CITY OF NEWPORT BEACH
FINANCE COMMITTEE
STAFF REPORT

Agenda Item No. 5D
January 13, 2022

TO: HONORABLE CHAIR AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
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SUBJECT: LONG RANGE FINANCIAL FORECAST (LRFF) UPDATE

EXECUTIVE SUMMARY

The City is projected to be in a financially sound position over the next 20-year period and is in excellent financial position relative to most other local agencies with a revenue base and reserves unparalleled by any similar size City in the County. The forecast projects a surplus balance (revenues net of expenditures) in each year over the next 20 years. Any short term deficits that may arise as a result of an economic downturn or other unforeseen event likely will be absorbed without long-term reliance on the Contingency Reserve – no structural deficit is apparent.

DISCUSSION

Strategic planning begins with determining the City's fiscal capacity based upon long-term financial forecasts of recurring available revenues and future financial obligations. Prior to the adoption of the annual budget, the Finance Department annually prepares a General Fund Long-Range Financial Forecast (LRFF) that evaluates known internal and external issues impacting the City's financial condition. The LRFF is intended to help the City attain and maintain financial sustainability; sufficient long-term information to guide financial decisions; and sufficient resources to provide programs and services for the community.

Methodology

The Finance Department utilizes a three-step step process when preparing the LRFF. First, a baseline growth scenario for the various revenue and expenditure categories is established by analyzing historical compound annual growth rates (CAGR), historical average growth rates and/or other assumptions of future growth based on the latest information from consultants and other sources. Some allowance is made in assuming higher near-term growth rates for our rapidly recovering post-COVID 19 revenue sources such as sales tax and transient occupancy tax. Next, line items that may vary from the typical escalation patterns are segregated and are increased by their unique defined schedule (dollar or percentage growth basis). These items include such items as additional discretionary pension payments which are on a fixed annual contribution schedule, interest income, known and expected ground lease revenue from various properties, transfers out to support the various master financing plans (Facilities Financing Plan, Harbor and Beaches Master Plan, Facilities Master Plan), and any emerging commitments the City has on the horizon. Finally, the model is designed to be flexible enough to model one or more alternate baseline scenarios or fiscal impacts should there be a need.

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

The Fiscal Year 2021-22 adopted budget, stripped of one-time items, was used as a base budget from which forward growth assumptions were launched.

Annual General Fund transfers-out in support of:

- FFP – $8.5m up to $12.5m in out years annually
- CIP – $5.0m annually
- Facilities Maintenance – $1.5m annually
- Tidelands Harbor Capital – $4.5m annually
- Contingency Reserve funding annually (25% of expenditures, less discretionary pension funding)

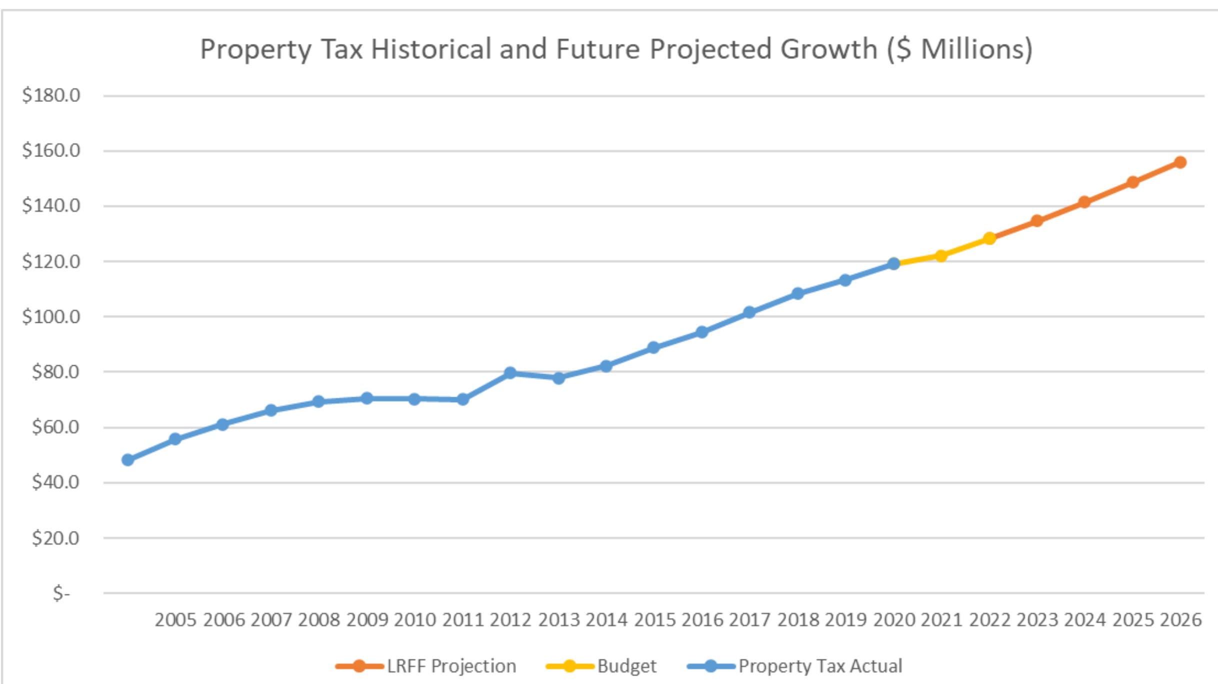
In spite of having realized year-end surpluses in excess of $10 million over the past several years, we did not program future surpluses in our projections. Surpluses that appear in the forecast represent the net operating result of annual revenues less forecast expenditures (there is no assumed expenditure savings or revenues exceeding budget as is typically realized each year – the forecast assumes all revenues and expenditures are fully realized as presented).

Revenue Assumptions
The methodology used for calculating revenue changes from Fiscal Year 2022-23 to Fiscal Year 2041-42 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. Then an outlook is developed that factors in the ebb and flow of economic cycles. As the result, this approach provides variable, as opposed to static and linear, forecast growth patterns. This 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 75% of total General Fund revenues. Consequently, the future growth assumptions for these top revenue sources can sway the forecast considerably.

Property Taxes

While the COVID-19 pandemic delayed some home and property sales in the 2020 calendar year, it did not significantly impact property tax revenue growth due to transfer of ownership, higher sale prices, and the construction/renovation of properties over the past year. The stay-at-home orders, business closures, and economic impacts did impact the overall growth experienced, as the annual consumer price index adjustment calculated by the State was only 1.036%, or roughly ½ of the 2% maximum allowable growth factor seen in most years. However, we project continued consistent and vigorous demand for Newport Beach's coastal property over the long run. This demand has allowed the City to enjoy long-term growth trends with its number one revenue source, which remains the least impacted by COVID-19. Value changes in Newport Beach show continued appreciation in property values in Fiscal Year 2021-22. Over the past 10 years, assessed valuation increased an average of 5.5% per annum and 6.2% over a twenty-year period. Newport Beach's assessed property values increased 4.5 percent in Fiscal Year 2021-22, with a local assessed value of $63.3 billion. The average annual 17-year growth for all items in this category including secured property tax, unsecured property tax, supplemental taxes, redevelopment agency residual and prior year penalties and interest is 6.1%. Staff conservatively forecast 5% annual growth for property taxes as a whole.

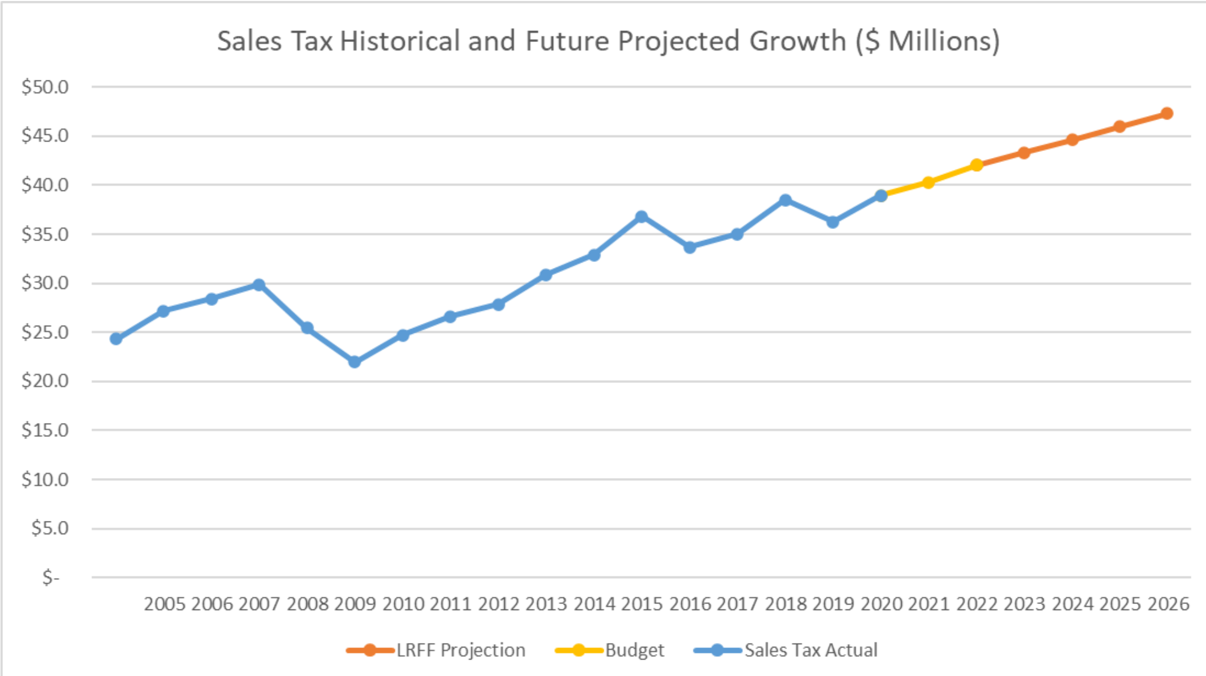


Sales Tax

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. These industries are also heavily impacted by tourism. At the onset of the pandemic when businesses were shut down, sales tax revenue potential appeared drastically diminished. Staff's initial projections held the ongoing assumption that the restrictions in place in April 2020 would remain for the rest of the fiscal year. However, sales tax revenues were higher than anticipated because businesses pivoted in creative ways to reach their customers – they were able to open at some capacity sooner than expected, and consumer spending was relatively strong. Online car sales increased and sales at local dealerships have picked up significantly. RVs and boat sales became more popular as families could not travel internationally. Online sales increased dramatically, resulting in significant growth in the City's county pool allocation. An uptick in sales related to home improvement projects was also evident. For these reasons actual sales tax revenues came in at $4.4 million or 12.8% higher than anticipated in Fiscal Year 2020-21 and surpassed the previous highest annual sales tax revenues in Fiscal Year 2018-19 of $38.5 million and the prior year receipts of $36.2 million.

Looking ahead, sustained sales tax growth is still anticipated through the end of the 2021 calendar year and will resume its traditional growth trend in 2022 and beyond. However, inflationary effects are showing up in the cost of many taxable products. Pent up demand for travel and experiences, the return of commuters and more costly fuel, and labor shortages having upward pressure on prices may begin to consume more disposable income and tighten growth by the start of 2022.

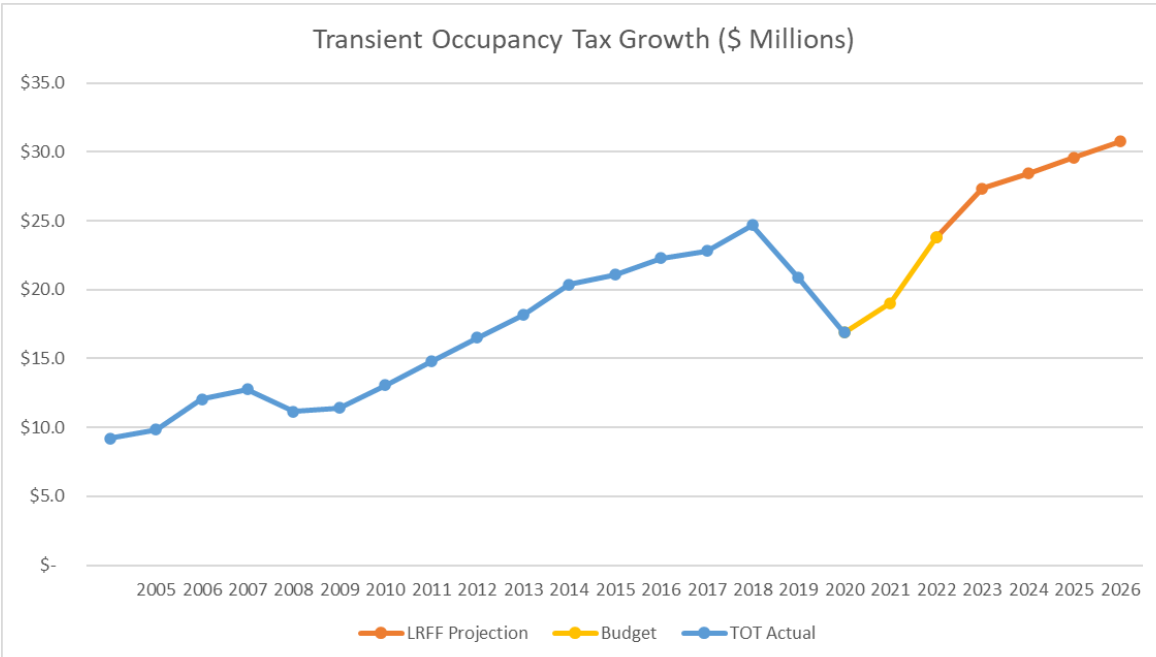
The post-Great Recession CAGR through Fiscal Year 2018-19, excluding the economic aberration of COVID-19 in Fiscal Years 2019-20 and 2020-21 is 4.3%. The economic outlook for the City's largest industry segments appears positive for the foreseeable future. We conservatively forecast 4% annual growth for sales tax.



Transient Occupancy Tax

Transient occupancy tax (TOT) was the City's most severely impacted revenue source as the pandemic unfolded. However, the City has seen a steady rebound and comeback with the City recording the highest TOT tax rate ever through August 2021. Revenues received during the last quarter of the Fiscal Year 2020-21 fiscal year accounted for 38.6% of all revenue received for the entire fiscal year. The fourth quarter receipts were much higher than the previous year and somewhat narrowed the revenue loss gap when compared to prior years, which led to year-end revenue collections reaching 81% of the prior year actuals.

A steady improvement in occupancy rates combined with an increase in daily room rates is estimated to dramatically improve TOT revenue over the next two years. We project receipts of $23.8 million in Fiscal Year 2022-23. This amount represents a 25% increase over the Fiscal Year 2021-22 adopted budget but remains only 96% of the actual revenues received in Fiscal Year 2018-19. Continued strong growth of 15% is anticipated in Fiscal Year 2023-24 and staying generally consistent with historical trends, we project growth of 4% every year thereafter.



Other revenues (service fees and charges, fines and penalties, property income, transfers in, and other miscellaneous revenues) which make up 27% of the total are projected to grow modestly at 2.6% on average over the next 20 years. This assumption is based on the average growth from the preceding 15 years.

Expenditure Assumptions

Regular salaries for both miscellaneous and public safety are on average assumed to grow at 2% annually. This is based on the most recent negotiated MOU agreements. The forecast assumes no growth in personnel headcount. Special and other pays (certification pay, bilingual pay, motor office pay, scholastic achievement, etc.) is projected to grow commensurately with salaries at 2% annually, with the exception of Fiscal Year 2022-23 which has a 20% increase from the prior year due to the elimination of an assumed $2,000,000 vacancy-related salary savings that was included in the budget during the two fiscal years most impacted by the pandemic. The benefits category which consists of various stipends, life insurance, Medicare fringes, retiree health plan contribution, and the City's pension contributions to CalPERS among other miscellaneous benefits is projected to grow on average at just over 1% annually based on negotiated MOU increases for the early part of the forecast and then grow at over 4% annually thereafter. The forecast assumes continued funding of the City's unfunded actuarial liability at the $35 million level through Fiscal Year 2028-29, after which the liability is eliminated assuming no dramatic changes in either future CalPERS experience studies or the discount rate. This assumes that the City Council authorizes additional contributions through future surplus balances of $5.0 million tapering to $2.0 million after five years. This is consistent with City Council action in recent years with the recommendation of the Finance Committee. This additional allocation to CalPERS is not reflected in the forecast as it is considered discretionary for City Council action on an annual basis and would be funded from prior year surplus.

General Fund Expenditure Forecast FY23 – FY27

	FY 2022-23	FY 2023-24	FY 2024-25	FY 2025-26	FY 2026-27
Regular Salaries	$ 80,216,297	$ 81,820,623	$ 83,457,035	$ 85,126,176	$ 86,828,699
Growth Rate	**2.0%**	**2.0%**	**2.0%**	**2.0%**	**2.0%**
Special and Other Pays	$ 13,713,472	$ 13,987,741	$ 14,267,496	$ 14,552,846	$ 14,843,903
Growth Rate	19.8%	2.0%	2.0%	2.0%	2.0%
Benefits [1]	$ 61,889,034	$ 62,158,256	$ 62,432,862	$ 63,589,024	$ 64,803,353
Growth Rate	0.4%	0.4%	0.4%	1.9%	1.9%
Non-Personnel Costs [2]	$ 107,580,106	$ 112,098,583	$ 117,438,663	$ 123,341,037	$ 129,403,997
Growth Rate	6.0%	4.2%	4.8%	5.0%	4.9%
Total General Fund Expenditures	**$ 263,398,909**	**$ 270,065,202**	**$ 277,596,056**	**$ 286,609,083**	**$ 295,879,952**
Growth Rate	4.0%	2.5%	2.8%	3.2%	3.2%
Surplus (Deficit)	**$ 2,502,519**	**$ 8,798,552**	**$ 12,163,260**	**$ 16,214,406**	**$ 18,849,873**

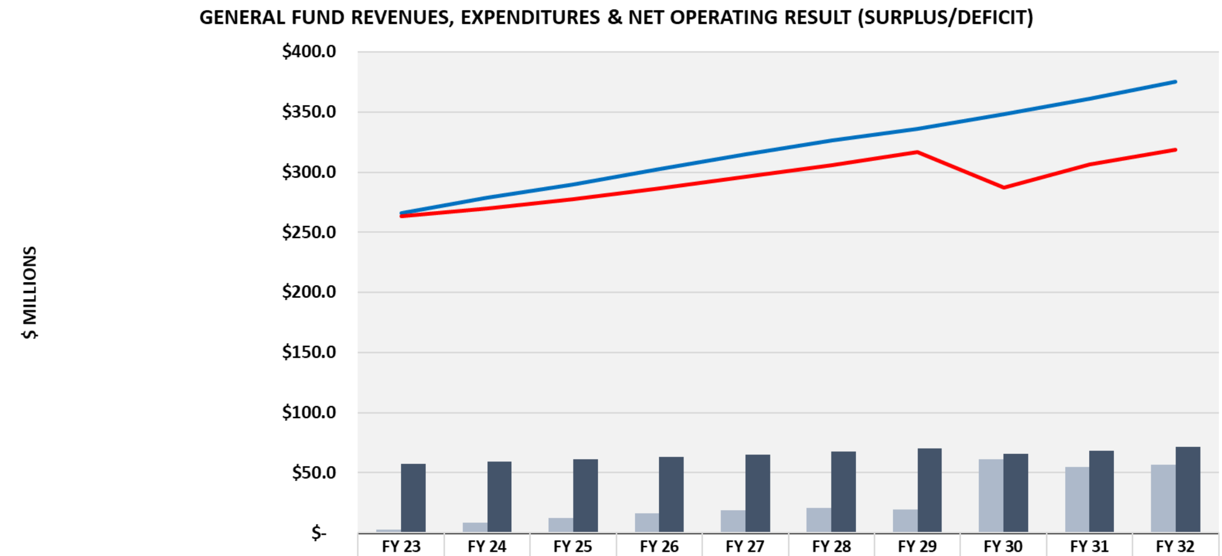
[1] Assumes CalPERS unfunded liability payment remains at a flat $35 million per year through 2029.

[2] Assumes transfers out to FFP, CIP, etc. remain flat and includes funds set aside for growth in contingency reserve.

Non-personnel costs include contract services, utilities, supplies and materials, maintenance and repair, and transfers-out. These expenditures are projected to grow on average at 5.4% annually.

Conclusion

The City is in excellent financial position relative to most other local agencies with a revenue base and reserves unparalleled by any similar size City in the County. The LRFF projects a surplus balance (revenues net of expenditures) of $2.5 million in Fiscal Year 2022-23. Surpluses are also projected for the remaining years of the model. This is partly due to the compounding effect of constant positive annual growth factors projected for the City's top three revenue sources. The compounding was mitigated by introducing variable, as opposed to static and linear, growth patterns that more closely align with the normal "ups and downs" of the economic cycle.



	FY 23	FY 24	FY 25	FY 26	FY 27	FY 28	FY 29	FY 30	FY 31	FY 32
NET OPERATING RESULT	$2.5	$8.8	$12.2	$16.2	$18.8	$20.6	$19.7	$61.2	$55.0	$56.9
ENDING CONTINGENCY FUND BALANCE	$57.4	$59.2	$61.0	$63.1	$65.3	$67.7	$70.1	$65.7	$68.4	$71.3
TOTAL REVENUES	$265.9	$278.9	$289.8	$302.8	$314.7	$326.5	$336.1	$348.5	$361.2	$375.4
TOTAL EXPENDITURES	$263.4	$270.1	$277.6	$286.6	$295.9	$305.9	$316.4	$287.3	$306.2	$318.5

The City currently has a contingency reserve of $55.3 million, which represents 25% of operating expenditures. This reserve serves as a means to respond to unexpected deviations in operating trends for 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 revenue shortfall during the COVID-19 pandemic. The small proposed 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 revenue receipts have improved considerably since the Great Recession and are again recovering quickly from the depths of the COVID-19 pandemic, future recessions or shifts in consumer habits (such as retail purchases or hotel stays) may alter the course of revenues and new patterns may emerge that differ significantly from our past results. Agencies dependent on traditional brick-and-mortar retail stores for a major portion of their sales tax will be facing new challenges in the coming years as merchants retrench and downsize to cope with a rapidly changing environment. Generational preferences for experiences over merchandise, plus the growing costs of health care, education, and housing, are reducing discretionary spending for taxable goods while time-challenged consumers are opting for the convenience of online shopping. The City routinely faces financially impactful events such as significant increases to CalPERS pension plans, 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 strength provides the Council with the ability to make strategic decisions each year that deploy new revenues toward the most critical needs of our citizens.

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

Submitted by:

/s/ Scott Catlett

Scott Catlett
Finance Director/Treasurer

Attachment:

A. 20-Year LRFF Table and Associated Graph