CITY OF NEWPORT BEACH
FINANCE COMMITTEE
STAFF REPORT

Agenda Item No. 6C
January 23, 2025

TO: HONORABLE CHAIR AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
Jason Al-Imam, Finance Director/Treasurer
949-644-3123, jalimam@newportbeachca.gov

SUBJECT: GENERAL FUND AND TIDELANDS FUND LONG RANGE FINANCIAL FORECAST UPDATE

EXECUTIVE SUMMARY

The City is projected to remain financially sound over the next 20 years, with a strong revenue base and healthy reserves. The forecast anticipates a surplus (revenues exceeding expenditures) each year during this period. Any short-term deficits resulting from economic downturns or unforeseen events are expected to be absorbed without long-term reliance on the Contingency Reserve, and no structural deficit is apparent.

DISCUSSION

Strategic planning begins by determining the City's fiscal capacity, based on long-term financial forecasts of recurring revenues and future financial obligations. Before adopting the annual budget, staff prepares a Long-Range Financial Forecast (LRFF) each year for the General Fund to evaluate internal and external factors affecting the City's financial condition. This year, staff also prepared an LRFF for the Tide and Submerged Land Operating Fund, known as the Tidelands Fund. The LRFF aims to help the City achieve and maintain financial sustainability, provide long-term guidance for financial decisions, and ensure sufficient resources to deliver programs and services to the community.

Methodology

The Finance Department follows a three-step process when preparing the LRFF. First, a baseline growth scenario for various revenue and expenditure categories is established by analyzing historical compound annual growth rates (CAGR), historical average growth rates, and other future growth assumptions based on the latest data from consultants and other sources. Allowances are made for lower near-term growth rates, reflecting current data and anticipated changes in consumer activity for revenue sources such as sales tax and transient occupancy tax.

Next, line items that deviate from typical escalation patterns are adjusted according to their unique schedules, based on either dollar or percentage growth. These items include discretionary pension payments on a fixed annual contribution schedule, interest income, known and expected ground lease revenue from various properties, and transfers to support master financing plans, including the Facilities Financing Plan, Harbor and Beaches Master Plan, and Facilities Master Plan. Emerging commitments on the horizon are also considered.

Finally, the model is designed to be flexible, allowing for alternate baseline scenarios or fiscal impact analyses as needed.

Major Assumptions
Major assumptions used in the model include the following:

The Fiscal Year 2024-25 adopted budget, excluding one-time items, was used as the base budget from which forward growth assumptions were developed. To refine the projections for the near-term years, the methodology for establishing the base for growth assumptions related to certain revenues and expenditures was updated. These updates incorporate the Fiscal Year 2024-25 revised budget and the latest available actual receipts and data. Additional information is summarized below.

Annual General Fund transfers-out in support of:

- FFP – $15.3 million to $23.9 million annually, representing 3% of general fund revenues as outlined in Council Policy F-28, and includes an additional $6 million for future capital projects.
- CIP – $6.5 million annually
- Facilities Maintenance – $2.5 million annually
- Tidelands Harbor Capital – $6.0 million, indexed at 2.5% annually, through Fiscal Year 2032-33, and reduced to $4.5 million thereafter
- Parks Maintenance Fund - $2.3 million annually

Despite realizing year-end surpluses exceeding $10 million over the past several years, staff did not program future surpluses in the projections. Surpluses appearing in the forecast represent the net operating result of annual revenues minus forecasted expenditures. The forecast does not assume expenditure savings or revenues exceeding budgeted amounts, which are typically realized each year. Consequently, the forecast is prepared by projecting revenues conservatively and expenditures liberally.

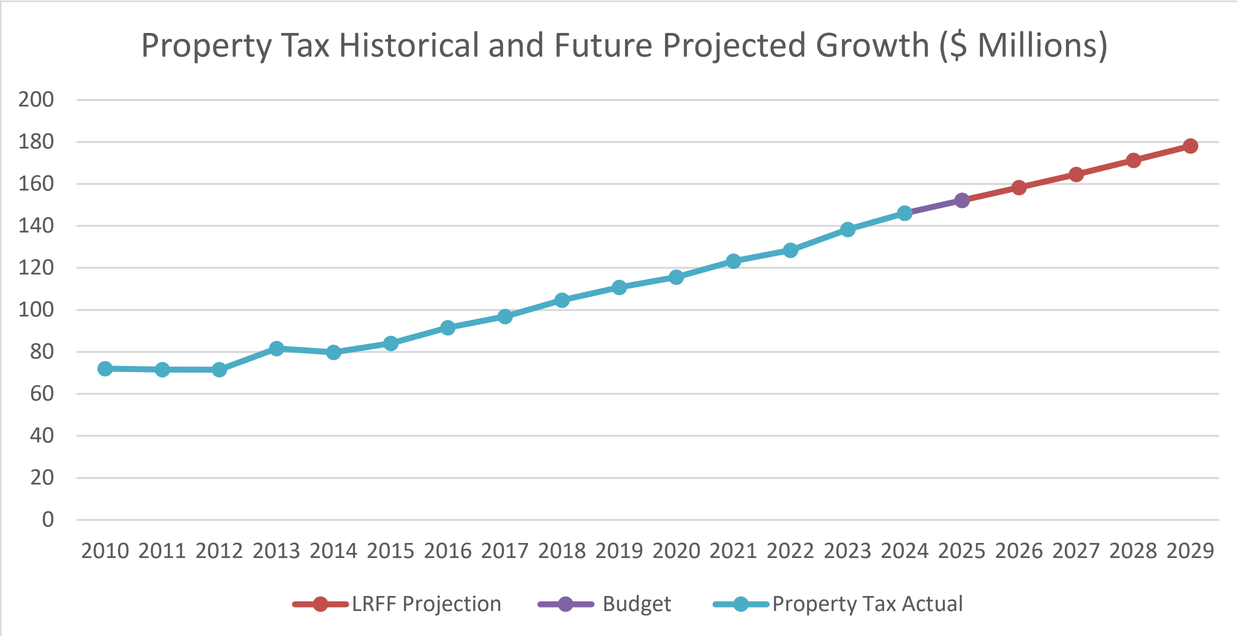
Revenue Assumptions
The methodology used for calculating revenue changes from Fiscal Year 2025-26 to Fiscal Year 2045-46 is initially based on historical revenue trends using CAGR or the annual average growth for each revenue category, depending on which seems most applicable for the particular revenue growth category based on how it may change going forward. This methodology is adjusted based on staff's knowledge of known one-time

past events and other extraneous factors. Thereafter, an outlook is developed that factors in the cyclical nature of the economic cycle, which tends to fluctuate from periods of economic expansion followed by economic contraction. As a result, this approach provides for dynamic forecasting as opposed to linear or static growth assumptions, which mitigates the compounding effect that can tend to distort revenue growth over time.

The General Fund’s top three revenue sources (property tax, sales tax, and transient occupancy tax) account for approximately 72% of total General Fund revenues. Consequently, the future growth assumptions for these primary revenue sources can have a considerable impact on the twenty-year forecast. The forecast for these three revenue sources is based on the most recently available economic data in addition to the updated projections reflected in the Fiscal Year 2024-25 revised budget.

Property Taxes
These revenues are primarily dependent on the assessed valuation established in January of each year. Newport Beach’s assessed property values increased 5.5% in Fiscal Year 2024-25 largely due to changes in ownership and new construction. In Fiscal Year 2025-26, assessed property values are projected to increase 4.4% based on an increase in assessed values from home sales from January 2024 through September 2024. This growth is partly due to the two-percent inflation adjustment provided under Proposition 13. In addition, assessed values are projected to increase in Fiscal Year 2025-26 due to changes in ownership and new construction, although at a slower pace as home sales have slowed due to higher interest rates.

In outer years of the forecast, staff continues to expect consistent and vigorous demand for Newport Beach property. Changes to these revenues that may result from a dampened housing economy are less dramatic and less abrupt than with other revenues due to a tax collection lag and the high value of assessed properties in Newport Beach. The lag is due to the lengthy time it takes (ranging from 12-18 months) to assess property values, process appeals and other adjustments, prepare the property tax rolls and submit them to the County Tax Collector. While property tax growth rates fell sharply during the Great Recession, the City has experienced positive local assessed value growth during each of the past 20 years. Even while growth may have slowed, the assessed value in Newport Beach never declined throughout the Great Recession. This demand has allowed the City to enjoy long-term growth trends from its largest source of revenue. The average annual historical growth rate for this revenue category is 5.6% over the past 20 years. Beyond Fiscal Year 2025-26, staff conservatively forecast 3-4% annual growth for property taxes as a whole, which includes supplemental taxes and property transfer tax revenue.

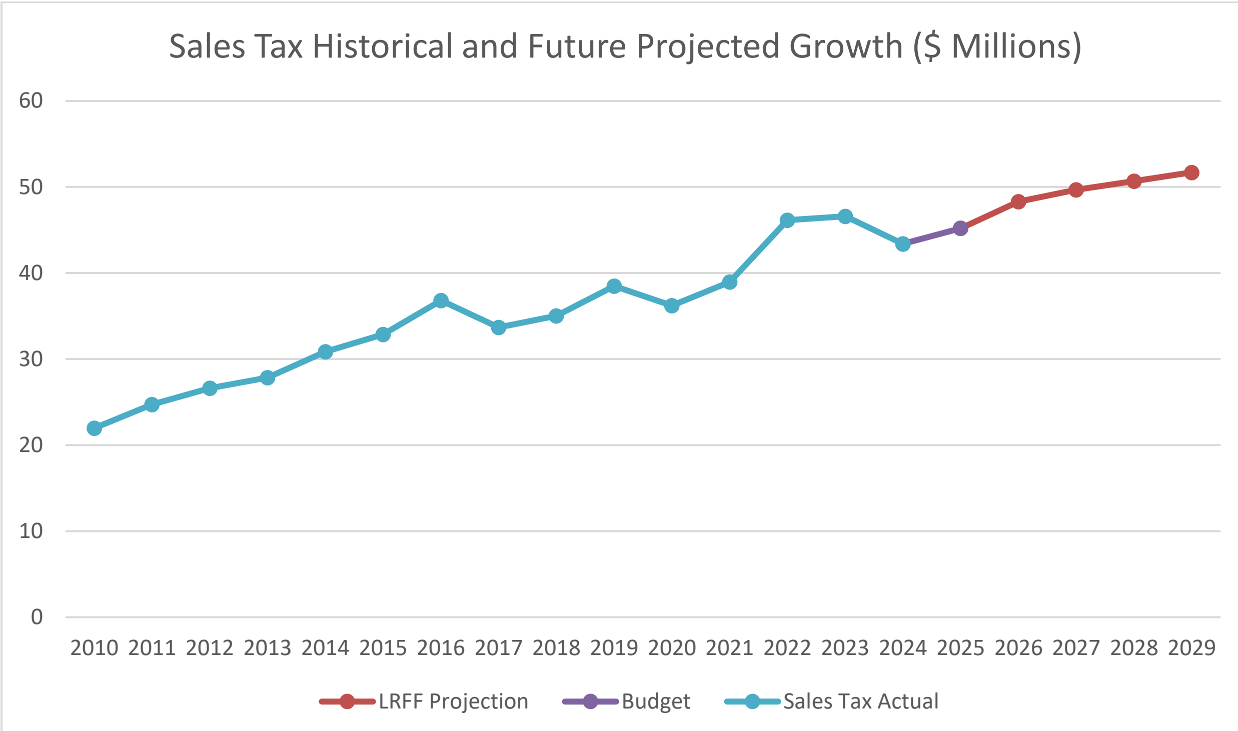


<u>Sales Tax</u>

The second largest funding source for the General Fund is sales tax revenue, which is largely generated from three main industry categories including autos and transportation, general consumer goods, and restaurants/hotels.

Sales tax revenue was down 6.7% for Fiscal Year 2023-24 and is projected to increase 4.1% in Fiscal Year 2024-25 due to anticipated growth in the autos and transportation and the state and county pools.

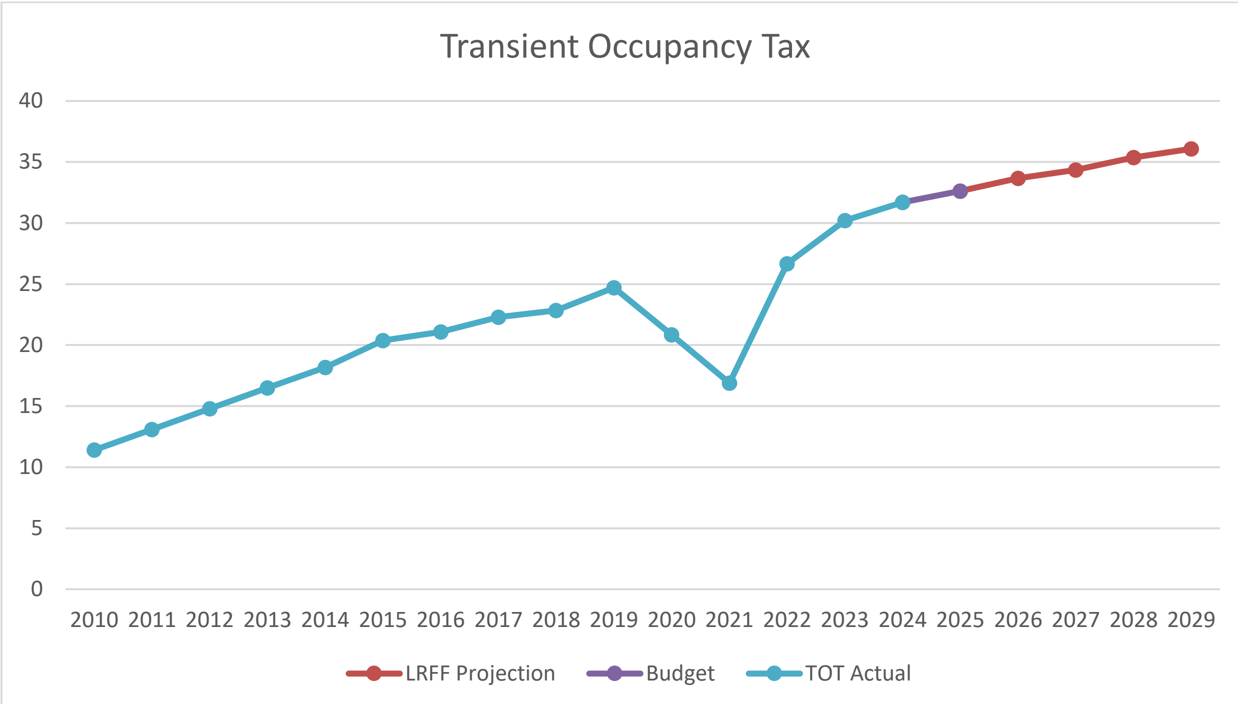
Looking ahead, sustained sales tax growth is anticipated throughout the forecast, with Fiscal Year 2025-26 anticipated to increase by 6.9%, or approximately $3 million, compared to the Fiscal Year 2024-25 projection. Beyond Fiscal Year 2025-26, staff conservatively forecast annual growth of 2.6% on average each year for sales tax.



<u>Transient Occupancy Tax (TOT)</u>

The third largest funding source for the General Fund is TOT which makes up more than 10% of revenues. TOT revenue is derived from commercial and residential property. Commercial TOT revenue is derived from 21 hotels and resorts and accounts for approximately 74% of TOT revenues. Residential TOT revenue is derived from approximately 1,550 vacation rentals representing 26% of TOT revenue. TOT revenue from short-term residential stays has nearly doubled since 2019-20, whereas hotel TOT revenue increased 46% over the same period. While commercial occupancy levels have not returned to pre-pandemic levels, they are increasing and are largely offset by higher room rates.

The budget for Fiscal Year 2024-25 assumed a 2% growth rate over the prior year. For Fiscal Year 2025-26, staff projects receipts of $33.7 million, representing a 3.2% increase over the prior year. Generally consistent with historical trends, staff projects 2.9% average annual growth thereafter.



Other revenues (service fees and charges, fines and penalties, property income, transfers in, and other miscellaneous revenues) which make up 28% of the City's total revenues are projected to grow modestly at 3% on average over the next 20 years. This assumption is based on the average growth from the preceding 20 years. Service fees and charges are projected to grow by an average of 2% annually each year and Property Income, which includes leases and parking revenue, is projected to grow by an average of 4% annually over the next 20 years. Transfers in, which represents the Tidelands payment to the General Fund for the Cost Allocation Plan is estimated to grow at 3% annually.

Expenditure Assumptions

Regular salaries for both miscellaneous and public safety are reflective of the approved adjustments through the end of the current MOU agreements. Thereafter, regular salaries are assumed to grow at 2% annually. The forecast assumes no growth in personnel headcount. Special and other pays (e.g., certification pay, bilingual pay, motor officer pay, scholastic achievement, etc.) is projected to grow at 2% annually. The benefits category, which consists of life insurance, Medicare, retiree health plan contributions, and the City's pension contributions to CalPERS, among other miscellaneous benefits, is projected to grow at 2% annually. However, based on the following assumptions and certain items in this category forecasted at alternate growth rates, the projected average year-over-year change is 0%. This category includes the 1.5% reduction in the employee's share of pension contributions to CalPERS through December 2025 for applicable bargaining units.

The forecast assumes a baseline allocation of $40 million in annual funding for the pension liability, with $38 million coming from the General Fund. In Fiscal Year 2032-33, the pension liability is projected to be eliminated, assuming CalPERS continues to achieve an average investment return of 6.8% and there are no significant changes in future CalPERS experience studies or the discount rate. The baseline allocation of $40 million annually exceeds the required payment to CalPERS by approximately $10 million. An additional $5 million is also expected to be allocated each year from the year-end surplus, bringing the total annual payment for the pension liability to $45 million. This approach aligns with the pension paydown strategy discussed with the Finance Committee in November 2024. It also assumes that the City Council will continue to authorize additional contributions during this period, consistent with recent Council actions and Finance Committee recommendations.

General Fund Expenditure Forecast FY2025-26– FY2029-30

	FY 2025-26	FY 2026-27	FY 2027-28	FY 2028-29	FY 2029-30
Regular Salaries	$ 95,146,664	$ 97,049,597	$ 98,990,589	$ 100,970,401	$ 102,989,809
Growth Rate	2.0%	2.0%	2.0%	2.0%	2.0%
Special and Other Pays	$ 16,777,018	$ 17,112,558	$ 17,454,809	$ 17,803,905	$ 18,159,983
Growth Rate	1.8%	2.0%	2.0%	2.0%	2.0%
Benefits [1]	$ 71,678,450	$ 73,017,135	$ 74,422,950	$ 75,899,659	$ 77,451,245
Growth Rate	-6.2%	1.9%	1.9%	2.0%	2.0%
Non-Personnel Costs	$ 90,524,454	$ 95,013,548	$ 99,923,832	$ 105,102,412	$ 110,564,164
Growth Rate	3.0%	5.0%	5.2%	5.2%	5.2%
Transfers Out [2]	$ 48,176,029	$ 49,338,503	$ 50,321,883	$ 50,183,624	$ 51,011,794
Growth Rate	22.7%	2.4%	2.0%	-0.3%	1.7%
Total General Fund Expenditures	**$ 322,302,615**	**$ 331,531,341**	**$ 341,114,063**	**$ 349,960,002**	**$ 360,176,995**
Growth Rate	2.9%	2.9%	2.9%	2.6%	2.9%

Non-personnel costs include contract services, utilities, supplies and materials, and maintenance and repair. These expenditures are projected to grow an average of 5.2% annually. While some of these costs may increase by the consumer price index (CPI), many of the City’s contracts have capped the rate by which certain services or goods may increase by CPI. Thus, although CPI has remained high, that percentage was not broadly projected for contract services or supplies and materials. In Fiscal Year 2023-24, the City’s unfunded OPEB liability was paid down, which reduces general fund expenditures by approximately $4 million annually beginning in Fiscal Year 2024-25.

Transfers out includes transfers from the General Fund to various other funds for future capital improvement projects, as well as a transfer to support the Tidelands Fund operations.

Tidelands Fund Forecasting

Each year, the Tidelands Fund transfers approximately $20 million to the General Fund to cover costs associated with activities in the Tidelands areas supported by General Fund services. Allocated direct services impacting the Tidelands Fund include public safety services, such as Police Department patrols, traffic operations, Fire Department operations, emergency medical services, and marine safety. They also include public facilities services, such as Public Works Department maintenance of public spaces and Finance Department management of parking.

Revenue in the Tidelands Fund is insufficient to fully cover the costs of Tidelands operations. As a result, the General Fund must subsidize these operations, with the subsidy estimated at $12.3 million for Fiscal Year 2024-25. Consequently, the performance of the General Fund and the long-range financial plan must account for projections related to the Tidelands Fund's revenues, expenditures, and the related subsidy from the General Fund.

In response to a recent internal audit recommendation presented to the Finance Committee in November 2024, staff developed a long-range financial forecast (LRFF) for the Tidelands Fund. The Tidelands LRFF uses the same methodology as the General Fund LRFF. The Fiscal Year 2024-25 adopted budget, excluding one-time items, was used as a base from which forward growth assumptions were developed.

Tidelands Revenue Assumptions

The Tidelands Fund's revenue sources are related to the operation of the City's tidelands, including but not limited to rents from moorings, piers, and leases, as well as income from parking lots, meters, and the sale of oil. The Tidelands Fund's top three revenue sources—property income, parking revenue, and a transfer subsidy from the General Fund—account for approximately 99% of total Tidelands revenue. Consequently, the growth assumptions for these primary revenue sources significantly impact the twenty-year forecast. The forecast for these three revenue sources is based on the most recent economic data and updated projections reflected in the Fiscal Year 2024-25 revised budget.

<u>Property Income</u>

Property income is the primary revenue source for the Tidelands Fund. For Fiscal Year 2024-25, Tide and Submerged Land Operating income is projected to generate $8.4 million from leases and an additional $1.3 million from oil sales. Looking ahead to Fiscal Year 2025-26, property income revenues are expected to grow by 4%, or $386,764.

<u>Parking Revenue</u>

Parking revenue is made up of $2.6 million from the Balboa Parking Lot, $1.4 million from the Ocean Front Lot, and $847,758 from a combination of smaller lots. In Fiscal Year 2025-26, parking revenues are projected to increase by 4%, or $187,740.

General Fund Subsidy

Historically, the Tidelands Fund has not generated sufficient revenue to cover the full cost of operations, largely due to public safety expenses such as lifeguarding, EMS response, and police services at ocean beaches. This remains true in Fiscal Year 2024-25. To address the ongoing gap between revenues and expenditures, the City's General Fund subsidizes the operations of the Tidelands Fund annually. Since Tidelands revenues and expenditures fluctuate year to year, the General Fund subsidy also varies. For Fiscal Year 2024-25, the General Fund transferred $12.3 million to subsidize the Tidelands Fund.

Tidelands Expenditure Assumptions

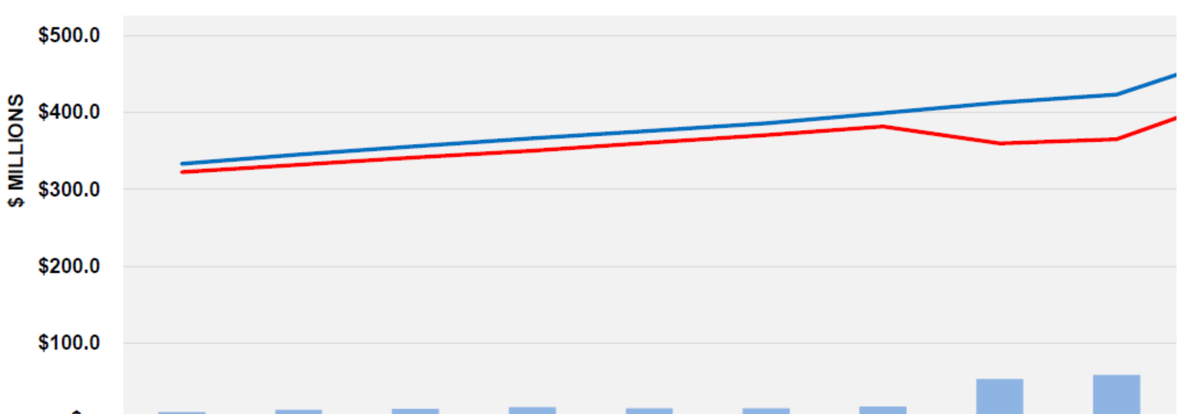
Regular salaries are reflective of the approved adjustments through the end of the current MOU agreements. Thereafter, regular salaries are assumed to grow at 2% annually. The forecast assumes no growth in personnel headcount. Non-personnel costs include contract services, utilities, supplies and materials, and maintenance and repair. These expenditures are projected to grow an average of 4.5% annually.

The largest expense in the Tidelands Fund is the transfer out to the General Fund to cover the allocated costs, which are the Citywide expenditures that support the management and operation of the Tidelands that are accounted for in the General Fund. Assumptions for these costs are based on the current Cost Allocation Plan and are escalated each year by 3%.

CONCLUSION

The City is in a strong financial position. The General Fund LRFF projects a surplus balance (revenues net of expenditures) of approximately $10.6 million in Fiscal Year 2025-26. Surpluses are also projected for the remaining years of the model.

General Fund Revenues, Expenditures & Net Operating Results
FY 2025-26– FY 2033-34



	FY 26	FY 27	FY 28	FY 29	FY 30	FY 31	FY 32	FY 33	FY 34
NET OPERATING RESULT	$10.6	$13.5	$14.7	$16.5	$15.6	$15.3	$17.3	$53.3	$58.4
TOTAL REVENUES	$332.9	$345.0	$355.8	$366.5	$375.8	$385.7	$398.9	$412.8	$423.2
TOTAL EXPENDITURES	$322.3	$331.5	$341.1	$350.0	$360.2	$370.4	$381.6	$359.5	$364.7

The City currently has a contingency reserve of $66.0 million, which represents 25% of operating expenditures. This reserve serves as a means of responding to unexpected deviations in operating trends over the 20-year term of the forecast. Historically, the City has not utilized its contingency reserve to balance its annual budgets and only did so recently to cover a revenue shortfall during the COVID-19 pandemic. The draw of less than $3 million from the contingency reserve during Fiscal Year 2020-21 was quickly reversed with the first quarter budget update that year.

However, the City is not without its fiscal challenges. Although revenues have improved considerably since the Great Recession, future recessions or shifts in consumer behavior—such as changes in consumer spending and the outlook for travel and leisure—may alter the course of revenues, and new patterns could emerge that differ from past trends.

The City routinely faces financially impactful events, such as significant increases in CalPERS pension costs due to underperforming investment returns, unfunded state mandates, and the need to ramp up savings to meet substantial near-term facilities maintenance and replacement obligations in accordance with our long-term infrastructure financing plans. Fortunately, the City's revenue base provides the ability to make strategic decisions each year, deploying the necessary resources toward the most critical needs of our citizens.

In summary, the General Fund is projected to remain in a financially sound position over the next 20 years. Any short-term deficits that may arise can be absorbed without long-term reliance on the Contingency Reserve—no structural deficit is apparent.

Submitted by:

/s/ Shelby Burguan

Attachments:

A. 20-Year Long-Range Financial Forecast for the General Fund
B. 20-Year Long-Range Financial Forecast for the Tidelands Fund