

ELEMENTS OF THE GENERAL FUND FORECAST

ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT

Overview

This document provides three alternative Five-Year Forecast scenarios for General Fund revenues and expenditures: Base Case, Optimistic Case, and Pessimistic Case. The Base Case is considered the most likely projection and that which the Administration recommends be used to formulate the 2009-2010 Proposed Operating Budget. Given the uncertainties inherent in any five-year forecast, however, two alternative case forecasts for the General Fund are also provided. These scenarios attempt to model the potential impact of more optimistic and pessimistic views of the future economic environment. Given the severity of the economic downturn and the volatility in the global economic conditions, it is obviously even more difficult than usual to predict economic performance in the coming year and certainly over the next five years.

- ❑ **Base Case** – The Base Case forecast is built on the assumption that the deep global recession will continue to impact economic performance through 2009. The impact on this region, however, is expected to be somewhat less severe than in other regions in California and the nation as a whole. In the out years of the Forecast, the economy is expected to slowly recover, resulting in slow growth in General Fund revenue collections over the forecast period.
- ❑ **Optimistic Case** – In the Optimistic Case, it is assumed that the economic stimulus package recently passed by Congress and the banking aid measures being undertaken by the Federal Reserve and the Treasury are more successful than anticipated. This leads to a quicker and more robust recovery. When compared to the Base Case scenario, the overall Gross Domestic Product (GDP) increases substantially, more jobs are created, and the unemployment rate is significantly lower. This results in higher collections in the economically sensitive categories, such as Property Tax and Sales Tax.
- ❑ **Pessimistic Case** – The Pessimistic Case, alternatively, attempts to model the potential outcome of an even deeper, longer lasting recession. Under this scenario, the economic stimulus efforts are not able stop the economic decline. The City’s revenues, particularly Property Tax and Sales Tax, would be more severely impacted by the high unemployment rates, very low consumer confidence, low inflation, and falling home prices.

Base Case Forecast

As with all forecasts, this one is based on a series of assumptions regarding the overall economic environment, now and in the future. These assumptions were reached after reviewing the projections included in a number of economic forecasts. The economic conditions and the projected impacts on City revenues will continue to be closely monitored and any new developments will be factored into the City Manager’s 2009-2010 Proposed Operating Budget, scheduled to be published on May 1, 2009.

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ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

Base Case Forecast (Cont'd.)

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

Current National Conditions

Currently, the U.S. economy is declining at an alarming rate. While the economic performance in the first three quarters of 2008 were already very weak, the last quarter of 2008 was one of the most dismal in decades. The 6.2% drop in the Gross Domestic Product (GDP) in the fourth quarter of 2008 was the worst decline in 25 years. On a national level, total non-farm payroll jobs fell by 2.6 million in 2008, the largest job loss total since 1945. The majority of these job losses occurred in the last four months of the year. (Source: Bureau of Labor Statistics). The unemployment rates at the national, State and local levels also increased by approximately 50% from December 2007 to December 2008. Given the alarming deterioration of the economy at the end of the year, the Conference Board Consumer Confidence Index fell to a new all-time low in December 2008 (Index began in 1967).

In the first quarter of 2009, the news continues to get worse as the economy continues its downward spiral. In January 2009, U.S. employment fell sharply with the loss of almost 600,000 jobs and an increase in the unemployment rate from 7.2% to 7.6%. The California unemployment rate reached double-digit levels in January of 10.1%, the highest rate since June 1983. At the end of February, the Dow Jones Industrial average was at its lowest point since May 1, 1997. The 11.7% decline in the Dow in February 2009 was the worst decline for that month since February 1933, which had a decline of 15.6%. The Conference Board Consumer Confidence Index also reached new all-time lows in both January and February 2009.

Prior to fall 2008, housing was the leading cause of the decline with home construction, resales, and prices falling at rates not seen since the end of World War II. In the fall of 2008, a new dimension was added to the crisis with the abrupt decline in the fortunes of major U.S. investment banks, JP Morgan, Morgan Stanley, Lehman Brothers and others. The world banking system has essentially frozen up with virtually no lending taking place. The unprecedented actions taken by American regulators and the Treasury Department seem to have averted for the moment a financial catastrophe. However, the loss to the American financial system has been significant. All of the large American investment banks are either out of business, part of another bank, or have transformed themselves from investment to commercial banks.

The recent decline in energy prices is one of the only positive trends in today's economy. The decline in the price of oil from the mid-\$100 dollar range to the current \$40-\$50 range is adding almost \$400 billion dollars of additional spending power to the American consumers. But even this extremely large increase in spending power has been overshadowed by spending drops

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ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

Base Case Forecast (Cont'd.)

Current National Conditions (Cont'd.)

resulting from the onslaught of job losses, the loss of equity in real estate and equity investments, and the overall loss of consumer confidence.

The National Economic Outlook

The severe economic recession is expected to continue through at least 2009, with high unemployment, a decline in GDP, and extremely low consumer confidence levels. It is hoped that economic performance will show some signs of improvement in 2010, if the immense fiscal stimulus efforts begin yielding results. Many economists are beginning to worry, however, that the economic recession may linger well into 2010. As a consequence of the stimulus and accompanying decline in federal tax revenues, the federal budget deficit is expected to exceed \$1 trillion in 2009.

The unemployment rate is expected to remain high into 2010. From that point, the economy is expected to be on a path of recovery. However, the recovery will not be a fast one and the economy will remain weak for many years into the forecast period. In the later years of the Forecast, the U.S. GDP is projected to experience more historical rates of growth. Inflation is also expected to remain low through 2010, increasing only in the out years of the Forecast.

Energy prices are expected to remain moderate as the decline in demand for fuel brought on by the recession will help curb price increases. In the longer run, conservation programs, higher mileage and alternative fuel vehicles will help to moderate price increases as the economy begins to regain its footing.

Current Santa Clara County Economic Conditions

With the dot-com collapse in the last recession, Silicon Valley was one of the first and most deeply impacted regions in the nation. This has not been the case in this recession. Until the last quarter of 2008, Silicon Valley was somewhat less impacted than other areas in the State and the nation. However, this deep global recession has now enveloped this region as well, as evidenced by increasing job losses, rising unemployment, steep declines in home prices, rising foreclosures, and rising commercial vacancy rates.

In 2008, a total of 11,000 jobs were lost in the San José Metropolitan Statistical Area, the largest decline since the high-tech bubble crash in the early part of this decade. Several large high-tech companies have announced significant layoffs and more are expected in the upcoming months.

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ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

Base Case Forecast (Cont'd.)

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

Unemployment Rate (Unadjusted)

	Dec. 2007	Nov. 2008	Dec. 2008
San José Metropolitan Statistical Area	5.1%	7.2%	7.8%
State of California	5.9%	8.3%	9.1%
United States	4.8%	6.5%	7.1%

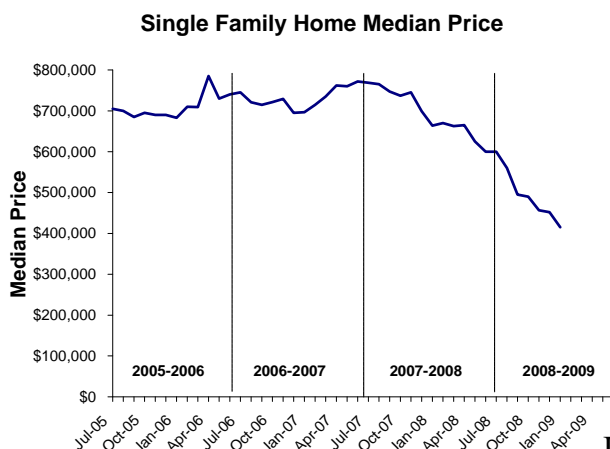
Source: California Employment Development Department

The unemployment rate in the San José metropolitan area continues to increase with a rate of 7.8% in December 2008. This figure is up significantly from 5.1% a year ago. When comparing the December 2008 unemployment rate in this region with the State and the nation, this area fares better than the State that had an unadjusted unemployment rate of 9.1%, but is slightly worse than the nation, which had an unadjusted unemployment rate of 7.1%. As of this writing, January 2009 unemployment data for the nation and California has been released. The U.S. unemployment rate (not seasonally adjusted) increased again to 8.5% and the unadjusted rate for California reached double-digit levels at 10.6%.

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Real estate performance in Santa Clara County remains extremely weak with a significant increase in the number of foreclosures. In the last quarter of 2008, approximately 3,000 San José homes received a new foreclosure filing. At this point, approximately 1.7% of the home ownership units are in some state of foreclosure. The vacancy rates for office space in San José also increased over 60%, from 10.8% in the fourth quarter of 2007 to 17.5% in the fourth quarter of 2008.

Following the nation-wide trend, local home prices have declined sharply over the last year. The median home price for single family homes within San José dropped an unprecedented 35% from \$699,000 in December 2007 to \$452,000 in December 2008. In January 2009, this figure fell further to \$415,000, the lowest level since January 2000. With the home prices dropping significantly, there has, however, been a corresponding increase in the number of sales. In January, the property transfers for all types of residences were up 92% from the extremely low level experienced in January 2008.



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Base Case Forecast (Cont'd.)

Santa Clara County Economic Outlook

The local economy is also expected to continue to face significant challenges through the remainder of the year. On an overall basis, this region's economy is expected to contract sharply in 2009.

For the near-term forecast period, local employment levels are expected to continue to decline in 2009 and the unemployment rate will continue to track well over 7%. After 2009, it is hoped that if the federal stimulus package has its intended effect and the general economy begins to recover, employment numbers would begin to grow again and the unemployment rate should start to decline. For most of the remainder of the forecast period, job growth in the County is expected to be lower than the historical norm, but will be positive.

Both consumer and business spending are also expected to be weak in 2009. The record lows in consumer confidence, the declines in real estate values, the volatility in the stock market, and the credit crunch in the financial markets are all factors that have and will continue to drive down spending. This region, however, does benefit greatly from the innovative nature of its companies, from the start-ups to the well-established businesses. While the County's high-tech companies have been impacted by the deep global recession, the products developed by these companies are expected to remain in demand over the forecast period. The world is also in the process of shifting to new "green" technologies and energy alternatives. Silicon Valley is potentially a leader in both of these fields.

In 2009, home prices are expected to continue to fall, significantly impacting the City's Property Tax receipts in the early years of the Forecast. Home prices are expected to begin to show some growth after 2009; but the rate of increase will be somewhat muted by an expected rise in interest rates that will make it a bit more difficult for prospective buyers to purchase a home. Still, home prices should continue to rise through the rest of the forecast horizon as both employment and incomes gain traction as we move through the forecast years.

In summary, the severe economic recession is expected to continue to impact economic performance in 2009-2010, with lingering impacts in 2010-2011. In the last three years of the Forecast, the resumption of modest revenue growth is anticipated.

Optimistic and Pessimistic Scenarios

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

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ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

Optimistic and Pessimistic Scenarios (Cont'd.)

Optimistic Case

In the Optimistic Case, the economic stimulus package recently passed by Congress and the banking aid measures being undertaken by the Federal Reserve and the Treasury are more successful than anticipated. With a more robust recovery, overall GDP will increase substantially above that of the Base Scenario. Along with it, many more jobs will be created and the unemployment rate will fall.

One slightly negative aspect of a more robust recovery is that it becomes more likely that inflation will be higher as well. With higher inflation, interest rates, particularly mortgage rates, will increase. For this scenario however, it is assumed that the increases in interest rates are not sufficient to derail the recovery. Interest rates are currently very low and there is sufficient room on the upside for them to increase in this scenario without unduly harming the recovery.

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

General increases in inflation, employment, and consumer attitudes promote increased spending, which generate Sales Tax for the City. Car sales could be expected to rebound from the dismal performance experienced in 2008. Development activity is also expected to improve. Higher energy prices increase Utility Taxes and Franchise Fees as well. By the end of the Forecast period, revenues are \$45 million above the Base Case.

Pessimistic Case

The Pessimistic Scenario is one in which the economic stimulus efforts are not able to curb the economic decline. The economy simply does not respond sufficiently to keep it from falling into an even deeper recession. This scenario would have an immediate and longer lasting negative impact on City revenues.

In this scenario, the economy is declining rapidly, which drives down inflation. For the first several years, prices for goods and services are actually forecast to fall before recovering very late in the forecast cycle. Home prices also continue to fall, resulting in significantly lower Property Tax receipts. The downward property reassessments under Proposition 8 continue to severely impact Property Tax collections. In addition, low inflation means that the Proposition 13 inflation adjustments fall below the 2% level. Property taxes fall for the first three years of this forecast before finally hitting the lowest point in the fourth year.

ELEMENTS OF THE GENERAL FUND FORECAST

ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

Optimistic and Pessimistic Scenarios (Cont'd.)

Pessimistic Case (Cont'd.)

Sales Tax receipts are also significantly lower in this scenario. The very high unemployment rates and very low consumer confidence combine with falling prices to reduce Sales Taxes in the first two years of the Forecast. The other economically sensitive revenues are also expected to fall in this scenario. Gasoline Taxes, however, rise slightly because these per unit taxes are positively affected by the forecast for lower oil prices that result in higher gasoline consumption. By the end of the Forecast period, total revenues are \$65 million below the Base Case.

Impact of Forecasted Economic Conditions on Revenue Collections

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

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REVENUE FORECAST

An in-depth analysis of the General Fund revenue categories was completed to develop the 2009-2010 revenue estimates included in this Forecast. Over 500 revenue sources were examined to estimate the outcome in 2008-2009 and, building upon those projections, to develop the 2009-2010 revenue estimates. These revenue estimates will be closely examined and updated again during the preparation of the 2009-2010 Proposed Operating Budget.

As displayed in the Forecast, revenues (exclusive of Beginning Fund Balance) are shown to increase from \$774.5 million in 2009-2010 to \$862.5 million in 2013-2014, for an average growth rate of 2.84% per year. This is slightly above the average growth rate presented in the February 2008 Forecast (2.78%). It is important to note, however, that the relatively low growth rate in the last forecast was due, in part, to the scheduled sunseting of the Emergency Communications System Support (ECSS) Fee in 2009-2010. This is not, however, a factor in this forecast due to the replacement of the ECSS Fee with a voter-approved Telephone Tax. The low growth rate in this Forecast is due primarily to the low projected growth of only 1.34% in 2010-2011, reflecting the lingering impact of the economic downturn as well as the phase-out of a number of transfers and reimbursements.

Understanding the basis for the revenue estimates included in this Forecast requires discussion of the assumptions used for estimating each of the revenue categories. The following discussion focuses on estimates used for the 2009-2010 General Fund Forecast.

Property Tax

Property Tax receipts of \$207.9 million are projected for 2008-2009, which represents growth of 2.0% over the prior year. This growth reflects increases in both the Secured and Unsecured categories, offset by a decrease in the SB 813 (property resales) collection area. In 2009-2010, collections are expected to remain relatively flat with an estimate of \$207.8 million. Additional information about each of the Property Tax sub-categories is provided below.

Secured Property Taxes account for approximately 90% of the revenues in this category. In 2008-2009, Secured Property Tax receipts are expected to reach \$191.2 million, an increase of 4.2% over the prior year. These receipts are based on real estate activity through January 1, 2008. The 2009-2010 Secured Property Tax levy will be based on real estate activity through January 1, 2009. The residential real estate market experienced a significant slowdown in 2008, with a 35% drop in the median sales price. Based on the significant drop in home prices, the Santa Clara County Assessor's Office will be evaluating property sales that have occurred since 2000 for potential reassessment. This includes the review of almost 42,000 single family homes in San José, or 20% of the total. The impact of these reassessments is not yet known.

It is currently estimated that very low Secured Property Tax growth of only 1% will be realized in 2009-2010, bringing the estimate to \$193.1 million. It should be noted that final data on the actual tax levy for 2009-2010 is not available as adjustments are made through July 1, 2009. It is anticipated that initial information on the impacts of the Property Tax reassessments will not be available until May 2009, after the release of the 2009-2010 Proposed Operating Budget. If

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REVENUE FORECAST (CONT'D.)

Property Tax (Cont'd.)

necessary, refinements to the Property Tax estimates will be brought forward in the Proposed Budget review process.

Unsecured Property Taxes are the second largest revenue source in this category. Growth in this category is driven primarily by increases in the value of personal property (e.g. equipment and machinery used by business and industry for manufacturing and production). During the last decade, performance in this category has been extremely volatile with annual growth or declines reaching double-digit levels based primarily on the strength of the local business sector. In 2008-2009 collections in this category are expected to reach \$11.1 million, which is consistent with 2007-2008 actual receipts. Given the severe economic downturn, collections are expected to decrease 10.0% in 2009-2010 to \$10.0 million.

SB 813 Property Taxes (supplemental taxes) represent payments for taxes owed on recent housing resales. With the significant drop in housing prices, SB 813 Property Tax receipts are expected to fall 45% from \$7.9 million in 2007-2008 to \$4.4 million in 2008-2009. Collections are projected to fall an additional 20% to \$3.5 million in 2009-2010 based on the assumption that the housing market will continue to experience steep declines through 2009-2010.

All other property taxes (Homeowners Property Tax Relief and Agricultural Tax Relief) are assumed to have little or no growth in 2009-2010, consistent with historical trends.

In the out years of the Forecast, annual Property Tax performance is expected to range from a decline of 1.5% in 2010-2011 to an increase of 5.0% in 2013-2014. These projected growth rates are far below those experienced in recent years and reflect the impact of the significant drop in housing prices. This is the first time in memory that Property Tax collections are projected to actually decline in one of the years of the Forecast.

Sales Tax

The Sales Tax category includes General Sales Taxes and Proposition 172 Sales Taxes. Overall, collections are expected to decrease 5.0% in 2008-2009 to \$146.3 million and an additional 5.0% in 2009-2010 to \$139.0 million.

The forecast for the General Sales Tax revenue estimate assumes collections of \$142.0 million in 2008-2009, a decrease of 5.0% over the 2007-2008 collection level of \$149.5 million. This reflects actual performance for the first quarter of 2008-2009 (decline of 0.4%) and the assumption that a decline 6.5% will be realized in each of the remaining three quarters of the fiscal year. The rapidly deteriorating economy is expected to negatively impact receipts through 2008-2009 and into next fiscal year.

Collections in all sectors are expected to be impacted. With the dismal holiday season, high unemployment, and record-setting lows in consumer confidence, the retail sector is expected to be very weak. The global economic recession and the lack of a credit market will affect the

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REVENUE FORECAST (CONT'D.)

Sales Tax (Cont'd.)

business-to-business sector. Large declines are also projected in the transportation sector that has experienced a steep decline from automobile sales as well as the decline in gas prices. For 2009-2010, General Sales Tax receipts are expected to fall an additional 5.0% to \$134.9 million. It is assumed that the economy will continue to stall through the first half of the fiscal year and improve only slightly in the second half.

Proposition 172 Sales Tax collections (representing the one-half cent tax that is allocated to counties and cities on an ongoing basis for the use in funding public safety programs) are expected to total \$4.3 million in 2008-2009, which represents a decline of 5.0% from the actual 2007-2008 collections of \$4.5 million based on activity through the first seven months of 2008-2009. In 2009-2010, collections are projected to fall an additional 5.0% to \$4.1 million.

Through the remaining years of the Forecast, Sales Tax performance is expected to improve, with growth ranging from a low of 3.84% in 2010-2011 to a high of 4.85% in 2013-2014.

Departmental Charges and Other Licenses

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

When developing the forecast estimates for these categories, the revenues are generally set at the anticipated collection levels. For 2009-2010, the development-related revenues are expected to be very weak, continuing the dismal performance experienced in 2008-2009. In cases where the development-related revenues are projected to exceed costs, the impacted departments will need to develop budget proposals for incorporation into the 2009-2010 Proposed Operating Budget to increase resources to meet the service demands or to reduce fees. Conversely, if the projected revenues are not sufficient to cover the base costs, departments will be submitting proposals to reduce costs and/or increase fees to bring projected revenues and expenditures back in line for a net-zero General Fund impact. For 2009-2010, the Building, Public Works, and Fire Fee Program revenues are projected to be below the base costs, which will require budget actions to bring these programs in balance.

For the non-development-related fees and charges, the 2009-2010 estimates are based on current collection trends. In the out years of the forecast, both the Departmental Charges and Other Licenses categories are expected to experience growth of 3.4% in 2010-2011 and 1.4% in each of the remaining years of the Forecast. The growth rates in the out years are tied to the expected increases in costs for which the fees are designed to recover. It should be noted that cost-of-living salary adjustments have not been factored into the last three years of the Forecast. There are currently no negotiated agreements for that period.

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REVENUE FORECAST (CONT'D.)

Business License Tax

This category includes General Business License Tax and Disposal Facility Tax. In 2008-2009 General Business Tax proceeds are expected to reach only \$12.3 million, which is well below the Adopted Budget estimate of \$13.3 million. The severe economic downturn has impacted the number of businesses as well as the staffing levels, which directly impact Business Tax receipts. In 2009-2010, collections are projected to drop to \$12.0 million to reflect the loss of revenue associated with the Business Discovery Program, which was funded on a one-time basis in 2008-2009.

In the Disposal Facility Tax category, collections are estimated at \$13.2 million in 2008-2009, a decrease of 5.3% from the 2007-2008 collection level. Receipts are expected to fall an additional 2.0% to \$12.9 million in 2009-2010 as a result of the economic downturn and continued recycling efforts.

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

Money and Property

This category consists primarily of interest income. The 2009-2010 estimate for interest earnings in the General Fund and for the other funds where earnings are transferred to the General Fund assumes an average interest rate of only 2.06%, applied to an average cash balance of approximately \$180 million for a total collection level of \$3.7 million. This forecast reflects a significant decline in both the average cash balance (down from \$240 million) and the average interest rate yield (down from 3.41%) adopted in 2008-2009. The decline in the cash balance is primarily the result of change approved in 2008-2009 to prepay the City's contribution to its two retirement plans at the beginning of each fiscal year in an effort to maximize the earnings from these plans and reduce the City's contribution rates to the system. The lower interest yield projection, which was provided by the Finance Department, reflects the impact of the current economic conditions.

Interest from other sources, such as capital and special funds, have been adjusted to reflect the various impacts of expected activity, fund balance levels, and interest rate yields in 2009-2010. Interest earnings from these sources are expected to generate \$3.2 million in 2009-2010. An additional \$1.0 million is expected to be generated from the remaining sources in this category, including subrogation recovery funds, and the rental of facilities. In the out years of the Forecast, increases ranging from 2.01% to 2.61% are projected.

Motor Vehicle In-Lieu

In 2008-2009, Motor Vehicle In-Lieu collections are expected to reach only \$3.0 million, a significant drop from the \$4.1 million received in 2007-2008. In 2009-2010, collections are expected to drop an additional 7.8% to \$2.8 million. This reflects the 23% drop in new car and light truck registrations experienced in 2009 and an additional 15% projected drop in 2009, with

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REVENUE FORECAST (CONT'D.)

Motor Vehicle In-Lieu (Cont'd.)

some relief expected by 2010 (California Auto Outlook, January 2009). In the out years of the forecast, small changes ranging from a decrease of 0.33% in 2010-2011 to an increase of 0.90% in 2013-2014 are anticipated.

Federal Revenue

The Federal Revenue category consists of grant revenues. Two grants are anticipated in 2009-2010: the Senior Companion Program grant (\$130,000); and the Retired and Senior Volunteer Program (RSVP) grant (\$92,000).

Other State Revenue

The Other State Revenue category includes the Aircraft In-Lieu payments, State grant revenues, and other State reimbursements. The Aircraft In-Lieu payment is expected to reach \$4.6 million in 2008-2009, a decline 10.9% from the 2007-2008 receipts of \$5.2 million. In 2009-2010 collections are expected to decline an additional 10.0% to \$4.1 million as a result of the steep economic downturn.

The following State grants and reimbursements are expected in 2009-2010: Public Library Foundation (\$337,000); the California Library Literacy Service grant (\$50,000); the Waste Tire Enforcement grant (\$170,000); the Abandoned Vehicles Abatement Program (\$700,000); Auto Theft reimbursement (\$370,000); and the Highway Maintenance Charges reimbursement (\$287,000). The majority of these revenues are set at the 2008-2009 Adopted Budget level.

Growth of approximately 2% annually is projected in the out years of the Forecast.

Gas Tax

The Gas Tax estimate assumes that collections in 2008-2009 will drop 10.9% to \$16.7 million based on current tracking levels this year. In 2009-2010, an additional 2% decline is projected, bringing collections to \$16.4 million. These collection levels are below historical tracking patterns for this category and reflect the impact of volatile gas prices as well as the severe economic downturn. In the out years of the Forecast, growth of 0.5% annually is projected.

Transient Occupancy Tax

It is currently estimated that Transient Occupancy Tax receipts for 2008-2009 will total \$8.9 million, reflecting a decline of 6.7% from the 2007-2008 collection level. In 2009-2010, an additional decline of 14.2% from the 2008-2009 estimate is anticipated, reflecting the impact of the deep economic recession as well as the loss of business during the construction period for the Convention Center expansion. These revenue estimates were based on a study performed by an independent consultant Horwath HTL. In the remaining years of the Forecast, annual growth ranging from 2.7% to 9.1% is projected.

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REVENUE FORECAST (CONT'D.)

Telephone Tax

In November 2008, voters approved a ballot measure that replaced the Emergency Communication System Support (ECSS) Fee with a Telephone Tax. The new tax was set at a rate 10% below the existing ECSS Fee. In 2009-2010, an estimated \$21.6 million will be generated from this new tax. In the out years of the Forecast, collections in this area are expected to increase 2% per year.

Utility Tax

Utility Taxes are imposed on electricity, gas, water, and telephone usage. Collections in 2008-2009 are anticipated to total \$84.5 million, representing an increase of 2.8% from the 2007-2008 collection level. In 2009-2010, Utility Tax collections are projected to increase less than 1% to \$85.0 million. In the Electricity category, a 4% increase is projected in 2009-2010 based on estimated rate increases. In the Gas category, it is assumed that collections will remain at the 2008-2009 level based on the assumption that Gas rates will experience declines in 2009 and will increase in 2010. Water Utility Tax receipts are also expected to remain at 2008-2009 levels as projected rate increases in this category of 5-10% are anticipated to be offset by lower consumption associated with potential water conservation efforts that may become mandatory. A decline of 4.2% in the Telephone Utility category is projected in 2009-2010. This decline reflects the impact of the ballot measure approved by the voters in November 2008 that lowered the tax rate by 10% and modernized the tax base, partially offset by the projected 2% increase in activity.

In the out years of the Forecast, growth ranging from 3.5% to 4.9% annually is expected in the Utility Tax category.

Franchise Fees

Franchise Fees are collected in the Electricity, Gas, Cable, Tow, Commercial Solid Waste, Water, and Nitrogen Gas Pipeline categories. Overall, collections are projected at \$41.3 million in 2008-2009, a slight increase over the 2007-2008 actual receipts of \$41.1 million. The growth in 2008-2009 was held down by the projected 6.1% decline in the Commercial Solid Waste category. In 2009-2010, Franchise Fees are expected remain essentially flat at \$41.2 million. In 2009-2010, growth is projected in the Electricity (4.0%), and Cable Television (2.0%) Franchise Fee categories. This growth, however, is offset by projected declines in the Commercial Solid Waste (down 2.7%) and Gas (down 10%) Franchise Fee categories. The decline in Commercial Solid Waste Franchise Fees reflects the impact of the severe economic downturn as well as recycling efforts. The Gas Franchise Fee category is also expected to decline based on the projected decline in gas prices in calendar year 2009. The remaining categories are expected to remain at the 2008-2009 estimated level for 2009-2010.

In the out years of the Forecast, Franchise Fee revenues are anticipated to increase from 3.4% to 4.8% annually.

ELEMENTS OF THE GENERAL FUND FORECAST

REVENUE FORECAST (CONT'D.)

Fines, Forfeitures and Penalties

In 2008-2009, the Fines, Forfeitures and Penalties category is expected to generate \$15.1 million. This figure includes a penalty payment of \$539,000 from the Garden City Card Club as well as additional revenue of \$230,000 generated from the partial year implementation of a parking fine increase that was approved in February 2009. In 2009-2010, a total of \$15.5 million is projected and includes the final payment of \$45,000 from the Garden City Card Club as well as the full year implementation of the increase to the parking penalty fee. In the out years of the Forecast, growth ranging from 1.0% to 1.3% is projected annually.

Revenue from Local Agencies

In 2009-2010, revenue of \$47.7 million is projected from other local agencies, such as the Redevelopment Agency, the Central Fire District, and the County. The largest portion of the Revenue from Local Agencies category consists of reimbursements from the San José Redevelopment Agency (SJRA). The SJRA reimburses the General Fund for the Convention Center lease payment that is projected at \$14.7 million for 2009-2010. Estimated SJRA reimbursements for City service costs for 2009-2010 of \$18.5 million are based on the assumption that ongoing support will remain consistent with current levels. This figure includes SJRA reimbursements for eligible expenditures (which enable the City to fund the San José Best Program at \$4.0 million and to cover the annualized cost for eight Police Officer positions at \$1.0 million).

The City also receives reimbursement from the Central Fire District for the County areas covered by the San José Fire Department. These payments are based on the property tax assessments for fire services collected in those areas, which are passed on to the City. For 2008-2009, Central Fire District payments are expected to end the year at \$7.5 million. This includes a true-up payment from the prior year of \$900,000. In 2009-2010, collections are expected to drop to \$6.9 million. This assumes a minimal true-up payment in 2009-2010 and a 1% increase in Property Tax receipts.

In 2009-2010, payments from the County of Santa Clara for the first responder advanced life support program (Paramedic Program) are assumed at \$1.8 million as the receipts are based on the annual adjustments approved by the contract with the County. In addition, the City is expected to receive \$1.7 million from the County for the Adult Day Care and Senior Nutrition programs. Payments of \$1.8 million from other local agencies are expected to reimburse the City for the Police Department CAL-ID program.

No revenue is projected from Enterprise Fund In-Lieu payments from the Water Pollution Control Plant or the Municipal Water System. The \$2.4 million budgeted from this source in 2008-2009 was the last year of a two-year phase-out of this payment.

In the remaining years of the Forecast, the Revenue from Local Agencies category is projected to increase annually by 0.16% to 2.17%, based on the scheduled payments and cost-of-living adjustments for staff reimbursements.

ELEMENTS OF THE GENERAL FUND FORECAST

REVENUE FORECAST (CONT'D.)

Other Revenue

The Other Revenue category consists of miscellaneous revenues received from a variety of sources, including proceeds from the Sale of Surplus Property, cost reimbursements for the Investment Program, Arena Rental, Suite, Parking, and Naming revenues, and reimbursements from the Airport to cover a portion of the Airport West property debt service payments.

Revenue estimates assume continuation of current year activity levels with revisions, where appropriate, for 2009-2010 costs or agreements. The proceeds from the Sale of Surplus Property category has been set at \$200,000 to assume that, at a minimum, a portion of costs of the Real Estate Division related to the sales process will be recovered. Airport reimbursement for the Airport West property of \$1.7 million is projected in 2009-2010. However, no Airport reimbursements for this property are projected in the out years of the Forecast based on the assumption that the Airport will no longer have a use for this property once the Airport expansion is complete.

The 2009-2010 estimate for Other Revenue is \$13.3 million. In 2010-2011, a decline of 11.3% is projected, primarily due to the elimination of the Airport reimbursement for the Airport West property. Increases of 1.9% are projected for both 2011-2012 and 2012-2013 followed by a slight decline of 0.20% in 2013-2014 to reflect changes in scheduled payments.

Overhead Reimbursements

The Overhead Reimbursements category includes overhead reimbursements from both operating and capital funds. In 2009-2010, a total of \$37.9 million is projected. This estimate is based on 2009-2010 overhead rates prepared by the Finance Department applied against the projected 2009-2010 salaries for those positions for which an overhead rate is applied. The overhead revenue estimate has been decreased to reflect the potential loss of overhead associated with positions that are likely to be eliminated in the 2009-2010 Budget, including positions at the Airport and the Convention Center.

In the remaining years of the forecast, annual increases ranging from 1.4% to 3.4% are assumed reflecting the anticipated salary and cost-of-living and adjustments. It should be noted that cost-of-living salary adjustments have not been factored into the last three years of the Forecast. There are currently no negotiated agreements for that period.

Transfers

The Transfers category is projected at \$24.5 million for 2009-2010. This reflects a drop from the 2008-2009 Adopted Budget estimate of \$51.7 million, primarily due to the elimination of the \$26.0 million transfer from the Emergency Communication System Support (ECSS) Fee Fund and the phase-out of the Municipal Water Rate-of-Return Transfer (\$445,000). Through the approval of a November 2008 ballot measure, the ECSS Fee has been replaced with a Telephone Tax effective April 2009 and is reflected in a separate category in this document.

ELEMENTS OF THE GENERAL FUND FORECAST

REVENUE FORECAST (CONT'D.)

Transfers (Cont'd.)

Adjustments to the Airport Crash Fire Rescue and Airport Police Consolidation reimbursements have been assumed in 2009-2010 and the remaining four years of the Forecast to reflect updated salary and benefit costs and projected cost-of-living adjustments. The remaining transfers have been reflected at current year levels, with slight adjustments for costs or payment schedules as necessary.

In 2010-2011, the Transfers are expected to drop to \$23.6 million to reflect the scheduled phase-out of transfers from two special funds. In the remaining years of the Forecast, annual increases ranging from 0.9% to 1.8% are assumed.

Reimbursements for Services

The Reimbursements for Services category reimburses the City for actual costs associated with the Deferred Compensation Program and the Maintenance Assessment District Funds. These amounts have been set to recover costs in 2009-2010 of \$669,000, with increases ranging from 3.4% in 2010-2011 and dropping to 1.4% in the remaining of forecast to reflect salary and benefit adjustments.

Beginning Fund Balance

The forecast estimate for available Beginning Fund Balance in 2009-2010 of \$50.4 million is based on the following assumptions:

- A Contingency Reserve balance of \$28.7 million will remain uncommitted by year-end.
- A total of \$16.5 million will be achieved from a combination of excess revenue, expenditure savings, and the liquidation of prior-year carryover encumbrances. This figure is based on a review of actual revenue and expenditure performance in 2008-2009.
- A total of \$5.2 million will be provided from various Reserves for use in 2009-2010. The Forecast includes \$3.1 million from the Parks Maintenance Earmarked Reserve to support prior year General Fund balancing plans (\$1.6 million), Enhanced Parks Maintenance staffing (\$1.2 million), and Public-Private Partnership efforts (\$330,000). The Tully Branch Library Sunday Hours Reserve will provide \$60,000 to continue this activity in 2009-2010. The Wellness Reserve will provide \$311,000 to fund the Wellness Program and the Neighborhood Investment Reserve will provide \$316,000 to fund 3.0 Community Coordinator positions that support the Strong Neighborhoods Initiative. In addition, the Salary Reserve will provide \$1.4 million that is no longer necessary after the completion of salary and benefit calculations in 2008-2009.

The future year beginning fund balance estimates assume that excess revenues of 1% and expenditure savings of 1.5% - 2% would be generated annually. This would generate fund balance ranging from \$20.6 million in 2010-2011 to \$26.9 million in 2013-2014. The carried

ELEMENTS OF THE GENERAL FUND FORECAST

REVENUE FORECAST (CONT'D.)

Beginning Fund Balance (Cont'd.)

over Contingency Reserve portion is adjusted upward based on the Contingency Reserve allocation from the prior year.

One-Time Funding Available

Not included in the Forecast but available for Council consideration is the 2009-2010 Future Deficit Reserve of \$4.0 million that was established, per City Council policy, as part of the 2007-2008 Annual Report. This reserve was set aside to fund a portion of the shortfall that was projected for 2009-2010 in the February 2008 Forecast. This reserve is not assumed in the remaining forecast years. However, the amount of funding that has been set aside historically for future year deficits has ranged from a low of \$4.3 million in 2000-2001 to a high of \$18.4 million in 2005-2006. Per City Council policy, a portion of the remaining unallocated funds available at the close of each fiscal year is directed to be used to cover any projected shortfall in the following year based on the Five-Year General Fund Forecast.

In addition, the \$2.3 million Airport West Proceeds Reserve is available and could be used to offset a portion of the Airport West debt service costs for one year (2009-2010). The Reserve was established in 2008-2009 from option payments received for the Airport West property.

The Forecast does not assume the use of the \$15.3 million Economic Uncertainty Reserve that was established to address higher than anticipated declines in revenue resulting from the current economic downturn.

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST

Personal Services

As is our usual practice, the first year (2009-2010) projection for personal services costs in this Forecast has been calculated at a detailed level. An extract of payroll system information as of August 2008 was used as the starting point. This individual position-level information was then reviewed, corrected, and updated by each department to include current vacancies and filled positions, accurate salary step status, as well as any position reallocations. Also, 2008-2009 ongoing position reductions (cost savings) and additions (cost increases) were annualized, and projections for all categories of benefit costs in the coming year were made.

Personal services costs continue to account for approximately three-quarters of the General Fund's total costs. The Personal Services category has been broken down into its three major components (Salaries and Other Compensation, Retirement, and Health and Other Fringe Benefits). This display of personal services costs is intended to show how these different elements drive rising personnel costs. For example, even without any negotiated salary increases, growth in the other major personnel cost components (scheduled non-management step increases, retirement and health and other fringe benefits) impact personal services and, particularly in recent years, have been responsible for a growing element of the major increases in personnel costs. To provide historical context to the growth in this category, from 2000-2001 to 2008-2009, total average personal services costs grew by 59%, with average salary and other compensation increasing 43% over this period, while retirement costs increased 127% and health and other fringe benefit costs grew by 118%.

For 2009-2010, the total personal services preliminary estimate, as displayed in Section Two of this report, represents a decrease of approximately 0.6% (\$4.1 million) from the 2008-2009 Adopted Budget level. It should be noted, however, that the level of growth shown for personal services costs in the Forecast actually significantly understates the underlying personal services growth for 2009-2010 due to several reasons that are discussed below. Once the 2009-2010 personal services category has been adjusted for one-time items, the underlying growth of personal services is approximately 2.3% next year.

Specific factors impacting the elements of the personal services costs in the Forecast include:

- Approved salary compensation and benefit increases as negotiated with four of the thirteen bargaining/employee groups, including Police Officers Association (POA), City Association of Management Personnel (CAMP), Confidential Employees' Organization (CEO), and Municipal Employees' Federation (MEF);
- Forecasted new negotiated salary compensation and benefit increases with nine of the thirteen bargaining/employee groups, including International Association of Firefighters (IAFF), International Union of Operating Engineers, Local #3 (OE#3), International Brotherhood of Electrical Workers (IBEW), Association of Engineers and Architects, Units 41 and 42 (AEA), Association of Engineers and Architects, Units 43 (AEA), Association of Maintenance Supervisory Personnel (AMSP), Association of Building, Mechanical and Electrical Inspectors (ABMEI), Unrepresented Non-Management (Unit 82), and Executive Management (Unit 99);

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Personal Services (Cont'd.)

- Salary step increases for current non-management employees (an overall 1.3%, or \$7.1 million salary and benefit growth level for the category);
- The implementation of the retirement rates for both the Federated and Police/Fire Retirement plans for the pre-funding of the City's annual contribution which resulted in a net savings of \$4.1 million in the General Fund. This was one of the balancing strategies that the City approved for 2009-2010. These savings are partially offset by a loss of interest earnings revenue of approximately \$1.7 million;
- Forecasted health rate increases of 10%;
- The new inclusion of the five year phase-in plan to fully fund the City's share of the annual required contribution for retiree healthcare benefits for Police Officers' Association (POA) employees, as negotiated (\$2.4 million in 2009-2010 and increasing to \$9.9 million by 2013-2014). In addition to the Personal Services funding to cover the liability for POA employees, this Forecast includes \$8.3 million by the end of the five-year period to address the projected General Fund liability for non-POA employees, bringing the total retiree healthcare benefits funding in the General Fund to \$18.2 million. A portion of this ongoing General Fund funding (\$1.5 million) was set aside as an Earmarked Reserve in the 2008-2009 Adopted Budget. The remaining funding is reflected in the Committed Additions section of this document (\$0.2 million in 2009-2010 and increasing to \$6.8 million by 2013-2014);
- The impact of actions taken during 2008-2009 to rebalance the Development Fee Program with the elimination of 52 positions. The Planning and Building Fee Programs are by City Council policy required to achieve 100% cost recovery. Due to a steep decline in development activity, actions to address a revenue shortfall on an ongoing basis were necessary;
- The impact of deleting rebudgeted items in the Salary Reserve, primarily the funding for miscellaneous benefits and items previously carried over from prior years; and
- Elimination of two programs, Challenges and Choices and Summer Work Experience, that were approved by the City Council to be eliminated beginning in 2009-2010.

It is also important to note that not included in the Personal Services category are two large General Fund cost categories: Workers' Compensation Claims Payments and Sick Leave Payments Upon Retirement which are other significant components of the total costs of the City's workforce. These costs are included in the City-Wide Expenses category of this forecast. In 2009-2010, \$15.7 million for Workers' Compensation Claims Payments and \$9.3 million for Sick Leave Payments Upon Retirement have been included in this General Fund Forecast.

It should be further noted that due to the mechanism used to represent the desired outcome in fee programs, personal services expenditures in this forecast are understated by an additional \$4.1 million. The \$4.1 million represents the shortfall that would exist in the development-related fee programs in the Planning, Building and Code Enforcement, Fire and Public Works Departments

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Personal Services (Cont'd.)

if all costs were reflected. These fee programs are intended by the City Council to recover 100% of the cost of development review and inspection and, as a result, costs are reflected in this Forecast at the expected revenue collection level. The Public Works, Fire, and Building fee programs will be required to develop strategies that will address this \$4.1 million shortfall in the 2009-2010 Proposed Budget.

Retirement costs are calculated as a percentage of salary costs. In this Forecast, retirement costs have only been adjusted for the impact of the pre-funding of the City's contribution and step increases and cost-of-living adjustments (COLAs). It should be noted that every two years, an actuarial study is completed on the City's two retirement systems, Federated and Police and Fire. The next actuarial studies are scheduled to be completed in 2009-2010 for implementation in 2010-2011. Presently, the extreme volatility and steep declines in the U.S. financial markets are negatively impacting performance in the two retirement systems. The extent of that impact upon the contribution rates is not known at this time although the likelihood is for significant upward movement in rates and City costs to offset the investment losses. Due to the volatility of retirement rates, however, no specific predictions for the retirement rate contribution adjustments that will be required have been assumed in the out years of this Forecast.

As with past forecasts, personal services costs in years two through five of this Forecast have been projected on a more global basis, using the detailed costs calculated for the first year as a base, and then growing that base by an overall percentage factor representing expected growth from salary and benefit adjustments. For this Forecast, the out years were projected to inflate at a composite rate of approximately 2.8%. This projected rate of growth is well below the 4.3% presumed in the February 2008 forecast due entirely to a change in forecast methodology. In this Forecast, no cost-of-living salary increases for any employees in the last three years of the Forecast has been assumed reflecting the fact that there are no negotiated agreements covering this period. In past years, projected increases were built into the Forecast. Thus, the approval of any negotiated salary or benefit increases in those years, without any offsetting increase in revenues or reduction in costs, will have the effect of driving up the City's shortfall. In this regard, consideration of salary increases is being treated as a resource allocation policy decision and any decision will be made in the context of what is affordable in light of the City's many service delivery priorities.

Non-Personal/Equipment

Non-personal/equipment expenditures for the first year of the forecast have also been calculated at a detailed level. The process utilized by the Budget Office includes adjusting each department's current year budget to eliminate one-time cost allocations, annualizing all partial-year reductions or additions approved for 2008-2009, and including projected adjustments for specific large non-personal/equipment allocations (e.g., utilities, leases, contracted services, and Police Department vehicle replacement) as described later in greater detail. The resulting 2009-2010 estimates represent a decrease (\$2,613,000) from the current year level. Departmental gas and electricity funding for 2009-2010 has been slightly adjusted in this Forecast to reflect

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Non-Personal/Equipment (Cont'd.)

approved gas and electricity rates and projected consumption changes from new or expanded City facilities.

Other specific adjustments included in the 2009-2010 non-personal/equipment base include increases for the scheduled replacement of police vehicles (\$1.1 million), vehicle maintenance and operating costs (\$49,000) and contractually required cost of living increases to major contracts. An increase of \$1,147,000 from 2008-2009 for the scheduled replacement of the Police Department's marked, unmarked and covert fleet has been included. This is an increase of \$697,000 from what was assumed in the prior forecast due to higher vehicle usage. A major component of the City's vehicle maintenance and operating costs is fueling. Over the last eight months, fuel costs have fallen from the high costs that were being experienced last summer. This reduction in fuel costs almost entirely offsets increases to staffing costs needed to maintain the fleet. In addition to contractually required cost of living increases to major contracts, a 1.5% increase, which represents one-half of the San Francisco-Oakland-San José area consumer price index for the past 12 months, has been applied to eligible expenditures. Eligible expenditures in the non-personal/equipment category are non-centrally determined details, such as supplies, postage, and printing, and expenditures that have not already been inflated for negotiated contracts and agreements. For the out years of the forecast, a growth rate of 2.0% has been assumed from the 2009-2010 non-personal/equipment base level in each of the four years. This projection is unchanged from that assumed in recent forecasts.

Other Expenditures

The General Fund **Capital Projects** category includes debt service payments for Central Service Yard – Phase I (\$796,000 in 2009-2010). These payments increase to \$1,673,000 in the out years as a result of prior budget actions taken in 2008-2009 that impacted both 2008-2009 and 2009-2010. Also included in this category is the continuation of allocations for Arena repairs, unanticipated maintenance of City facilities, and fuel tanks and methane monitoring control and replacement.

As was the case in previous forecasts, continued capital funding for the Replacement of Fire Apparatus is carried in this Forecast. In 2009-2010, the level of funding is \$1.8 million and increases to \$3.2 million in 2012-2013 to fund the current Fire Vehicle Replacement Policy. This is consistent with the previous forecast.

The City-Wide Expenses program in the first year of the Forecast (2009-2010) represents a net reduction of \$45.4 million from the 2008-2009 level. This large reduction reflects the combined impact of deleting rebudgets (\$41.3 million) and other one-time items (\$16.9 million). This category also includes funding for debt service payments for several City facilities. The payments for the Convention Center and Airport West Property, which are reimbursed partially by Airport funds and Redevelopment Agency, have been adjusted by a net reduction of \$3.0 million to reflect the latest payment schedules. Workers' Compensation Claims payments in this forecast range from \$15.7 million in 2009-2010 to \$19.7 million in 2013-2014, which is an

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Other Expenditures (Cont'd.)

increase of \$2.1 million from the last forecast reflecting an increase in projections for growth in increased medical costs. Sick Leave Payments Upon Retirement expenditures have been included in this forecast at \$9.3 million for 2009-2010.

The **Earmarked Reserves** category includes a reserve for the Comprehensive General Plan Update (\$200,000) and for Retiree Healthcare Benefits (\$1.8 million, \$300,000 of which is offset by contributions from other funds). The General Plan Update Reserve is entirely offset by revenues collected from a surcharge on development permits. The Retiree Healthcare Reserve is an ongoing initial investment that was established in the 2008-2009 Adopted Operating Budget to begin to address the long-term liability associated with retiree healthcare. Two recent Governmental Accounting Standards Board accounting statements require changes in accounting and external reporting for post-employment benefits. Actuarial studies have been completed on the City's two retirement plans, Federated and Police and Fire, to calculate the liability under these new accounting standards. Based on the most recent analysis, the total liability is estimated at \$18.2 million annually for the City's General Fund share of the costs associated with retiree healthcare benefits. This liability figure will be updated as part of new studies to be completed in early 2009-2010. As discussed under the Personal Services category, this Forecast includes funding to fully address the projected General Fund liability by 2013-2014 in this Earmarked Reserve (\$1.5 million) as well as the Personal Services and Committed Additions sections (\$16.7 million).

The Forecast does not include a number of Earmarked Reserves that may remain unspent in 2008-2009, and be rebudgeted to 2009-2010. Some of the larger current Earmarked Reserves include the Development Fee Program Reserves, Workers' Compensation/General Liability Catastrophic Reserve, Enhanced Parks Maintenance Reserve, Salary and Benefits Reserve, Future Capital Projects (FF&E) Reserve, Neighborhood Investment Fund Reserve, and Economic Uncertainty Reserve.

As in previous years, the **Equipment** category includes a general equipment reserve of \$100,000 for subsequent allocation in the 2009-2010 Proposed Budget. Similarly, \$250,000 is assumed annually for computer equipment and automation projects also for subsequent allocation during the Proposed Budget process.

The Transfers category includes funding for Communications Center debt service as required under the terms of financing used for construction of this facility (final payment of \$2.4 million in 2009-2010); funding to cover a portion of the debt service payments for the Hayes Mansion Conference Center (\$4.1 million per year) and Rancho del Pueblo and Los Lagos Golf Courses (\$1.3 million per year); and payments in accordance with the San José Arena Management (\$1.5 million per year in years one through three) for Arena repairs and capital enhancements. All of the debt service and maintenance and operations costs for the Hayes Mansion Conference Center and golf courses are funded in the Community Facilities Revenue and Municipal Golf Course Funds, however, revenues in those funds are not projected to be sufficient to completely cover these costs. These transfers have been increased in this Forecast by \$200,000 and \$300,000,

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

Other Expenditures (Cont'd.)

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

A **Vehicle Replacement/General Fleet** allocation (\$2.1 million in 2009-2010) is included to fund a vehicle replacement schedule for the General Fleet (\$1.6 million) and for the retrofit of diesel powered vehicles. State regulations necessitate the City to replace the City's diesel-powered vehicles throughout the forecast period, in order to comply with new regulations to reduce the use of fossil fuels and the release of harmful emissions. In this Forecast, costs range from \$482,000 in 2009-2010 to \$177,000 in 2012-2013.

In 2009-2010, **Vehicle Replacement/Police Fleet** funding is carried in the Non-Personal/Equipment category (\$3.9 million). Due to the large variation in funding levels necessary to fund the replacement of Police vehicles over the five-year period, the incremental costs necessary to ensure that replacement schedules for the marked, covert, and unmarked Police fleet are met are shown as a separate line item. In this Forecast, they range from an increased need resulting in additional costs of \$724,000 in 2011-2012 to a reduced need resulting in savings of \$2,175,000 in 2013-2014.

Contingency Reserve

Per City Council policy, the 2009-2010 Contingency Reserve is projected at the level necessary to comply with the City Council policy to maintain a 3% Contingency Reserve (\$28.7 million). Amounts necessary to remain in compliance with that policy are also included in each of the remaining four years of the Forecast.

Committed Additions to the Base General Fund Forecast

In this Forecast, projected additions to the base expenditure level have been included as **Committed Additions**. The **Committed Additions** are additional expenditures to which the City is considered to be committed by prior City Council action, such as the costs related to maintaining and operating capital projects previously approved by the City Council. The Forecast Base Case, considered most closely by the City Council, includes ongoing program costs plus committed additions.

The following committed additions, totaling \$5.0 million, are included in the 2010-2014 Forecast and explained in more detail in a later section of this document.

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

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

County Pocket Annexations costs (\$298,000 in 2009-2010) that would be required by the Department of Transportation have been included to maintain the approximately 40 miles of public streets and related infrastructure that will be annexed into the City from Unincorporated areas within the City of San José's Urban Service Area.

New Parks and Recreation Facilities Maintenance and Operations costs (\$130,000 in 2009-2010) are included at the levels necessary to support the additional costs of maintaining and operating new or expanded park facilities that were included in the City's latest Five-Year Capital Improvement Program and those that are being developed by other agencies. Examples of projects include Kirk Community Center Improvements in 2009-2010 and Edenvale Community Center in 2010-2011.

Increased costs from scheduled **New Traffic Infrastructure Assets Maintenance and Operations** (\$204,000 in 2009-2010) are included as a committed addition.

The approved bond measures from the elections of November 2000 and March 2002 will result in new and expanded library (**Measure O**), park (**Measure P**), and police and fire (**Measure O**) facilities and will require significant additional **Maintenance and Operations** funding (\$2,420,000 in 2009-2010). Some of the new facilities scheduled to open during this forecast period include: the South San José Police Substation, Fire Station 37 (Silver Creek/Yerba Buena Road), East San José Carnegie Branch, Santa Teresa Branch Library, Seven Trees Community Center and Library, Happy Hollow Park and Zoo, and Bascom Library and Community Center.

The hiring of **Additional Police Officers**, as directed by the City Council as part of the approval of the 2008-2009 Mayor's June Budget Message has been included in the forecast. The addition of 25 Police Officers annually through 2011-2012 is now included in this category. The cost of these positions is projected at \$1.8 million in 2009-2010 and expected to increase to \$10.8 million by 2013-2014.

A new item, **Retiree Healthcare Benefits**, has been included in the Forecast to reflect the five-year phase-in of the City's share of the General Fund annual required contribution for retiree healthcare benefits for non-POA employees. These costs increase from \$0.2 million in 2009-2010 to \$6.8 million in 2013-2014. As described previously, additional allocations for retiree healthcare benefits are displayed elsewhere in this document and include (1) Earmarked Reserves of \$1.8 million (\$1.5 million in the General Fund and \$300,000 in special funds) as those funds were added in 2008-2009 on an ongoing basis to begin to address the long-term liability of retiree healthcare benefits and (2) Personal Services funding increasing from \$2.4 million in 2009-2010 to \$9.9 million in 2013-2014 to cover the projected liability for POA employees, consistent with the recently negotiated funding agreement for this liability with the POA. In total, retiree healthcare benefits funding is increased to \$18.2 million annually by 2013-2014 to fully fund this liability.

ELEMENTS OF THE GENERAL FUND FORECAST

EXPENDITURE FORECAST (CONT'D.)

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

Budget Principle #8 states that Capital Improvement Projects shall not proceed for projects with annual operating and maintenance costs exceeding \$100,000 without City Council certification that funding will be made available in the applicable year of the cost impact. Consistent with that direction, this Forecast includes a detailed list and discussion of capital projects that are underway or were previously approved by the City Council with annual operating and maintenance costs in the General Fund greater than \$100,000. Funding for these projects have been included as part of approved Capital Improvement Programs or Redevelopment Agency Budgets. The majority of these costs are associated with the voter-approved General Obligation bonds for Park, Library, and Public Safety facilities. The operating and maintenance costs for these facilities are included in the figures presented in this Preliminary General Fund Forecast. In addition, four potential projects where funding has not yet been approved through the City Capital Improvement Program or Redevelopment Agency Capital Budget are identified. These projects are under very preliminary development and if approved, are anticipated to have an annualized operating and maintenance impact of at least \$2.3 million by 2013-2014. Consistent with the direction approved as part of Budget Principle #8, for purposes of this Forecast, these operating and maintenance costs are not included as part of the General Fund Five-Year Forecast "Committed Additions" category. Certification for these projects and other identified projects that have not been approved by the City Council will be sought as part of the 2010-2014 Proposed Capital Improvement Program. If certified by the City Council, the operating and maintenance costs associated with these facilities would then be included in subsequent General Fund Five-Year Forecast documents.

ELEMENTS OF THE GENERAL FUND FORECAST

OPERATING MARGIN

The Base Case with Committed Additions General Fund Forecast projects a shortfall in the first year (2009-2010) of \$61.2 million. This is higher than both the November 2008 Preliminary Forecast shortfall estimate of \$59.1 million and the February 2008 Forecast shortfall of \$42.5 million for 2009-2010.

Base Case expenditures, including committed additions, increase from \$886.1 million in 2009-2010 to \$1.0 billion in 2013-2014, for an average growth rate each year of approximately 3.4%. This rate of expenditure growth outpaces the average increase in General Fund sources (including Beginning Fund Balance) of 2.9%. The sources of revenue total \$824.9 million in 2009-2010, and grow to \$921.1 million in 2013-2014.

The following table shows how the projected shortfall has changed in the most recent forecasts. The incremental shortfall assumes each preceding deficit is solved completely with ongoing solutions in the year it appears. Each of the four out years of the Forecast is shown in the table, along with a comparison with the increments projected for those years in the February 2008 Forecast and the preliminary 2009-2010 update provided to the City Council in November 2008.

2010-2014 General Fund Forecast Changes in Operating Margin (\$ in Millions)					
	<u>2009-2010</u>	<u>2010-2011</u>	<u>2011-2012</u>	<u>2012-2013</u>	<u>2013-2014</u>
February 2008 Incremental Surplus/(Shortfall)	(\$42.52)	(\$5.49)	(\$4.73)	\$2.50	N/A
2008-2009 Adopted Budget Impact Incremental Surplus/(Shortfall)	(\$4.08)				
Revised Forecast	(\$46.60)	(\$5.49)	(\$4.73)	\$2.50	N/A
November 2008 Incremental Surplus/(Shortfall)	(\$59.14)	(\$26.95)	(\$0.11)	\$3.60	\$5.79
February 2009 Incremental Surplus/(Shortfall)	(\$61.19)	(\$36.74)	(\$4.92)	\$6.49	\$10.11
<i>One-time Funding Available</i>	\$6.30	N/A	N/A	N/A	N/A

In the February 2008 Forecast, an incremental shortfall of \$42.52 million for 2009-2010 was projected. This figure was based on the assumption that the entire 2008-2009 shortfall would be solved with ongoing actions. However, the 2008-2009 Adopted Budget included a combination

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of ongoing and one-time solutions. The carryover impact of those one-time measures is reflected in the 2008-2009 Adopted Budget Impact incremental shortfall of \$4.08 million and, when combined with the previous shortfall anticipated for 2009-2010, would result in a deficit of approximately \$46.6 million in 2009-2010.

In November 2008, staff prepared a Preliminary Five-Year General Fund Forecast incorporating the final 2007-2008 actual performance and the first few months of activity in 2008-2009. In that Preliminary Forecast, the General Fund deficit for 2009-2010 was increased to \$59.1 million. This increase in the projected deficit was the net result of a number of upward and downward adjustments to the City's many General Fund revenue and expenditure categories. The most significant changes included: downward adjustments to the economically sensitive revenue estimates; the addition of costs associated with the phase-in of the City's share of the General Fund annual required contribution for retiree health care benefits and 25 new Police Officer positions per City Council direction; the addition of \$20 million in revenue as a result of the passage of the November 2008 ballot measures; and slightly lower than anticipated cost-of-living adjustments.

For the February 2009 Forecast, staff completed an in-depth review of anticipated revenues and expenditures for 2009-2010 and the remaining four years of the forecast period. Based on this updated information, a 2009-2010 General Fund shortfall of \$61.2 million is projected, a net increase of \$2.1 million from the November 2008 figure. This relatively small increase was the result of net downward expenditure adjustments of \$15.4 million that are more than offset by a net revenue reduction of \$17.5 million.

The projected drop in expenditures for 2009-2010 was primarily the result of lower debt service costs for City Hall and the Airport West properties, lower assumed costs to address the City's General Fund liability for retiree healthcare benefits; lower costs assumed for the development fee program to align with projected revenues; and lower utility and fuel costs. Other expenditure adjustments were based on a more in-depth review of base costs.

The downward adjustment of \$17.5 million to the General Fund revenue estimates primarily reflects the projected impact of the rapidly deteriorating economy on the City's revenues. The majority of the decline was the result of adjustments to the economically sensitive revenue categories, including Sales Tax, Property tax, Business Tax, Transient Occupancy Tax, and Use of Money and Property (interest earnings). The revenue estimates for the development-related fee programs are also significantly lower than the November 2008 figures based on actual performance through the first half of 2008-2009.

The second year of the Forecast (2010-2011) also has a sizeable General Fund deficit of \$36.7 million. While economic performance is expected to recover somewhat by 2010-2011, revenue growth is still projected to be very low in that year (1.13%). This is due, in part, to the small decline in Property Tax revenues projected for that year. Because Property Tax receipts in each fiscal year are based on activity in the prior calendar year, there is somewhat of a lag in realizing the gains and losses due to economic performance. The large declines in real estate prices

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OPERATING MARGIN (CONT'D.)

expected in 2009 will impact Property Tax receipts in 2010-2011. Projected expenditure growth in 2010-2011 of 5.2% significantly outpaces the minimal revenue growth. This overall expenditure growth is driven by personal services increases projected at 4.3% due, in part, to the continued phase-in of retiree healthcare costs and by changes in Committed Additions.

The variances in the three out years are minimal, ranging from a slight deficit of \$4.9 million in 2011-2012 to a surplus of \$10.1 million in the last year of the Forecast. It is important to note again, however, that no cost-of-living adjustments (COLAs) for any of the City's employees have been assumed in the last three years. There are currently no negotiated agreements that cover this time period. This is a methodology change that was first incorporated into the November 2008 Preliminary General Fund Forecast. With this change, the consideration of salary increases is being treated as a resource allocation policy decision. This decision will need to be made in the context of what is affordable in light of the many service delivery priorities. At current rates, each 1% increase in salary has a General Fund price tag of approximately \$5.5 million.