City much needed flexibility in managing future pension cost increases, as the City's obligations are expected to increase substantially over the course of this decade. However, this flexibility may be adversely affected by stock market fluctuations to the extent there is significant decline in values during the withdrawal years.
- As in prior years, the projections continue to show that the long term financial health of the City is dependent on property-related taxes, especially the continuation of the Municipal Services Parcel Tax. The projections assume that the MSPT continues with a standard CPI adjustment each year, and the Committee supports this approach.
- The City continues to benefit from a robust economic recovery and rising Bay Area housing prices. Given the uncertainty as to how long such favorable economic conditions will persist, it is important to continue with conservative property tax and transfer tax assumptions.

The Committee appreciates the opportunity to serve the City and is especially appreciative of the work of the Finance Director in providing such a complete and thorough long term financial plan. It is impressive and commendable that the City has weathered the COVID-19 storm without significant budgetary impacts and is well-positioned to address the years to come. Please let us know if you have any questions or would like any additional analysis.

Thank you,

Budget Advisory and Financial Planning Committee
Deborah Leland, Chair
Andrew Flynn, Cathie Geddeis, Robert McBain, Paul Raskin, Frank Ryan and Vanessa Washington