June 5, 2017

Mr. Mayor and City Council,

As part of our annual efforts, the Budget Advisory and Financial Planning Committee (the "Committee") has completed a brief review of the most recent 7 year projections as prepared by John Chiang and the Interim City Finance Director. Due to the departure of the City Finance Director, the process has been constrained this year, but the inclusion of John Chiang in the process adds a great level of comfort for us.

Overall, we believe the assumptions used, and the results presented, to be reasonable and consistent with past practices, which has proven to be conservative. Given the age of the current real estate cycle, the Committee feels it is important to maintain the conservative nature. As in prior years, the projections show that the long-term financial health of the City is dependent on the Municipal Services Parcel Tax ("MSPT"). They also show that in the near term, the City continues to underfund certain longer term liabilities such as Other Post Employment Benefits ("OPEB") and the Facilities Maintenance Fund. Last year, we stated that

> "due to revenue limitations and the need to approve a balanced budget, the City continues to underfund certain longer term capital and operating items, such as facilities maintenance and retiree healthcare. The ability for the City to begin to address some of these longer term underfunded issues depends on an increase in the Municipal Services Parcel Tax."

We believe that with the increase in the MSPT and the side fund debt retirement in 2020, which frees up $1.3 million in annual debt service, the City will be better positioned to meet its obligations beginning after 2020.

As you know, this Committee wrote a more complete report concerning the long-term finances of the City as part of its four-year review of the MSPT in 2015. The budget and projection trajectory we have reviewed does not deviate significantly from that report. The projections use a detailed 2017-2018 budget as a baseline and then make steady state growth assumptions for revenues and expenses. It is worth noting that, while the projected FY16/17 numbers are still preliminary, net revenues are likely to be stronger than projected which will allow for additional transfers, beyond those shown in the budget, to address needs associated with facilities and unfunded liabilities.

The Committee feels 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 facilities/road maintenance) are set aside on a current basis. This is especially true during good economic times. The City has made significant strides in funding facilities maintenance and equipment replacement reserves over the past few years, and the projections continue and expand on that trend.

On the revenue side, the property tax growth rates are projected at 5% which is slightly higher than the most recent 10-year average of 4.7%. The Committee believes more work should be done in the future to better understand longer term property tax growth rates, but over this projection period, the growth seems reasonable. The transfer tax is held level at $2.8 million (average for the last 10 years), consistent with the recommendation of the 2011 Municipal Tax Review Committee ("MTRC"). The actual transfer tax collected has been above this level in the last three years but has come down from $4 million three years ago to $3.1 million last year. While for several years, Piedmont home sales exceeded 150 dropping to 120 last year, through the first 9 months ending in March, Piedmont has experienced only 64 home sales. This decline, if it continues, could negatively impact the transfer tax revenue as well as overall property tax revenue growth. Overall, total revenue growth is projected at 3.2% annually, which we believe reasonable.

On the expense side, the FY17/18 Budget shows a total of $22.1 million of base departmental and non-departmental expenditures (excluding the transfers out) of which:

- $11.5 million, or 52.0%, are salaries, growing at 3%
- $5.2 million, or 23.5%, are benefit costs (both current and retired), growing at over 5%, and
- $5.4 million, or 24.4% are supplies and services growing at 2%.

The resulting long term rate of expense growth is approximately 3.6%, which is below the long-term history but in keeping with the recent past. The actual growth rate will be dependent on negotiations with employees and CalPERS contribution levels. Although CalPERS has increased their contribution rates and reduced their investment assumptions, the State pension benefit plans are still seriously underfunded and contribution rates too low, resulting in some risk to Piedmont.

Additionally, the Council should keep in mind that the assumption of a 5% benefit cost growth rate is likely understated causing concern even beyond the CalPERS issue. The costs include monies paid for current retiree healthcare and that number is expected to grow at significantly higher rates as the number of retirees increases. The Committee recommends that future projections deal with current retiree healthcare costs as a separate line item.

To the credit of the Council and the City's employees, we note that modifications to CalPERS retirement plans and labor negotiations completed in 2013 have resulted in savings of approximately $1.4 million in the next Fiscal Year. These savings are significant and contribute substantially to the financial health of the City. The Committee continues to encourage the Council to seek ways to minimize the impact of uncontrollable benefit obligations on the City's budget. It is ***critical*** for the City to maintain the benefit cost sharing program with employees and continue to be vigilant on reducing uncontrollable benefit costs, such as retiree medical.

Because growth in expenditures slightly exceed growth in revenues over the projection period, the General Fund balance declines modestly over the 7-year period. However, the increased funding level for facilities and retiree healthcare in the later years, provides for more resources to fund current and future obligations. The Committee points out that several risks remain to the near and long term health of the City finances:

1. The City is in the process of completing a comprehensive long term facility maintenance/capital replacement schedule. Until that is completed, the City will be constrained in its ability to prioritize facility capital repair/ replacement projects. We believe this to be a very high priority. The City will always have more needs and wants than funds and an agreed upon capital plan will allow the Council to prioritize its needs and better utilize its scarce resources
2. Per the City manager's report, the City is underfunding street repair/replacement – this needs to be addressed as part of the overall capital repair/replacement analysis
3. No monies are being reserved for large capital projects such as building improvements and certain park and recreation facilities. This is not unusual, but it provides further warning to Council that significant new projects will require new sources of revenues.
4. The projections assume no economic downturn. The real estate cycle last peaked in 2007, making this one of the longest expansions in history.

Last year we noted that projected equipment replacement expenditures significantly exceeded equipment funding which leads to a looming shortfall. In repeating a recommendation from last year, the Committee recommends that the City Council instruct Staff to analyze both the Equipment Replacement and Facilities Maintenance Fund balances to determine a recommended target or minimum balance each year given the volatility of transfer tax revenues.

The Committee appreciates the opportunity to present our findings and looks forward to continuing more in depth work on better understanding equipment replacement and facilities maintenance funding levels and fund balances once the long term facilities plan is in place. Please let us know if you have any questions or would like any additional analysis.

Thank you,

Bill

Bill Hosler
Chair of the Budget Advisory and Financial Planning Committee