

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Debra Figone

SUBJECT: 2007-2008 ANNUAL REPORT

DATE: September 30, 2008

RECOMMENDATIONS

It is recommended that the City Council:

1. Accept the 2007-2008 City Manager's Annual Report of the Financing of the City of San José in compliance with City Charter Section 701 (F).
2. Adopt Appropriation Ordinance and Funding Sources Resolution amendments in various operating and capital funds to implement the 2007-2008 Annual Report recommendations, including appropriate technical adjustments, as detailed in Section III (Recommended Budget Adjustments and Clean-Up Actions).
3. Approve amendments to City Council Policy I-18 entitled Operating Budget and Capital Improvement Program Policy to add a subsection on the treatment of Interfund Loans to address a recommendation included in the *Audit of the Management of the City's Tax – Exempt Bond Program and Use of Interfund Loans to Provide Financing for Capital Projects*.
4. Adopt a resolution making certain determinations regarding the expenditure of Redevelopment Agency funds on certain public improvements specifically described in the memorandum from the Redevelopment Agency dated August 7, 2008, included in the Appendix section of this report. These funds pay for eligible capital projects, making funds available for the San José BEST program and to support the addition of eight Police Officers.

OUTCOME

In accordance with Section 701(F) of the San José City Charter, the 2007-2008 Annual Report describes the financial status of the City at the end of the 2007-2008 fiscal year. As specified in the City Charter, the focus of the City Manager's Annual Report is a comparison of actual revenue collections and expenditures to projections included in the City's budget. This will provide the City Council with the information necessary to review the financial performance of the City's funds and an understanding of the City's General Fund fund balance.

Approval of the recommended budget actions will implement the rebudget and clean-up adjustments necessary based on final 2007-2008 performance. Other adjustments are recommended to 1) recognize additional grant and reimbursement-related projects; 2) provide additional funding for technical adjustments as well as fiscal and program needs; and 3) allocate the additional 2007-2008 General Fund Ending Fund Balance/2008-2009 Beginning Fund Balance. In addition, the amendment to the Operating Budget and Capital Improvement Program Policy will address an audit recommendation associated with the treatment of Interfund Loans.

EXECUTIVE SUMMARY

The City enjoyed solid financial performance in 2007-2008. With prudent budgeting and management of the City's numerous funds, there are no major problems to report. With only a few exceptions, expenditures and revenues occurred within budgeted levels, and relatively stable fund balances remained in the individual City funds at year end. The steady performance in 2007-2008 serves as a good foundation for 2008-2009. This will be extremely important given the deteriorating state of the economy that is expected to present challenges in 2008-2009.

Weak economic performance was experienced in 2007-2008 and it is expected to get worse in 2008-2009. In 2007-2008, local job growth stalled, the unemployment rate increased, the slowdown in the housing market continued, Sales Tax performance was mediocre, and passenger activity at the Airport declined. Given the conservative growth assumptions for 2007-2008, the General Fund revenue collections still met the budgeted estimates. Looking forward, the modest economic growth projected for 2008-2009 may not be met if the economy falls into a recession. To address a potential drop in General Fund revenues, it is recommended that \$5 million of the excess fund balance from 2007-2008 be allocated to the Economic Uncertainty Reserve, increasing this reserve from \$10 million to \$15 million. This Reserve was established to address fluctuations in economic performance and would serve as a temporary safety valve if revenues drop below current projections and budget rebalancing actions are needed.

The General Fund ended 2007-2008 with a fund balance of \$223.7 million, which was \$20.8 million above the estimate used in the development of the 2008-2009 Adopted Budget. This additional fund balance, which represented only 1.9% of the modified budget, was almost entirely the result of expenditure savings. Of this amount, \$2.4 million is recommended to reconcile the development fee programs or to adjust rebudget amounts that are carried over to 2008-2009 to complete projects. The remaining \$18.4 million is recommended to be allocated to address current year needs, to increase the Economic Uncertainty Reserve, to establish the 2009-2010 Future Deficit Reserve and the Street Maintenance Reserve, and to pay off a portion of the outstanding Fiber Optics Loan.

PROPOSED ALLOCATION OF FUND BALANCE IN THE GENERAL FUND (\$000s)

Additional Fund Balance	\$ 20,770
Rebudget/Clean-Up Adjustments	
Changes to Fee Reserves	2,299
Rebudgets/Technical Adjustments	93
Sub-total Rebudget/Clean-Up Adjustments	2,392
Recommended Adjustments	
Required/Recommended Current Year Adjustments	6,773
Street Maintenance and Repair Reserve	5,802
2009-2010 Future Deficit Reserve	4,000
Fiber Optics Loan Repayment	1,803
Sub-total Recommended Adjustments	\$ 18,378
Total Allocation of Fund Balance	\$ 20,770

EXECUTIVE SUMMARY (CONT'D.)

As we move forward, the Administration will continue to monitor and report on the City's financial performance through Bi-Monthly Financial Reports and the Mid-Year Budget Review. The financial results of 2007-2008 will also be factored into the development of the 2010-2014 General Fund Forecast. The preliminary forecast is expected to be released this November.

BACKGROUND

Each year the City issues the Annual Report at the end of September, three months after the close of the fiscal year as required by the City Charter. The Annual Report document includes the following sections:

- **Transmittal Memorandum** – An overall summary of the 2007-2008 Annual Report.
- **Section I: General Fund** – A summary of the General Fund performance in 2007-2008, including the following: Results of Operations in the General Fund; Revenue Performance; and Expenditure Performance.
- **Section II: Special/Capital Funds** – Financial information on the 2007-2008 year-end performance for each special and capital fund. It includes a discussion of variances between actual and budgeted revenues and expenditures as well as a comparison between the actual ending fund balance and the fund balance estimated for 2007-2008 in the development of the 2008-2009 Adopted Budget.
- **Section III: Recommended Budget Adjustments and Clean-Up Actions** – Description of the recommended budget adjustments and clean-up actions. The proposed actions generally fall into three categories: (1) upward and downward adjustments to the rebudget figures to ensure the appropriate amount of unexpended funds are carried over to 2008-2009 to complete projects; (2) adjustments to the 2008-2009 Beginning Fund Balance amounts in various funds, including the General Fund base on final reconciliation of 2007-2008; and (3) actions that based on more recent information are necessary to revise the 2008-2009 budget to correct technical problems, complete City Council direction and/or address newly emerging, urgent budget issues.
- **Section IV: Financial Statements** – Financial results, prepared by the Finance Department, for all budgeted fund groups for 2007-2008.
- **Section V: Appendix** – Memorandum on determinations regarding the Redevelopment Agency funds to be transferred to the City for public improvement projects and memorandum on the recommended adjustments to the Community Development Block Grant Fund.

ANALYSIS

This Analysis section includes the following:

- an overview of the economic environment;
- a discussion of the 2007-2008 General Fund financial performance;
- an analysis of the impact of the General Fund performance on the 2008-2009 Adopted Budget;
- a discussion of the financial status of selected other City funds; and
- a description of the proposed amendment to the Operating Budget and Capital Improvement Program Policy that incorporates Interfund Loans.

Economic Environment

While the City ended the year in sound fiscal shape, the overall economic environment is not promising. Many economic indicators point to a significant slowdown in the economy. These include the increasing unemployment rate, the lack of job growth, the continued slowdown in the housing market, volatility in the stock market, the high cost of fuel, the decline in Sales Tax in the most recent quarter, and the decline in Airport passenger growth. In addition, the recent collapse of the financial markets and the government take over of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) raise much more serious concerns about the overall health of the economy.

In 2007-2008, the housing market continued its steep decline in this region, which negatively impacts a number of the City's revenue sources, including Construction and Conveyance Taxes and Property Taxes. The slowdown in this area can also indirectly impact Sales Tax collections with the downward spending in construction materials and the reduction of consumer spending as the "wealth effect" associated with housing appreciation diminishes.

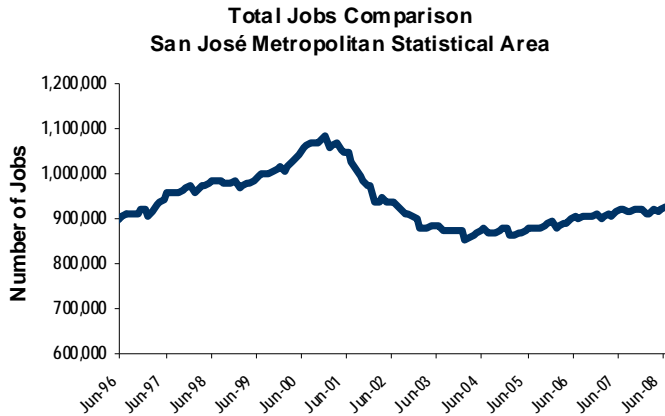


The number of housing sales dropped 38% in 2007-2008. The single family home median price also dropped by 22% from \$772,000 in June 2007 to \$600,000 in June 2008. This impacted Construction and Conveyance Tax revenues, which fell 36% in 2007-2008. The impact on Property Tax receipts, however, is expected to be more serious in 2008-2009 and 2009-2010 given the timing of adjustments to the property tax roll. For instance, the 2007-2008 Secured Property Tax receipts

were based on the value of property assessed as of January 1, 2007, with adjustments for roll corrections. Since the worst of the slowdown in the housing market had not yet been experienced by that time, the actual collections in 2007-2008 were still relatively strong. The

Economic Environment (Cont'd.)

growth in these receipts, however, is expected to be significantly lower in 2008-2009 and 2009-2010.



In the employment area, job growth stalled in 2007-2008. The June 2008 employment figure of 923,200 was almost identical to the June 2007 figure of 922,400 jobs. This performance contrasts with the recent trends for modest job growth, including a 2.1% increase experienced in 2006-2007. The number of jobs in this region also remains well below the peak of 1.1 million jobs in December 2000.

The unemployment rate for the San José area also increased during 2007-2008. In June 2008, the unemployment rate of 6.1% was well above the 4.8% figure from June 2007. When comparing the performance in San José with the State and the nation as a whole, the 6.1% unemployment rate in San José tracked above the unadjusted rate for the nation (5.7%) but was below the unadjusted figure for the State (7.0%) at the end of the fiscal year.

On a national level, consumer confidence also continued to fall and ended 2007-2008 at one of the lowest levels ever recorded. The Conference Board Consumer Confidence Index, which had experienced declines in May 2008, fell even further in June 2008. Lynn Franco, Director of The Conference Board Consumer Research Center stated: “This month’s Consumer Confidence Index is the fifth lowest reading ever. Consumers’ assessment of present-day conditions continues to grow more negative and suggests the economy remains stuck in low gear. Looking ahead, consumers’ economic outlook is so bleak that the Expectations Index has reached a new all-time low. Perhaps the silver lining to this otherwise dismal report is that Consumer Confidence may be nearing the bottom.”

The economic environment has deteriorated further since the end of the 2007-2008 fiscal year with the collapse of the financial markets. In its third quarterly report of 2008, the UCLA Anderson Forecast advocates that the national economy is not technically in a recession. The Forecast, however, readily acknowledges all of the current problems facing the economy and, recession or not, asserts that the national economy is “stalled”. According to UCLA Anderson Forecast Senior Economist David Shulman, “What we are describing is an economy operating at its “stall speed” where any modest shock can trigger a full-blown recession.” According to Shulman, the economy is in for a period of well below trend growth over the next several quarters and below trend growth thereafter. The California Forecast predicts an even weaker California economy with California’s fiscal crisis, and the weakness in housing and finance creating a continuing drag on economic growth. The California housing market is predicted to continue its decline, along with the associated employment in real estate-related sectors.

2007-2008 General Fund Performance

The City's General Fund ended the 2007-2008 fiscal year well within budget. The General Fund Ending Fund Balance of \$223.65 million was approximately \$20.8 million above the fund balance estimate assumed when the 2008-2009 Adopted Budget was developed, primarily as a result of expenditure savings. The variance of \$1.2 million from the Source of Funds was only 0.1% of the budget and the \$19.6 million variance generated from Use of Funds was only 1.8% of the budget.

The following table summarizes the General Fund performance in 2007-2008, comparing the actual results to the modified budget and the estimates used to develop the 2008-2009 Adopted Budget.

Table 1
Results of Operations in the General Fund
For the Year Ended June 30, 2008
(\$000's)

<i>Sources</i>	2007-2008 Revised Budget	2007-2008 Year-end Estimate	2007-2008 Budgetary Basis Actual	Actual to Budget Variance	Actual to Estimate Variance
<i>Beginning</i>					
<i>Fund Balance</i>	272,726	272,726	272,726	-	-
<i>Liquidation of Carry-over Encumbrances</i>	-	1,065	3,582	3,582	2,517
<i>Revenue</i>	829,048	829,048	827,741	(1,307)	(1,307) *
<i>Totals</i>	<u>1,101,774</u>	<u>1,102,839</u>	<u>1,104,049</u>	<u>2,275</u>	<u>1,210</u>
<i>Uses</i>					
<i>Expenditures</i>	938,831	869,096	850,024	88,807	19,072 *
<i>Transfers</i>	30,374	30,374	30,374	-	-
<i>Reserves</i>	132,569	487	-	132,569	487
<i>Totals</i>	<u>1,101,774</u>	<u>899,957</u>	<u>880,398</u>	<u>221,376</u>	<u>19,559</u>
<i>Ending</i>					
<i>Fund Balance</i>	<u>-</u>	<u>202,882</u>	<u>223,651</u>	<u>223,651</u>	<u>20,769</u>

* After adjusting for a net-zero \$4.2 million of grant and reimbursement related revenues and expenditures not received or expended in 2007-2008, but carried over to 2008-2009, the revenue variance resulted in a surplus of \$2.9 million and the expenditures variance actually totaled \$14.9 million.

In this Annual Report document, budget actions are recommended to distribute the additional fund balance of \$20.8 million. When determining the proposed distribution of these funds, the first priority is to complete technical adjustments associated with the final reconciliation of 2007-2008. Net technical adjustments of \$2.4 million are recommended in this document to reconcile the development fee programs for 2007-2008 (\$2.3 million) and to adjust various rebudget amounts (\$0.1 million). After accounting for these technical adjustments, the remaining unallocated fund balance in the General Fund is \$18.4 million (1.7%). The proposed use of these funds are summarized later in this transmittal letter and described in Section III of this report.

2007-2008 General Fund Performance (Cont'd.)

To identify revenue and expenditure trends, the actual 2007-2008 revenues and expenditures are compared to the prior year. In 2007-2008, the General Fund revenues (excluding Beginning Fund Balance) increased by 2.7% over 2006-2007, while the Uses of Funds grew by a significantly higher rate of 10.9%. This was due, in part, to the use of one-time funds that had been carried over to 2007-2008 as part of the Beginning Fund Balance as well as the final resolution of the Fire Arbitration proceedings. Table 2 below compares the City's financial performance in 2007-2008, with the financial performance of the prior year.

Table 2
General Fund
Comparison of Year-End Actuals With Prior Year
(\$ in millions)

<u>Sources</u>	<u>2006-2007</u> <u>Actuals</u>	<u>2007-2008</u> <u>Actuals</u>	<u>Change</u>	<u>% Change</u>
<i>Beginning Fund Balance</i>	235.7	276.3	40.6	17.2%
<i>Revenue</i>	806.0	827.7	21.7	2.7%
<i>Total Source</i>	<u>1,041.7</u>	<u>1,104.0</u>	<u>62.3</u>	6.0%
<u>Uses</u>				
<i>Personal Services</i>	543.7	608.5	64.8	11.9%
<i>Non-Personal/Equipment</i>	105.8	108.1	2.3	2.2%
<i>City-Wide Expenses</i>	102.5	104.4	1.9	1.9%
<i>Capital Projects</i>	12.7	29.1	16.4	129.1%
<i>Transfers</i>	29.4	30.3	0.9	3.1%
<i>Reserves</i>			0.0	N/A
<i>Total Use</i>	<u>794.1</u>	<u>880.4</u>	<u>86.3</u>	10.9%

As shown in Table 2, 2007-2008 General Fund revenues of \$827.7 million represented an increase of 2.7% from the 2006-2007 collection level. In 2007-2008, growth was experienced in many of the revenue categories, including Property Tax, Sales Tax, Transient Occupancy Tax, Utility Tax, and Use of Money and Property. Growth in those categories was partially offset by declines in the Other Revenue, Revenue from the Federal Government, and Revenue from the State categories. A detailed discussion of the revenue performance by category is provided in Section I of this document.

General Fund expenditures of \$880.4 million in 2007-2008 increased 10.9% (\$86.3 million) when compared to the prior year expenditure level of \$794.1 million. The largest component of growth was in the personal services category, which increased by 11.9% (\$64.8 million). Of the \$64.8 million increase, \$49.8 million (76.8%) was the result of personal services increases in the Fire and Police Departments. The Fire Department experienced the largest growth with an increase of \$30.7 million (25.5%). A significant portion of this growth, however, was the result of adjustments associated with the Fire Arbitration award. The Fire Department's personal services budget was increased by \$27.3 million during 2007-2008 to account for the 2007-2008

2007-2008 General Fund Performance (Cont'd.)

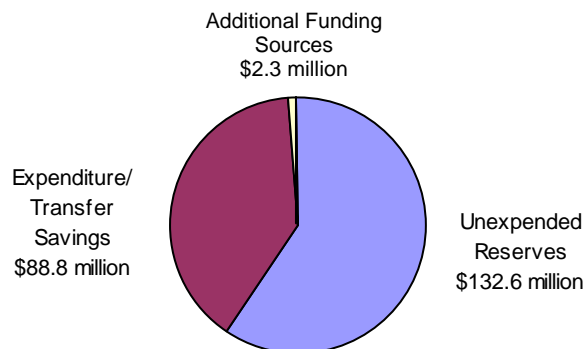
salary increases (\$16.9 million) as well as prior year increases (\$10.4 million) awarded as part of the Fire Arbitration. A portion of the arbitration award increase was related to an enhanced retirement benefit. This enhancement provides a 90% retirement benefit at 30 years of service with a significant increase to the retirement formula at 20 years of service. Police Department personal services expenditures were up \$19.1 million (7.9%) in 2007-2008. This increase was driven by cost-of-living adjustment of 5.7% for sworn personnel and 3.0% for non-sworn personnel, step increases and promotions, and the addition of new staff. The personal services expenditures for the remaining non-public safety departments were up 8.2% from the prior year.

The Capital Projects category also experienced significant growth in 2007-2008, primarily due to larger expenditures and encumbrances associated with the following projects: Street Maintenance Repair (\$6.4 million); COPS 2003-2004 Interoperability Grant (\$4.5 million); South San José Police Substation (\$3.8 million); and Fire Apparatus Repair and Replacement (\$2.7 million).

2007-2008 Ending Fund Balance

The current budgeting practice of the City is to use the projected level of fund balance expected to remain in the General Fund at the end of any fiscal year as a funding source for the following year. The Ending Fund Balance estimate always contains two components: the portion of the fund balance that needs to be rebudgeted for completing projects or retaining reserves; and that portion which is undesignated and available as a general funding source in the coming year. For 2008-2009, a total fund balance estimate of \$202.9 million was including as a funding source in balancing this year's budget. The 2007-2008 General Fund Ending Fund Balance of \$223.7 million was \$20.8 million above this estimate. The components of the 2007-2008 General Fund Ending Fund Balance include unexpended reserves, expenditure/transfer savings, and additional funding sources as described below:

**2007-2008 General Fund
Ending Fund Balance Components
Total \$223.7 million**



2007-2008 Ending Fund Balance (Cont'd.)

The total Source of Funds ended the year \$2.3 million above the budgeted estimate as a result of slightly lower revenues (-\$1.3 million) that were offset by the liquidation of carryover encumbrances (\$3.6 million). For the Use of Funds, unexpended reserves totaling \$132.6 million represented the largest component of the 2007-2008 Ending Fund Balance followed by Expenditure/Transfer savings totaling \$88.8 million.

General Fund Reserve categories include: Earmarked Reserves (\$79.1 million) established to address specific needs; the Contingency Reserve (\$29.7 million) set at 3% of expenditures per City Council policy; and the Ending Fund Balance Reserve (\$23.8 million) established at the end of each year from excess revenues and expenditure savings that are considered an ongoing funding source and programmed into the Adopted Budget. Of the \$132.6 million in Reserves, \$86.6 million was approved for rebudget or assumed as savings in the development of the 2008-2009 Adopted Budget and \$45.5 million was used in balancing the 2008-2009 Adopted Budget. Following is additional information regarding the three reserve categories.

- ***Earmarked Reserves (\$79.1 million)*** – At the end of 2007-2008, the largest Earmarked Reserves were as follows: the Salary and Benefits Reserve (\$10.0 million); Economic Uncertainty Reserve (\$10.0 million); Development-Related Activities Reserves (\$9.2 million); 2008-2009 Future Deficit Reserve (\$7.3 million); Enhanced Park Maintenance (\$6.2 million); Future Capital Projects (FF&E) Reserve (\$5.7 million); Hayes Mansion Conference Center Line of Credit Reserve (\$5.0 million); Neighborhood Investment Reserve (\$4.6 million); and Neighborhood Capital Improvements (\$4.3 million) Reserve. It was assumed that a portion of these reserves would be liquidated and used in balancing the 2008-2009 Adopted Budget, such as the 2008-2009 Future Deficit Reserve and portions of the Development-Related Activities Reserves.
- ***Ending Fund Balance Reserve (\$23.8 million)*** – In the development of the annual budget, it was assumed that some level of ongoing expenditure savings and excess revenues from the prior year would be available to carry forward into the next year. This Reserve was established at the end of 2007-2008 to meet the excess revenue and expenditure savings assumptions that were used in the development of the 2008-2009 Adopted Budget and was funded from 2007-2008 revenue surpluses and expenditure savings.
- ***Contingency Reserve (\$29.7 million)*** – The City Council has established a Budget Policy of maintaining a 3% Contingency Reserve in the General Fund. This Reserve has only been used as a last resort for unexpected critical needs. At the end of 2007-2008, the General Fund Contingency Reserve balance was \$29.7 million, which was \$0.6 million above the 2007-2008 Adopted Budget level of \$29.1 million. As part of the 2008-2009 Adopted Budget, \$29.2 million of the \$29.7 million Contingency Reserve was rebudgeted. It is recommended that the remaining \$0.5 million that has not yet been carried over to 2008-2009 be rebudgeted as part of this report. No additional funding is necessary to be added to the Contingency Reserve in 2008-2009 in order to meet the 3% Contingency Reserve level.

2007-2008 Ending Fund Balance (Cont'd.)

In 2007-2008, Expenditure/Transfer savings totaled \$88.8 million. Over 75% of these savings (\$69.3 million) was rebudgeted to 2008-2009 to complete projects. Based on actual 2007-2008 expenditures, adjustments are recommended in this document that would reduce rebudgets approved in the 2008-2009 Adopted Budget by \$1.9 million. This downward adjustment is primarily the result of higher than projected capital expenditures that occurred at the end of 2007-2008. In addition, the fee-related expenditure savings of \$2.5 million are recommended to be added to the appropriate development fee program reserve. After accounting for these adjustments, net expenditure/transfer savings totaled \$18.9 million at year-end, or 1.9% of the modified budget.

Impacts on the 2008-2009 General Fund Budget

2007-2008 Ending Fund Balance/2008-2009 Beginning Fund Balance

As discussed above, it was assumed that \$202.9 million would remain at the end of 2007-2008 and would be carried over to 2008-2009 as Beginning Fund Balance as part of the adoption of the 2008-2009 Operating Budget. These funds, which were expected to be generated from unexpended reserves, unexpended funds that were rebudgeted to 2008-2009, excess revenues, expenditure savings and the liquidation of carryover encumbrances, were programmed for use in the 2008-2009 Adopted Budget. The actual General Fund Ending Fund Balance was above the estimate used in the 2008-2009 Adopted Budget by \$20.8 million, primarily due to additional expenditure savings.

The following chart details the recommended uses of the \$20.8 million additional fund balance. It is recommended that a small portion (\$2.4 million) of the additional fund balance be allocated to address rebudgets and clean-up adjustments. Of the remaining \$18.4 million, it is recommended that \$6.8 million be allocated to address a limited number of funding needs that have arisen in 2008-2009 and to increase the Economic Uncertainty Reserve. The remaining \$11.6 million is recommended to be distributed to the 2009-2010 Future Deficit Reserve, the Street Maintenance and Repair Reserve, and to repay a portion of the outstanding debt associated with the Fiber Optics loan per City Council policy.

PROPOSED ALLOCATION OF ADDITIONAL FUND BALANCE (\$000s)

Additional Fund Balance	\$ 20,770
Rebudget/Clean-Up Adjustments	
Changes to Fee Reserves	2,299
Rebudgets/Clean-Up Adjustments	93
Sub-total Rebudget/Clean-Up Adjustments	2,392
Recommended Adjustments	
Required/Recommended Current Year Adjustments	6,773
Street Maintenance and Repair Reserve	5,802
2009-2010 Future Deficit Reserve	4,000
Fiber Optics Loan Repayment	1,803
Sub-total Recommended Adjustments	\$ 18,378
Total Allocation of Fund Balance	\$ 20,770

Impacts on the 2008-2009 General Fund Budget (Cont'd.)

- **Changes to Fee Reserves (\$2.3 million)** – Consistent with the budget policy enacted several years ago, year-end reconciliations of the revenues and expenditures in the development fee programs are conducted to determine if revenues exceeded or fell below costs. To meet the commitment to the development community that all development fees will be used solely to support the development fee activities, any excess revenues and interest earnings over costs are placed in Development Fee Program Reserves. Based on the 2007-2008 results, a net \$2.3 million is recommended to be added to the Development Program Fee Reserves (Building, Planning, Fire, and Public Works), preserving all expenditure savings and/or excess revenue in these programs. In addition, use of the Development Fee Program Reserves is recommended to offset a projected shortfall in 2008-2009 in Building Fee Program Revenues (\$609,000) and one-time actions in Planning (\$35,000), Building (\$45,000), Fire (\$20,000) and Public Works (\$245,000) Fee Programs.
- **Rebudget/Clean-Up Adjustments (\$93,000)** – A series of adjustments are recommended to complete existing projects in 2008-2009 and to reflect any necessary technical budget adjustments. The Annual Report is the point in the budget process where action is required to rebudget unexpended funds that were not anticipated when the Adopted Budget was approved, but are required to complete a project in the current year. Also recommended are actions that actually reduce previous rebudgets to reflect instances where expenditure for which the rebudgets were approved actually occurred in 2007-2008, therefore, the funds are not available for rebudget to 2008-2009. Other adjustments are necessary to allocate revenue received in 2007-2008 to the correct expenditure appropriation. These include interest earnings for the Arts Stabilization Flexible Fund; interest earnings for the Public, Education and Government Access activities; Hayes Mansion bond proceeds; development fees for traffic signal design and review; and proceeds from the sale surplus property that are to be allocated to the Council District 10 Construction and Conveyance Tax Fund. In addition, there are net-zero adjustments to align costs to the correct appropriation. In accordance with prior City Council direction, the return of first year energy efficiency savings to the City's Energy Efficiency Fund is recommended in order to grow the allocation of funds available for energy savings projects. Projects recently completed include a power management project for an estimated 6,000 computers and monitors city-wide and lighting retrofits at four fire stations and the Mabury Service Yard.
- **Required/Recommended Current Year Adjustments (\$18.4 million)** – A number of General Fund budget additions are recommended to address current year funding needs that have emerged since the 2008-2009 budget was approved. These adjustments total \$18.4 million and can be classified under three categories: Required Technical Adjustments; 2008-2009 Fiscal/Program Needs; and Previous Council Direction. The Previous Council Direction category includes the distribution of unallocated funds after other recommended adjustments to the following categories per City Council direction: Street Maintenance Reserve, the 2009-2010 Future Deficit Reserve, and the Fiber Optics Loan repayment. Following is a summary of the recommended augmentations. These additions are also described in more detail in Section III of this report.

Impacts on the 2008-2009 General Fund Budget (Cont'd.)

Required Technical Adjustments (\$1.0 million)

- A technical adjustment to reduce the General Fund's share of the debt service payment for City Hall to reflect the appropriate spread of debt service costs among the City's funds (a net savings of \$126,000).
- Establish an Earmarked Reserve for State Budget Actions to cover the potential loss of SB 90 State Mandate reimbursements as well as the potential costs associated with the Jail Booking Fees (\$600,000).
- Reduce the Transfers and Reimbursements revenue estimate due to a re-calculation of the Convention and Cultural Affairs Fund overhead rate by the Finance Department (\$514,000).
- Establish funding for expenses related to the Chinese Historical Cultural Project that was approved by City Council during the 2005-2006 budget process for the City's share of the long term maintenance fund for the Ng Shing Temple (\$12,000).
- A technical adjustment to recognize revenue of \$311,000 from the sale of surplus City property located on North Ninth Street that was approved by City Council on August 19, 2008, and add this funding to the Economic Uncertainty Reserve (net \$0).

2008-2009 Fiscal/Program Needs (\$5.8 million)

- Increase the Economic Uncertainty Reserve from \$10 million to \$15 million to provide resources if the current economic downturn impacts City revenues more severely than projected when the 2008-2009 Adopted Budget was developed (\$5.0 million).
- Add funding for Economic Development Pre-Development Activities that advance the City's Economic Development Strategy in support of the recent Tesla Corporation economic initiative (\$300,000).
- Establish funding to conduct outreach for the completion of Census 2010. In the past, the State provided funding for outreach efforts to ensure an accurate population count. It is anticipated that the State will no longer pay for these costs (\$250,000).
- Establish funding to assist the Police Department in recruiting sufficient candidates to fill both sworn and non-sworn academy classes by expanding advertising, increasing attendance at job fairs, and expanding recruiting efforts outside the Bay Area (\$100,000).
- Add funding for Public Information Office (PIO) component of the 9-1-1 Call Center remodel. This component is not eligible for funding from the Emergency Communication System Support Fee Fund (\$50,000).
- Add one-time funding for Arena Employee Parking due to delays in the transfer of responsibility to the Redevelopment Agency (\$37,500).
- Add funding for the South San José Police Substation to provide sufficient funding to complete the installation of fiber optic cabling (\$35,000).
- Establish a Retirement Pre-Payment Reserve in the amount of \$1.8 million that reflects the net impact of pre-paying the City's contribution to its two retirement plans and will be used to true-up actual payroll costs with contribution rates later in the year (net \$0).

Impacts on the 2008-2009 General Fund Budget (Cont'd.)

Previous City Council Direction (\$11.6 million)

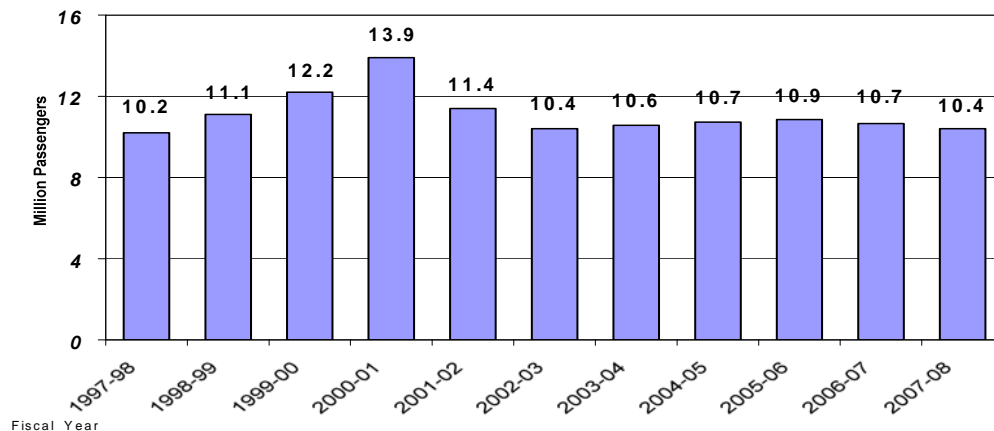
- Adjust funding and establish a reserve in the amount of \$2.3 million in compliance with the Mayor's June Budget Message to set aside all proceeds from the Airport West sale for possible use during the Mid-Year Budget Review. This increase recognizes the option payment from the developer, which is used to offset the carrying costs for the property (net \$0).
- Street Maintenance and Repair Reserve (\$5.8 million) – After the above actions, per City Council policy, one-half of the remaining \$11.7 million in unallocated funds is recommended to be used for street maintenance and repair projects. With this additional funding, the 2008-2009 funding for street maintenance will total \$46.0 million. This compares to the \$48.3 million need annually and is significantly higher than the 2006-2007 funding level of \$23.2 million.
- 2009-2010 Future Deficit Reserve (\$4.0 million) – Per City Council policy, a minimum of one-quarter of the remaining \$11.7 million in unallocated funds is recommended to be used to establish a 2009-2010 Future Deficit Reserve. This action would allocate approximately 35% of the remaining funds for this purpose and will help prepare the organization to address what is projected be another challenging budget year. This is also consistent with the fiscally conservative approach that has served the City so well up to this point.
- Fiber Optics Loan Repayment (\$1.8 million) – Per City Council policy, up to one-quarter of the remaining \$11.7 million in unallocated funds can be transferred to the Fiber Optics Development Fund to repay a portion of the outstanding loan (\$4.7 million) due to the Sewage Treatment Plant Connection Fee Fund. This action would allocate approximately 15% of the remaining funds for this purpose. Under the current loan agreement, the remaining balance of \$2.9 million is due by June 2011.
- **Grants/Reimbursements (\$0)** – A series of net-zero adjustments are recommended to reflect the revenues and expenditures for grant and reimbursement type activity such as: grants received for Mayor's Gang Prevention Task Force activities (\$530,000); a grant for landfill remediation efforts at Martin Park Landfill (\$213,000); two grants from the state for Urban Forestry to complement the City's efforts to advance its Green Vision (\$219,000); expansion of the State-funded Waste Tire Enforcement Program in Planning, Building and Code Enforcement (\$121,000); a transfer from Construction and Conveyance Tax Fund CD #8 for reimbursement for a prior year capital project (\$100,000); expansion of the Wellness Program to provide additional classes from revenues received from the City's health provider (\$87,000); State of the City Convocation (\$20,000); Police grant for homeland security training activities (\$12,000); and a downward adjustment to eliminate a Police grant that was anticipated to be received in 2008-2009 but due to changes in the grant is now being renegotiated (\$-196,000). A more complete listing of the net-zero adjustments can be found in section III of this document.

Status of Selected Special/Capital Funds

Airport Operating Funds

The Airport served almost 10.4 million passengers in 2007-2008, which was an overall decline of 2.6% in fiscal year passenger activity. Other Airport activity including: parking exits, pounds of mail/freight/cargo, traffic operations and gallons of aviation fuel each experienced declines in comparison to last fiscal year.

**Norman Y. Mineta San José International Airport
10 Year History Passenger Activity**



Overall, Airport operating revenues exceeded budgeted levels by 3% for the year. Airline Rates and Charges revenues (combined total of landing fees and terminal rents) ended the year 2% greater than budget. Other revenues tracked higher than budget, including interest earnings and revenues associated with the new advertising agreement with Clear Channel. Transfers of excess funds and reimbursement of bond improvement funds were the other significant increase. Although parking revenues fell slightly below budget levels, the shortfall was offset by an increase to rental car revenues based on the amended agreements that further clarified and expanded the definition of gross revenues.

The Airport set a target to save a total of \$1.0 million in personal services expenses during 2007-2008. The personal service savings target was exceeded by over \$1.7 million due in part to the large number of vacancies experienced over the course of the year. Non-personal/equipment categories also had significant savings levels, close to \$5.2 million spread over multiple categories which was available at the end of the year. Overall savings in the department totaled close to \$8.0 million. These savings contributed towards higher than anticipated fund balances in the Airport funds at year-end. Rental Car Contracts, accounted for in the Airport Customer Facility and Transportation Fee Fund, ended the year 4.4% below the levels experienced in 2007-2008. However year-end savings in personal services, non-personal/equipment and reserves (\$722,000) offset much of the decrease in revenues, allowing for the Rental Car Agency Contribution to total \$549,000, a significant reduction from the budgeted level of \$1.16 million.

Status of Selected Special/Capital Funds (Cont'd.)

Airport Operating Funds (Cont'd.)

The current state of the airline industry has received much attention and scrutiny in recent months. The commercial aviation industry is experiencing turbulent times and an uncertain future primarily due to the cost of oil. The result is loss of flights, passengers, capacity and revenues. As airlines reduce capacity, all airports are affected. Although the Airport is anticipating a 10% reduction in passenger activity and related revenues in 2008-2009, continued prudent financial management and conservative use of resources will enable continued operation within budget.

The Airport is focused on keeping San José competitive and attractive to carriers by increasing efficiencies for their operations, maintaining rates and charges below targets and avoiding decisions that reduce competitiveness or increase airline costs. The Terminal Area Improvement Program is projected for completion on time and on budget; however, further expansion will be deferred until specific growth triggers are met. Along with safety and security, meeting financial obligations will continue to be a top priority for the Airport.

Convention and Cultural Affairs Fund

The Convention and Cultural Affairs Fund accounts for the operation of the City's Convention Facilities that are managed by Team San José. In 2007-2008, activity at the Convention Facilities generated higher than anticipated revenues. The actual revenue collections were \$952,000 above the budgeted level due to higher than anticipated space rental and concessionary income.

In addition to higher than anticipated revenues, expenditure savings of \$750,000 were realized in this fund. The combination of excess revenue and expenditure savings resulted in a higher than anticipated fund balance. Per prior City Council direction, \$500,000 of the additional fund balance is recommended to be set aside in a sinking fund for future capital improvements as part of this report, bringing the total for the sinking fund to \$1.0 million. It is important to note that a key strategy for the proposed Convention Center expansion is to build a sufficient fund balance to cover the anticipated drop in revenue during construction and initial re-occupancy. The current ending fund balance is insufficient to cover the anticipated decline in revenues.

Transient Occupancy Tax Fund

Actual 2007-2008 revenues in the Transient Occupancy Tax (TOT) Fund exceeded the budgeted amount by almost \$1.0 million. When the 2007-2008 Adopted Operating Budget estimate (\$13.38 million) was developed, a 7% increase over the anticipated 2006-2007 year-end estimate was assumed. Revenues in 2007-2008, however ended the year 12% above the 2006-2007 actuals due to higher than anticipated room rates and occupancy levels. The average room rate for the City's fourteen largest hotels grew from \$133 to \$142 over the year. The average occupancy rate for the same hotels grew from 59.9% to 62.1%.

Status of Selected Special/Capital Funds (Cont'd.)

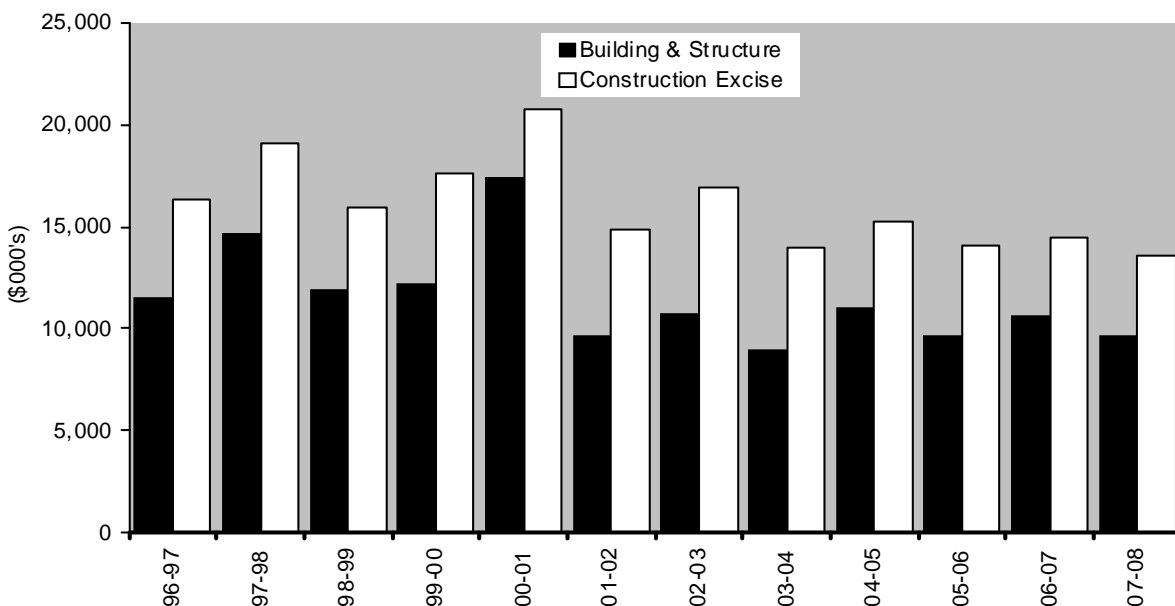
Capital Improvement Program Funds

As reported in Monthly Financial Reports, 2007-2008 collections in several of the major capital tax revenue categories continued to reflect the local slowdown in the development and real estate markets. Overall collections in construction-related revenue sources ended the year below budgeted levels, however, close to or above the levels assumed during the development of the 2008-2009 Adopted Capital Budget. As a result of the conservative budgeting in these revenue categories, no revision to the 2008-2009 Adopted Capital budget is required at this time.

Year-end collections in the Building and Structure Construction Tax category totaled \$9.6 million, which was \$566,000 below the modified budget estimate of \$10.2 million, however, ended the year above the estimate of \$8.8 million assumed to develop the 2008-2009 Adopted Budget. With a similar trend, Construction Excise Tax receipts of \$13.6 million fell short of the modified budget estimate of \$14.8 million by \$1.2 million, however, above the estimate of \$12.8 million assumed to develop the 2008-2009 Adopted Budget. Finally, Construction and Conveyance Tax collections of \$26.8 million was \$191,000 below the modified budget estimate of \$27.0 million, a drop of 35.9% compared to 2006-2007 levels.

The following graph displays the collection history of both the Building and Structure Construction Tax and Construction Excise Tax receipts over the past decade and illustrates the dramatic growth during the latter part of the 1990's. While collections have fallen from the peak in 2000-2001, they have remained relatively strong when considering the historical performance of these taxes.

Construction Tax Revenues



Status of Selected Special/Capital Funds (Cont'd.)

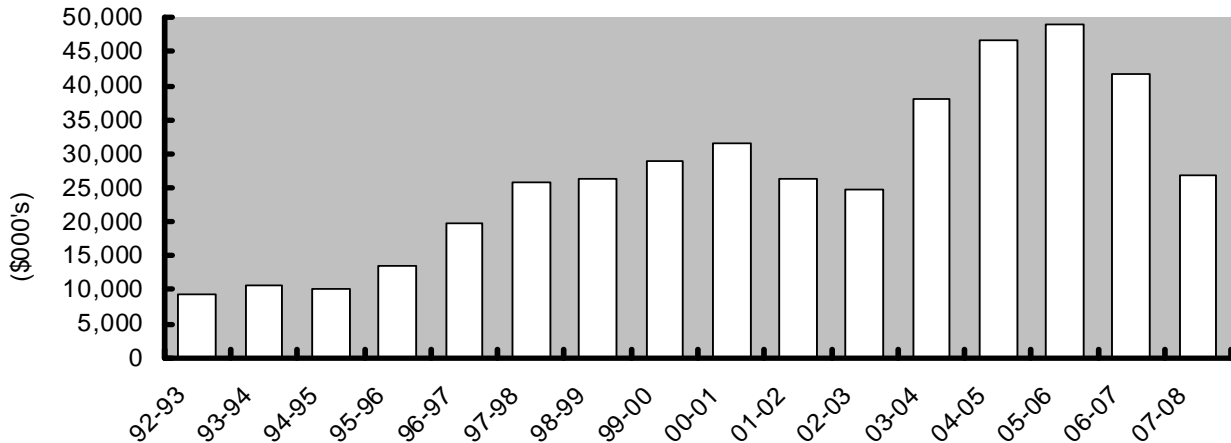
Construction and Conveyance Tax revenues, which are a significant source of funds for the Parks and Community Facilities Development, Library, Fire, Service Yards, and Communications capital programs, experienced a decline of 35.9% in 2007-2008. Actual receipts totaled \$26.8 million, down \$15.0 million from the 2006-2007 collections of \$41.8 million. This decline reflects the continued slowdown in the local real estate market, as described in previous Monthly Financial Reports, after extraordinary growth of almost 100% between 2002-2003 and 2005-2006. The decline in 2007-2008 represents the second straight year of lower revenues following a 14.7% decline experienced in 2006-2007 from the peak of \$49.0 million collected in 2005-2006. When the 2007-2008 budget was developed, it correctly assumed that there would be a slowdown in the real estate market that would result in lower revenue collections. Actual collections were 0.7% (\$191,000) below the 2007-2008 budget estimate of \$27.0 million. The 2008-2009 revenue estimate of \$23.0 million allows for a 14.2% decline from 2007-2008 actual collection levels.

It should be noted, however, that the slowdown in the housing market and recent concern over the national banking and financial markets indicate that the local real estate slowdown has not bottomed out. In fact, Construction and Conveyance Tax collections have declined in 24 of the past 26 months through June 2008 when compared to the same month in the prior year. The 2007-2008 revenue declines worsened in the second half of the year with a 45.9% decline compared to 26.4% decline in the first half due to further deterioration in housing prices in the second half of the year. The single-family median price of \$600,000 in June 2008 was 22.3% lower than the median price of \$772,000 in June 2007. The overall number of real estate transactions continues to drop with the second half of the year (January to June 2008) experiencing a 31.9% decline from the same period in the prior year (January to June 2007). The average days on market has increased from 44 days in June 2007 to 59 days in June 2008.

The following graph displays the collection history of Construction and Conveyance Tax receipts. As can be seen, during the recession years in the early 1990s collections hovered around the \$9-11 million level for approximately five years. Following that recession, collections surged, with receipts reaching \$31.6 million in 2000-2001. After reaching this peak, collections dropped in both 2001-2002 and 2002-2003. The unprecedented growth of 54% in 2003-2004 followed by additional 22% growth in 2004-2005 and 5% growth in 2005-2006 ended this downward trend. The declines experienced in 2006-2007 of 14.7% and 35.9% in 2007-2008 are indicative of the depressed real estate market. We believe that the housing market will continue to soften, impacting receipts in this category. A slowdown in the real estate market continues to be a major theme of the California forecast produced by the prestigious UCLA Anderson Business School. Even given the continued slowdown, the 2008-2009 Adopted Budget estimate of \$23.0 million is a conservative one. This estimate allows for a drop of 14% from the actual 2007-2008 collection level. Staff will closely monitor receipts in this area to determine if adjustments to this revenue category are necessary during the year.

Status of Selected Special/Capital Funds (Cont'd.)

Construction and Conveyance Tax Revenues



Airport Capital Funds

Major projects with expenditures and encumbrances in 2007-2008 include the Terminal Area Improvement, Phase I (\$371.2 million), Consolidated Rental Car Facility (\$218.1 million), North Concourse (\$132.6 million), Noise Attenuation – Category 1B (\$15.6 million), Public Parking Garage (\$12.4 million), Terminal Area Improvement, Phase II (\$4.1 million), and Central Plant Expansion (\$3.1 million) projects. The North Concourse is expected to be completed by late-2008.

In the Airport Capital Program, several projects were completed in 2007-2008 including Gate A1-C Relocation, Runway Guard Light Replacements, Signage Design, Taxiway Y Reconstruction, Taxiway Z Alignment, Terminal A+ Seating, FIS 3rd Floor Lounge, Terminal C carpet replacement, HVAC repairs, fire truck replacement, and Terminal C Phase I demolition.

Public Safety, Library, and Parks and Community Facilities General Obligation Bond Funds

Major improvements continue in the City’s parks, community centers, libraries and public safety facilities as a result of voter-approved bond measures that will generate a total of \$599 million for these purposes. In 2007-2008, \$207.3 million was expended or encumbered in the Public Safety (\$74.5 million), Library (\$48.5 million), and Parks and Community Facility (\$84.3 million) General Obligation Bond Funds. With the volatility of construction costs in recent years, adjustments to the various bond projects have been implemented in an effort to provide quality facilities with the funding available. Staff will continue to closely monitor the costs in these projects and, if shortfalls occur, bring forward recommended options to address the shortfalls.

Status of Selected Special/Capital Funds (Cont'd.)

In the Public Safety Program, the projects with the largest expenditures and encumbrances included the following: South San José Police Substation (\$60.2 million); Fire Station 17-Cambrian (\$3.1 million); Fire Station 12-Calero (\$2.7 million); Fire Station 35-Cottle/Poukeepsie (\$1.8 million); and Land Acquisition (\$1.2 million). In 2007-2008, a construction contract for the South San José Police Substation was awarded and Fire Stations 25, 34, and 35 were completed.

In the Library Program, the projects with the largest expenditures and encumbrances in 2007-2008 included the following: Santa Teresa Branch Library (\$9.6 million); Seven Trees Branch Library (\$9.2 million); East San José Carnegie Branch Library (\$7.5 million); Willow Glen Branch Library (\$5.7 million); Joyce Ellington Branch Library (\$5.2 million); Pearl Branch Library (\$5.2 million), Educational Park Branch Library (\$1.4 million); and Edenvale Branch Library (\$1.2 million). In 2007-2008, the Edenvale Branch Library, and the Joyce Ellington Branch Library were completed and opened. The Pearl Branch Library and the Willow Glen Branch Library completed construction in 2007-2008 and opened in August 2008. In addition, the construction contracts for the Santa Teresa Branch Library, Seven Trees Branch Library, and East San José Carnegie Branch Library were awarded.

In the Parks and Community Facilities Program, the projects with the largest expenditures and encumbrances included the following: Happy Hollow Park and Zoo Renovations and Improvements (\$35.8 million); Seven Trees Community Center (\$19.0 million); Roosevelt Community Center (\$13.0 million); Mayfair Community Center (\$9.3 million), Public Art (\$1.6 million), and Camden Community Center (\$1.1 million). In 2007-2008, several projects were completed including the TRAIL: Los Gatos Creek Trail – Reach 4 Lincoln Avenue to Auzerais Avenue), Lake Cunningham Skate Park, Butcher Dog Park, Almaden Lake Park Phase II, Columbus Park Horseshoe Court, Falls Creek Park, Fowler Creek Park Phase I, and Los Lagos Golf Course Safety Improvements. In addition, the construction contracts for Happy Hollow Park and Zoo Renovations and Improvements and Seven Trees Community Center projects were awarded.

Traffic Capital Program Funds

In 2007-2008, a total of \$79.3 million was spent or encumbered for traffic capital projects. The projects with the largest expenditures and encumbrances included Federal Pavement Maintenance (\$10.6 million), Pavement Maintenance (\$8.2 million), TCRP Payback – Pavement Maintenance (\$6.3 million), ITS: Stevens Creek – West (\$3.7 million), Senter Road: Tully to Singleton (\$3.1 million), Traffic Signals (\$2.6 million), Prop 42 – Pavement Maintenance (\$1.6 million), Fiber Optics Permit Engineering (\$1.4 million), Route 880: Coleman Interchange Utility Relocation (\$1.4 million), Traffic Signals – Rehabilitation (\$1.4 million), Bicycle and Pedestrian Facilities (\$1.2 million), Hamilton Ave – Meridian Ave to Hamilton Way (\$1.2 million), and Prop 1B – Pavement Maintenance (\$1.0 million). Projects completed in 2007-2008 include Maintenance Backlog – Street Resurfacing, Prop 42 – Pavement Maintenance, ITS: VTA Rapid 522 Bus Signal Priority Upgrade, Traffic Signal – Lightland/McLaughlin,

Status of Selected Special/Capital Funds (Cont'd.)

Saratoga/Graves ADA Accessibility Ramps, Zanker Road Median Island Landscaping, Agency Site Improvement, Downtown Surveillance Cameras Improvement Project, Diagonal Parking Installation and Pavement Improvements in Japantown, Quito Road: Saratoga to Bucknall, Thirteenth Street Streetscape Project, 6th and Reed Improvements, McLaughlin Avenue Improvement, Lucretia Avenue: Story to Phelan, Winchester Neighborhood ADA Ramp Installation, and City-wide ADA Accessibility Ramps.

Many Strong Neighborhoods Initiative projects were also completed, including the University Neighborhood Phase 2 Pedestrian Streetlight, Keyes Street/Greater Gardner Pedestrian Streetlight, Greater Gardner Street Reconstruction, 3rd and 4th Streets Couplet Conversion, 10th and 11th Street Land Reduction, William Street and McLaughlin Avenue Improvement, Delmas Park – Sidewalks, Traffic Signal at Oak and Almaden/Vine, Winchester Boulevard Signal Modification and Countdown Head Installation, Traffic Signal at 7th and Martha, Traffic Signal at King/Wilshire, and ADA Pedestrian Ramps.

Recommended Capital Budget Actions

In addition to the fund balance reconciliations completed for every fund and the numerous rebudget adjustments to properly account for project costs, there are a number of budget actions recommended in this report. It should be noted that as part of the Mayor's March 2008-2009 Budget Message, the City Council approved a budget principle stating that capital improvement projects shall not proceed for projects with annual operating and maintenance costs exceeding \$100,000 in the General Fund without City Council certification that funding will be made available in the applicable year of the cost impact. Certification shall demonstrate that funding for the entire cost of the project, including operating and maintenance costs, will not require a decrease in existing basic neighborhood services. City staff continues to evaluate the implementation of this certification process and will bring forward recommendations for City Council consideration as part of the General Fund Structural Deficit Elimination Plan discussion scheduled on December 5, 2008. The recommended actions in this report do not initiate new capital improvement projects with annual operating and maintenance costs exceeding \$100,000. Several recommendations included, however, dedicated resources to evaluate the feasibility of capital projects for potential capital investments in the future which may or may not have operating and maintenance costs. At the conclusion of the feasibility analysis, operating and maintenance costs would be considered for compliance with this budget principle prior to proceeding further with community outreach. Where applicable, discussions of operating and maintenance impacts are included in project descriptions in Section III of this document.

In the Airport Capital Program, a net decrease to grant revenue (\$1.6 million) primarily reflecting the elimination of grant funding for the Airport Rescue and Fire Fighting Facility Upgrade and the establishment of a transfer from the Airport Renewal and Replacement Fund (\$15,000) to correctly allocate the grant share portion of the Airfield Sign Replacement project are recommended in the Airport Revenue Capital Improvement Fund. In the Airport Revenue Bond Improvement Fund, major augmentations include funding for the Terminal Area Improvements,

Status of Selected Special/Capital Funds (Cont'd.)

Phase I (\$6.9 million) project to fund baggage handling improvements at Terminal A offset by an increase to commercial paper proceeds (\$1.4 million) and a reallocation of funds from the Terminal Area Improvements, Phase II appropriation (\$5.5 million); and decreases in the FMC Site Reuse Preparation (\$7.6 million) project and associated revenue to reflect a revision of outstanding projects associated with the reuse of the FMC site. In the Airport Renewal and Replacement Fund, major augmentations include a transfer from the Airport Revenue Fund to fund Terminal Area Improvements, Phase I (\$6.7 million), additional funding (\$447,000) for an escalator in the Consolidated Rental Car Facility project offset by payments by tenants, and new funding for the Aircraft Owners and Pilots Association Expo 2008 (\$109,000). Lastly, in the Passenger Facility Charges Fund, an increase to the Federal Inspection Services Facility appropriation (\$63,000), offset by a decrease in ending fund balance is recommended to fund settlement costs.

In the Library Capital Program, the elimination of a transfer from the Library Construction and Conveyance Tax Fund (\$665,000) to the Branch Libraries Bond Projects (Library Bond) Fund is recommended to reflect funding that is no longer necessary due to additional interest earnings and project savings in the Library Bond Fund. In addition, an augmentation in the Library Bond Fund (\$200,000) for miscellaneous post-construction costs for completed projects that no longer have appropriations is included in this document.

In the Parking Capital Program, an increase to the Security Improvements appropriation (\$250,000) is recommended to install more efficient energy light fixtures at four parking garages, offset by a decrease in ending fund balance.

In the Parks Capital Program, there are a series of augmentations to address needs or reallocate funding. In the Park Trust Fund, the following project adjustments are recommended: recognition of revenue from developers (\$2.6 million); establish appropriations for St. James Park Renovations Phase I (\$750,000), Kirk Community Center Renovation and FF&E (\$712,000), Buena Vista Park Expansion (\$280,000), Vista Park Turnkey Park (\$108,000), Del Monte Park Feasibility (\$86,000), TRAIL: Lower Silver Creek – Silverstone Place (\$50,000), West San José Community Center Dance Room Renovation (\$30,000), TRAIL: Bay Trail Reach 7 -Acquisition (\$23,000), Cypress Senior Center Parking Lot Expansion and Outdoor Patio Feasibility (\$20,000), Ryland Tile Restoration (\$15,000), and TRAIL: Penitencia Creek Reach 6 (\$15,000); and increase appropriations for Martin Park Expansion (\$2.1 million) and Selma Olinder Dog Park (\$60,000) projects. These actions are offset by a decrease to various reserves.

In addition, in the Parks Construction and Conveyance Tax Fund – District 1, funding is recommended for the temporary relocation of Cypress Senior Nutrition Program (\$100,000) project and Preliminary Studies (\$10,000). In the Parks Construction and Conveyance Tax Fund – District 3, a reallocation of O'Donnell's Garden Park (\$117,000) funding is recommended to a reserve. In the Parks Construction and Conveyance Tax Fund – District 4, funding is recommended for the TRAIL: Penitencia Creek Reach 6 (\$150,000) project. In the Parks Construction and Conveyance Tax Fund – District 9, funding is recommended for the temporary

Status of Selected Special/Capital Funds (Cont'd.)

relocation of Kirk Senior Nutrition Program (\$50,000) project. In the Parks Construction and Conveyance Tax Fund – District 10, funding is recommended for the TRAIL: Guadalupe Creek (Meridian to Singleton) Land Acquisition (\$21,000) project. In the Parks Construction and Conveyance Tax Fund – Central Fund, a reallocation of funding is recommended for Happy Hollow Park and Zoo Fixtures, Furnishings, and Equipment (\$800,000) from the Parks Fixtures, Furnishings, and Equipment appropriation. In the Parks Construction and Conveyance Tax Fund – City-Wide augmentations are included for the Grace Baptist Lease (\$2,000), Family Camp Survey (\$50,000), Brownfields Assessment Project (\$75,000) and Alum Rock Park Service Yards Fixtures, Furnishings and Equipment (\$10,000). Lastly, in the Lake Cunningham Fund, increases to the City-wide Skateboard Park Development (\$27,000) and Perimeter Landscaping (\$27,000) projects are recommended. Augmentations in these funds are offset by decreases to ending fund balance and/or recognition of additional grant revenues.

In the Public Safety Capital Program, a decrease to fire station land proceeds (\$1.05 million) is recommended in the Fire Construction and Conveyance Tax Fund to reflect the current project construction schedules. These sales are expected to occur in 2009-2010 or later, following project completion and community outreach. As a result, decreases to several appropriations are recommended to offset this revenue adjustment, with minimal impact expected as described in Section III of this document. In addition, funding is recommended in the Neighborhood Security Bond Fund for the Fire Station 12 – Calero (\$42,000) project to reappropriate funds that were liquidated in 2007-2008 to fund project close-out costs.

In the Service Yards Capital Program, an increase to the Central Service Yard Phase II Debt Service appropriation is recommended to fund the anticipated interest liability on outstanding commercial paper debt service.

In the Traffic Capital Program, a reimbursement of developer fees (\$1.3 million) is recommended in the North San José Traffic Impact Fee Fund. In the Building and Structure Construction Tax Fund, an augmentation to the Traffic Signals appropriation (\$14,000), offset by developer fee revenue is recommended. Recommendations in the Construction Excise Tax Fund include an increase to Fiber Optics Permit Engineering (\$634,000) offset by fee revenue, a reallocation of Branham Lane Improvements funding from reserves (\$500,000), recognition of grant revenues and expenditures for Bicycle and Pedestrian Facilities (\$182,000), and increases to the Underground Utility Program (\$75,000), Traffic Signal Communications and Synchronization (\$1.2 million), and ITS: Enhancements (\$330,000) projects offset by ending fund balance.

Proposed Amendment to the Operating Budget and Capital Improvement Program Policy

In December 2007, the City Auditor's Office issued *An Audit of the Management of the City's Tax-Exempt Bond Program and Use of Interfund Loans to Provide Financing for Capital Bond Projects*. This report included a recommendation to develop and implement a formal written policy on interfund loans, including the establishment of a prudent investor standard, and written procedures on how to manage and enforce such a policy.

The Administration recommends an amendment to City Council Policy I-18 entitled Operating Budget and Capital Improvement Program Policy to add a subsection on the treatment of Interfund Loans to address this recommendation. Following is the proposed language to be added to the City's Budget Policies:

INTERFUND LOANS

Interfund loans are loans from one City fund to another City fund for a designated purpose. To ensure that all interfund loans are appropriate, properly documented, and not established to the detriment of the fund issuing the loan, the following interfund loan eligibility and documentation requirements are established.

Interfund Loan Eligibility Requirements - Interfund loans may not be used to solve ongoing structural budget problems. Interfund loans must have an identified repayment source and date; include an interest component that equals the investment earnings the fund would have received had the loan not occurred; and be immediately due and payable if needed by the fund that provided the loan.

Interfund Loan Documentation Requirements - Loan amount, term, and repayment source will be identified any time a loan is recommended. Loans will be coordinated with the City Attorney's Office to ensure compliance with the Municipal Code and will be approved by the City Council. Payments made on outstanding loans shall be reflected in the Proposed and Adopted Budget and Annual Report, as applicable. A summary of all outstanding loans will also be included in the annual Proposed and Adopted Operating Budget and the Comprehensive Annual Financial Report (CAFR). The CAFR will also consistently include the loan term, rate of interest, and the interest amount due in its calculation of the total liability associated with the loan.

NEXT STEPS

The results of the 2007-2008 Annual Report will provide an updated starting point for monitoring 2008-2009 financial performance. The revenue and expenditure trends will be factored into the analysis of the General Fund and the numerous special and capital funds. Information on the City's finances for 2008-2009 will be provided in Bi-Monthly Financial Reports and the 2008-2009 Mid-Year Budget Review. These reports will also provide information on the current economic environment and its impact on the City's revenue collections.

The 2007-2008 Annual Report results will also be factored into the development of the 2009-2010 Proposed Budget. A preliminary 2010-2014 General Fund Forecast is anticipated to be released in November 2008, with a final General Fund Forecast planned to be released in February 2009. The Annual Report results will also serve as a resource for the development of the General Fund Structural Deficit Elimination Plan that is also scheduled to be released in November 2008. The 2009-2010 Proposed Capital and Operating Budget are scheduled to be released in late April 2009 and May 1, 2009, respectively.

PUBLIC OUTREACH/INTEREST

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

This document is posted on the City's website for October 21, 2008 Council agenda.

COORDINATION

The Budget Office coordinated with the Finance Department on the reconciliation of the City's funds and coordinated with all City Departments on recommended budget adjustments that are brought forward in this document. In addition, the proposed Interfund Loan Policy recommendation was coordinated with the City Attorney's Office, the Auditor's Office, and the Finance Department.

CONCLUSION

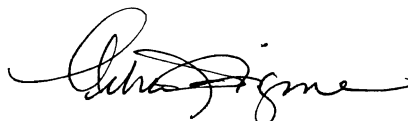
At the close of the 2007-2008 fiscal year, the City's finances remain in sound condition. The various City funds generally ended the year with revenues at or above estimated levels and expenditures within the budgeted allocations. As a result, I am pleased that there are no major financial problems to report in any City fund as of the end of the last fiscal year.

While the City ended the year in solid fiscal shape and a small additional fund balance accumulated in the General Fund, major short-term concerns exist given the quickly deteriorating state of the economy as well as long-term concerns about the City's General Fund structural deficit. The additional General Fund fund balance dollars generated at the end of 2007-2008 resulted from expenditure savings. These one-time savings do not translate into improved financial performance moving forward. Revenue collections in the General Fund, which could impact ongoing performance, ended the year almost exactly as projected. Only modest revenue growth was experienced in 2007-2008, consistent with the economic forecast for that year.

Although we will continue our many aggressive initiatives to stimulate and improve our local economy, and we have an excellent track record of progress in this area, we cannot lose sight of the fact that we are unavoidably connected to the health of the State and national economy. Of concern, therefore, is the fact that the deteriorating economic environment is expected to impact revenue growth at least through the next year. The collapse of the financial markets, the continuing impacts associated with the housing market, the high cost of fuel, the increases in the unemployment rate, the drop in consumer confidence, and the volatility in the stock market are expected to negatively impact the City's largest General Fund revenue sources, Property Tax and Sales Tax, as well as the City's interest earnings. Given the precarious state of the economy, a \$5 million increase to the Economic Uncertainty Reserve is recommended in this document, bringing this reserve to \$15 million. To put this amount in context, the \$15 million Reserve equates to roughly 10% of the City's 2008-2009 Sales Tax estimate.

Based on these factors, minimal economic growth is projected for 2008-2009. Because the 2008-2009 Adopted Budget assumed such modest growth levels, however, it is currently anticipated that the 2008-2009 revenue estimates should be met unless the economy falls into a recession. In that case, the Economic Uncertainty Reserve would serve as a safety valve until any necessary recalibration between revenues and expenditures occurred. In developing the upcoming preliminary five-year forecast, the Administration will closely analyze economic trends and the projected impacts of those trends on the City's revenues.

The Administration will continue to closely monitor the current year financial status and report to the City Council any significant developments through the regular Bi-Monthly Financial Reports.



Debra Figone
City Manager

Certification of Funds

I hereby certify that there will be available for appropriation in the designated funds and in the amounts as listed below in fiscal year 2008-2009 monies in excess of those heretofore appropriated therefrom:

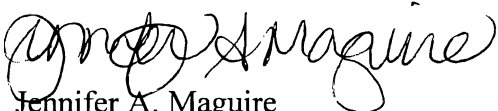
General Fund	\$ 22,559,886
Airport Capital Improvement	2,771,796
Airport Passenger Facilities Charge	3,572,772
Airport Renewal & Replacement	9,913,295
Airport Revenue Bond Improvement	37,825,351
Airport Surplus Revenue	5,264,476
Anti-Tobacco Settlement	247,314
Benefit Fund	167,121
Building & Structures Construction Tax	6,537,941
Branch Library Bond Project	1,092,559
Business Improvement District	344,558
Cash Reserve	38
City Hall Debt Service	2,117,915
Civic Center Construction	562,661
Civic Center Improvement	189,000
Civic Center Parking	139,371
Community Development Block Grant	1,245,532
Community Facilities Revenue	376,320
Community Facilities District Fund #1	16,842
Community Facilities District Fund #2 and #3	97,728
Community Facilities District Fund #8	187,205
Community Facilities District Fund #11	16,288
Community Facilities District Fund #12	446,160
Construction & Conveyance Tax – Central Fund	1,119,752
Construction & Conveyance Tax – Communications	443,010
Construction & Conveyance Tax – Library	1,299,159
Construction & Conveyance Tax – Council District 1	301,792
Construction & Conveyance Tax – Council District 2	256,660
Construction & Conveyance Tax – Council District 3	132,296
Construction & Conveyance Tax – Council District 4	478,499
Construction & Conveyance Tax – Council District 5	783,976
Construction & Conveyance Tax – Council District 6	190,473
Construction & Conveyance Tax – Council District 7	193,504
Construction & Conveyance Tax – Council District 8	375,288
Construction & Conveyance Tax – Council District 9	504,513
Construction & Conveyance Tax – Council District 10	520,023
Construction & Conveyance Tax – City-Wide	857,290
Construction & Conveyance Tax – Service Yards	401,707

Certification of Funds (Cont'd.)

Construction & Conveyance Tax – Parks Maintenance	5,993
Construction Excise Tax	4,497,370
Convention/Cultural Affairs	1,657,470
Dental Insurance	610,261
Downtown Property & Business Imprvt District	3,750
Economic Development Administration Loan	10,422
Economic Development Enhancement	480,306
Emergency Communication System Support Fee	1,049,683
Federal Drug Forfeiture	64,547
Federal Local Law Enforcement Block Grant	5,323
Fiber Optics Development	1,802,970
Gift Trust	71,406
Home Investment Partnership Program	7,072,657
Ice Centre Revenue	971,819
Integrated Waste Management	5,964,435
Library Parcel Tax	1,288,216
Maintenance Assessment District Fund #1	111,758
Maintenance Assessment District Fund #2	11,425
Maintenance Assessment District Fund #8	7,886
Maintenance. Assessment District Fund #11	21,432
Maintenance Assessment District Fund #13	309
Maintenance. Assessment District Fund #15	738,727
Maintenance. Assessment District Fund #18	5,763
Maintenance. Assessment District Fund #19	18,139
Maintenance. Assessment District Fund #20	54,234
Maintenance. Assessment District Fund #21	17,668
Maintenance. Assessment District Fund #22	36,598
Major Collectors and Arterials	171,650
Muni Water Major Facility Fee	23,257
Municipal Golf Course	133,174
Municipal Health Services Program	32,087
Neighborhood Security Bond	1,065,389
North San José Traffic Impact Fee	1,774,279
Parks & Recreation Bond Project	2,000,389
Public Works Program Support	694,788
Redevelopment Agency Capital Projects (City-side)	1,312,351
Residential Construction Tax	24,272
San José Arena Enhancement	177,437
Sanitary Sewer Connection Fee	2,183,502
Sewer Service & Use Charge	2,684,097
Sewer Service & Use Charge Capital	2,397,662
SJ-SC Treatment Plant Operating	2,030,226
SJ-SC Treatment Plant Income	1,685,176

Certification of Funds (Cont'd.)

State Drug Forfeiture	30,585
Storm Drainage Fee	5,783
Storm Sewer Capital	631,188
Storm Sewer Operating	3,385,664
Subdivision Park Trust	8,470,302
Supplemental Law Enforcement Services	53,982
Sewage Treatment Plant Connection Fee	2,404,669
Transient Occupancy Tax	58,597
Underground Utility	584,125
Unemployment Insurance	2,533
Water Utility Capital	154,976
Water Utility	64,855
Workforce Investment Act	2,998,480


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Budget Director