



## **CITY OF NEWPORT BEACH FINANCE COMMITTEE STAFF REPORT**

Agenda Item No. 5B  
May 12, 2022

**TO:** HONORABLE CHAIRMAN AND MEMBERS OF THE COMMITTEE

**FROM:** Finance Department  
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**SUBJECT: THIRD QUARTER BUDGET UPDATE**

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### **SUMMARY:**

The Finance Department prepares quarterly financial reports to review in detail the status of revenues and expenditures for the City's General Fund and to identify any concerning budgetary trends in other City funds. This report contains information on revenues, expenditures, and estimated fund balance for the third quarter of Fiscal Year 2021-22.

This third financial report of Fiscal Year 2021-22 provides an analysis of the financial activity of the City from the months of July 2021 through March 2022. Based on information available at the end of the third quarter, staff has made positive adjustments to year-end projected revenues and preliminary expenditure savings have been identified that should result in a healthy year-end budget surplus. Year-to-date expenditure budget adjustments are fully offset by the additional projected revenues.

### **RECOMMENDED ACTION:**

Review and discuss this report and provide any recommendations for consideration by the City Manager and City Council.

### **DISCUSSION:**

#### **Economic Overview**

Key economic indicators such as unemployment, taxable sales, and assessed property values continue to improve, which is indicative of the recent robust improvement to the economy. While recent trends in inflation have caused concern in the broader economy and financial markets, the City is well-positioned to weather any short-term increase in inflation thanks to the related increase in many of the City's revenues such as sales tax

and transient occupancy tax as prices increase and having long-term labor contracts in place with most of the City's employee associations.

The economy is expected to continue to grow through the remainder of the fiscal year. However, it is likely that the hardest hit industries will continue to see the strongest recovery as a return to normal consumer behavior spurs further growth in sales associated with restaurants, hotels, and general consumer goods purchased in brick-and-mortar establishments.

### General Fund Revenues

Overall General Fund revenue growth has outpaced projections generated by the City's consultants and staff that were incorporated into the adopted Fiscal Year 2021-22 budget. Growth in sales tax and transient occupancy tax has been the most pronounced, but growth in many other areas has contributed to a significant projected increase in General Fund revenues of \$19.2 million versus the adopted budget. Of note, sales tax in the categories hardest hit by the pandemic (brick-and-mortar businesses and restaurants & hotels) has now surpassed the record high levels seen just prior to the pandemic's onset, and transient occupancy tax is now projected to exceed the pre-pandemic high by year-end.

The following table summarizes the changes to projected General Fund revenues versus the adopted budget for Fiscal Year 2021-22. Details follow highlighting the reasons for the material variances.

### Fiscal Year 2021-22 Projected General Fund Revenues

Revenues by Category	PY Actual	A Adopted Budget	B Projected Actual	C = B-A Variance	D = C/A % Variance
Property Taxes	\$ 119,157,540	\$ 122,229,980	\$ 123,449,469	\$ 1,219,489	1.0%
Sales Tax	38,956,275	40,275,670	45,392,567	5,116,897	12.7%
Transient Occupancy Tax	16,886,197	19,027,493	25,573,145	6,545,652	34.4%
Other Taxes	12,849,340	10,815,117	12,824,996	2,009,879	18.6%
Service Fees & Charges	18,264,952	19,046,329	20,010,449	964,120	5.1%
Parking Revenue	7,074,853	5,681,942	5,989,448	307,506	5.4%
Licenses and Permits	5,133,399	5,106,646	5,106,646	-	0.0%
Property Income	5,115,255	5,044,403	5,922,927	878,524	17.4%
Fines & Penalties	4,012,568	3,292,102	3,379,886	87,784	2.7%
Intergovernmental	5,175,738	1,760,934	3,574,265	1,813,331	103.0%
Investment Earnings	1,598,624	1,112,200	1,112,200	-	0.0%
Misc Revenues	1,359,034	734,148	1,034,151	300,003	40.9%
<b>Total Revenues</b>	<b>\$ 235,583,776</b>	<b>\$ 234,126,964</b>	<b>\$ 253,370,149</b>	<b>\$ 19,243,185</b>	<b>8.1%</b>

**Property Tax** - Property taxes are the City's single largest General Fund revenue and represent approximately 50% of all General Fund revenues. As these revenues are primarily dependent on the assessed valuation established in January of 2021, there is typically very little variance seen from the original budget as the year progresses. The growth rate for Fiscal Year 2021-22 was smaller than what has been seen in recent years, primarily due to the lower 1.036% CPI factor. For Fiscal Year 2020-21, secured property tax payments came in strong, \$1.2 million over budget, which is an indication of timely property tax payments and higher valuations. Based on the higher prior year revenues and the most recent data shared by the City's property tax consultant, staff has increased the property tax revenue estimate for Fiscal Year 2021-22 by \$1.2 million to \$123.4 million.

Projections for Fiscal Year 2022-23 property tax revenues from the City's property tax consultant reflect a 6.5% increase in assessed values in the year ahead. This strong growth is a result of the CPI factor returning to the maximum 2.0% allowed and adding \$1.2 billion to the assessed valuation, as well as continued strong property sales activity and price appreciation adding \$2.8 billion to the assessed valuation. The City's total assessed valuation for Fiscal Year 2022-23 is now projected to grow from \$64.8 billion to \$69.0 billion.

**Sales Tax** - The second largest funding source for the General Fund is sales tax revenue, making up more than 15% of General Fund revenues. The City's sales tax base is largely generated from three industry categories – autos and transportation, general consumer goods, and restaurants/hotels. Most of these industries are also heavily impacted by tourism.

Because sales tax revenues are remitted to the City by the State several months after they are paid by consumers, information on which to report on for the third quarter reflects actual receipts through the end of the December 2021. However, based on the strong growth seen in recent quarters and the latest projections from the City's sales tax consultants, staff has increased the sales tax revenue estimate for Fiscal Year 2021-22 by \$5.1 million to \$45.4 million, an increase of 12.7%.

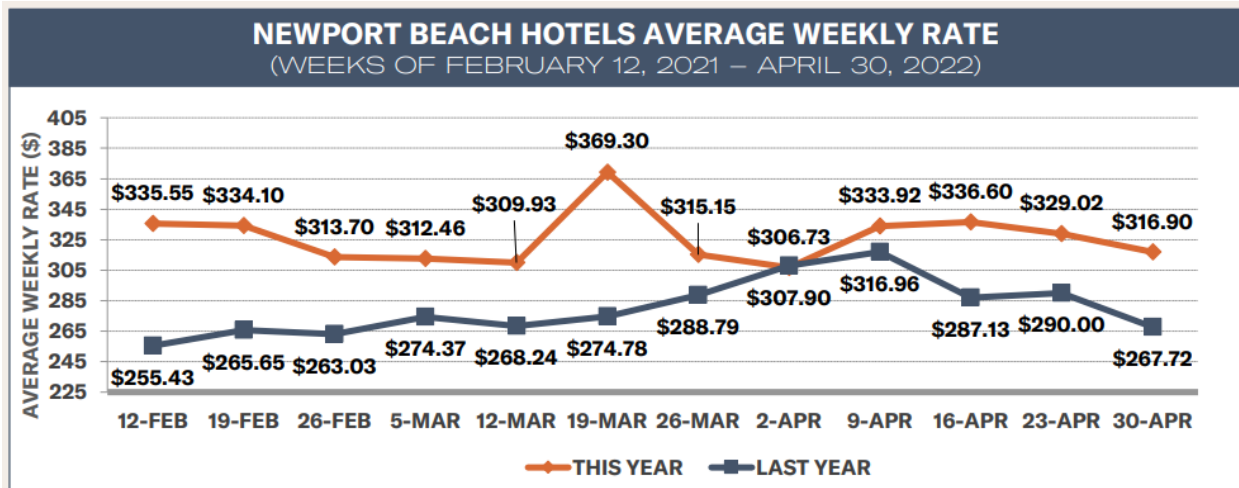
This increase results from two primary drivers. First, while auto sales have slowed due to inventory shortages, price increases have more than offset this decline and have resulted in strong growth in this category of sales tax revenues of 13.3% on a quarter over prior year quarter basis in the October through December quarter. Second, revenues from brick-and-mortar retail establishments and restaurants & hotels have now surpassed the pre-pandemic high as consumer behavior has largely returned to normal. These revenues grew at rates of 35.8% and 53.9%, respectively, versus the same prior year quarter. Also factoring into the strong growth is revenue from fuel and service stations, with 54.9% growth versus the same prior year quarter due to higher fuel prices and higher demand. Overall revenue was up 19.6% versus the same prior year quarter, leading to a year-end projection of 14.3% growth for the full fiscal year versus the prior fiscal year.

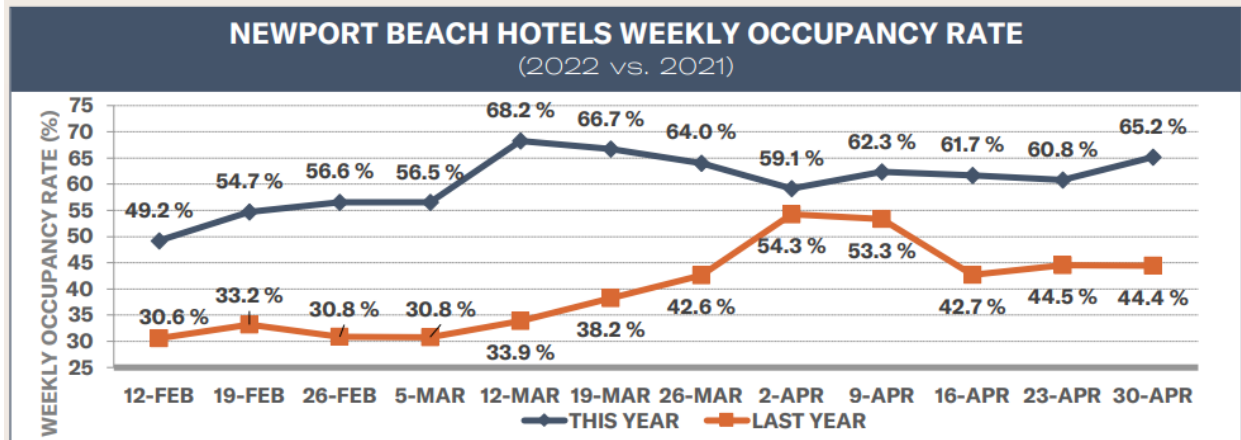
The outlook for sales tax revenues remains positive despite supply chain, pricing, and labor concerns, and the City expects to see continued growth in the years ahead.

**Transient Occupancy Tax** – The City has seen a steady rebound and comeback for TOT revenues as the effects of the pandemic receded. Initially, the TOT budget for the current fiscal year was developed in anticipation of full recovery of TOT revenues not occurring until the end of Fiscal Year 2022-23. However, staff's revised projection in the second quarter budget update estimated an increase in the budgeted revenues of \$6.5 million to \$25.6 million, an increase of 34.4%. Staff's analysis has confirmed the projection provided with the second quarter report and there is no further update to this projection at this time.

Two factors are causing this significant increase in the projection. First, revenue from short-term lodging businesses, which grew throughout the pandemic, is at a record high level. Second, many hotel properties are reporting record high TOT receipts and have been doing so for multiple consecutive months. While occupancy levels have not returned to pre-pandemic levels, they are slowly increasing. This lag in occupancy levels has been largely offset by higher daily room rates, resulting in hotel TOT revenues that are projected to approach the pre-pandemic high this fiscal year. When taken together, the strong growth in residential TOT makes up for the slightly lower hotel TOT projection and the two in total are now projected to result in a record year for TOT revenues for the City. The year-end projected revenues would exceed the prior year by 51.4% and the Fiscal Year 2018-19 record by \$876,000.

Data provided by Visit Newport Beach illustrates these very positive trends:





While the Marriot remains under renovation through the end of the month, it has now reopened as VEA Newport Beach with expanded meeting space, higher room rates, and a full complement of rooms available that have not been usable during the renovation process this past year. Staff has conservatively not included an impact in the TOT revenue projection from the changes to the hotel, which should result in a positive variance beyond the current projection once the hotel is fully open. The Fashion Island Hotel remains closed, but is expected to reopen in the Summer of 2023 following a sale and renovation as the Pendry Newport Beach. Similarly, because the timing of the Pendry's opening is uncertain, staff has not included any revenue from the hotel in the projection. These reopening's, combined with the expected return of more business travelers, are anticipated to have additional positive impact on the City's TOT revenues.

The outlook for TOT revenues continues to exceed expectations, and the reopening of the VEA and Pendry hotels with significant renovations and higher room rates presents further opportunity for growth. Projections anticipate 8.7% growth in the fiscal year ahead as the effects of the pandemic recede and trends return to more normal behavior.

**All Other Revenue** – This category includes all other revenue sources other than the top three (property tax, sales tax, and TOT). All Other Revenue is made up of the following:

- Other Taxes – real property transfer taxes, business license taxes, marine charter taxes, and franchise fees.
- Service Fees and Charges – plan check fees, recreation classes, emergency medical services fees, and numerous other cost-of-service fees.
- Parking Revenue – all General Fund related metered parking fees that are assessed throughout the various parking zones of the City.
- Licenses and Permits – fees charged to process building related permits, street closure permits, dog licenses, and police tow franchise fees.
- Property Income – City owned and managed income producing properties, long-term ground leases to concessions, restaurants, hotels and other businesses and

organizations, and rental of City facilities to the public.

- Fines and Penalties – parking citation fines collected by the City, administrative citation fines, fines remitted to the City from the County for vehicle code violations, and false alarm penalties.
- Intergovernmental Revenues – federal, state, and local grant revenues, which includes, but is not limited to, the City's portion of the ½ cent sales tax revenue paid to the County for public safety, state mandate reimbursements, reimbursement for strike teams sent to assist with fires, and revenue sharing with the County of Orange under the Waste Disposal Agreement (WDA).
- Investment Earnings – revenue generated from the investment of City funds.
- Miscellaneous Revenues – restricted revenue, damage to City property, bad debt, donations and contributions, non-operating revenues such as proceeds from the sale of materials and equipment, and other miscellaneous revenues.

Growth in other revenues as a whole is projected to be \$5.6 million above the adopted budget or 10.7%. Primary drivers of this growth include:

- Service fees and charges revenues are projected to exceed the adopted budget by \$1.0 million primarily due to increased revenue received from recreation fee-based classes and the Junior Lifeguard program as discussed in more detail in the prior quarter's financial report.
- Property income revenues are projected to exceed the adopted budget by \$0.9 million, primarily due to increased percentage-based rent revenues from the Lido House Hotel lease due to the hotel's increased revenues.
- Intergovernmental revenues are projected to exceed the adopted budget by \$1.8 million, primarily due to adjustments related to Fire Department mutual aid reimbursements and SB-2 Permanent Local Housing Allocation grant funds, as discussed in the first quarter's financial report in more detail.
- Property transfer tax revenues are projected to exceed the adopted budget by \$2.0 million due to the strong sales activity discussed earlier in this report.

Governmental accounting standards require the City to adjust the value of the City's investments to market value. Because the City normally holds investments to maturity and receives the full value of securities regardless of market value fluctuations, these are paper-only gains and losses that net to \$0 over time. The impact of the gains and losses associated with the change in the value of the City's investments is recorded at year-end as an addition to or subtraction from investment income. Because of the current volatile and rising interest rate environment, staff anticipates a significant negative adjustment at June 30, 2022, to reflect the fair value of the City's investments. If staff recorded the entry on April 30, 2022, a \$2.9 million negative revenue would be recorded in the General Fund to record the fair value adjustment. Staff does not yet know what the required adjustment

will be as of June 30, 2022, which could be higher or lower than the April 30 amount. Staff will advise the Committee in the fourth quarter report of the final amount of the adjustment, but it seemed appropriate to mention it now as it will likely be material and will reduce the projected surplus as reported later in this report.

### General Fund Expenditures

The Fiscal Year 2021-22 General Fund revised expenditure budget totals \$238.9 million. The year-to-date spending trends in the current fiscal year are generally consistent with prior years and do not indicate any cause for concern. Existing appropriations are on target to fund all current operational expenditures and staff are currently projecting sizable year-end budget savings comparable to what has been generated in prior fiscal years.

The table below summarizes the year-to-date changes to the adopted expenditure budget for Fiscal Year 2021-22, as well as projected expenditure savings by budget category. Details follow highlighting the reasons for the material variances. As promised in the second quarter report, budget savings has been analyzed and revised based on new information. Based on trends seen in prior years, additional budget savings are anticipated to materialize as the fiscal year progresses.

### Fiscal Year 2021-22 Projected General Fund Expenditures

Expenditures by Category	Adopted Budget	A Revised Budget	B Projected Actual	C = A-B Savings (Overage)	D = C/A % Variance
Salary & Benefits	\$151,713,101	\$159,393,983	\$155,078,233	\$ 4,315,751	2.7%
Contract Services	24,702,901	27,262,619	26,026,031	1,236,587	4.5%
Grant Operating	600,000	926,490	926,490	-	0.0%
Utilities	3,011,315	3,219,168	3,806,096	(586,928)	-18.2%
Supplies & Materials	3,739,730	4,425,598	4,345,944	79,654	1.8%
Maintenance & Repair	12,640,923	13,497,005	13,108,890	388,115	2.9%
Travel & Training	814,868	833,079	687,180	145,899	17.5%
General Expenses	2,130,552	2,303,168	2,332,914	(29,746)	-1.3%
Internal Svc Charge	25,078,890	25,093,732	25,093,732	-	0.0%
Risk Management	750,915	750,915	750,915	-	0.0%
Capital Expenditures	780,438	1,145,810	1,145,810	-	0.0%
<b>Total Expenditures</b>	<b>\$225,963,632</b>	<b>\$238,851,567</b>	<b>\$233,302,236</b>	<b>\$ 5,549,331</b>	<b>2.3%</b>

Significant expenditure budget variances are as follows:

- The revised salary and benefits budget totals \$159.4 million, an increase of \$7.7 million over the adopted budget. The increase is primarily due to the appropriation of \$5.0 million from Fiscal Year 2020-21 year-end budget surplus as an additional discretionary payment to CalPERS to further reduce the City's unfunded pension

liability. The remaining \$2.7 million relates to recently approved contracts with the majority of the City's employee associations. The City does not budget for unknown labor costs, which requires mid-year appropriations for negotiated salary and benefit increases in the year in which new labor contracts are negotiated. While the budget for the current year did include a \$2.0 million vacancy factor, additional salary and benefit savings beyond the vacancy factor of \$4.3 million are currently projected.

- Increases to the contract services budget relate to a variety of routine mid-year adjustments previously approved by the City Council, including \$0.6 million added to the contract instructors' budget for Recreation and Senior Services that is fully offset by higher revenues, \$0.4 million for the Be Well OC program, \$0.3 million for the Medical IGT Program that is fully offset by higher revenues, and appropriations offsetting several donations. Based on staff's most recent budget meetings with City Departments, contract services savings of \$1.2 million are currently projected.
- Staff identified and reported on an issue with the City's recent budgeting for utilities. A portion of this issue was addressed with a budget amendment approved by the City Council in the first quarter. However, additional overages are now apparent. Staff is evaluating this issue and will be making adjustments in the Fiscal Year 2022-23 budget to address it. As budget savings in other expenditure categories are anticipated to fully offset the projected \$0.6 million overage, staff is not recommending a further adjustment to the utilities budget at this time.
- Due to inflated prices for gasoline, the category titled General Expenses is projected to go over budget by just under \$30,000. As budget savings in other categories offset this overage, staff is not recommending an adjustment to the fuel budgets at this time.

Staff will also be including a budget amendment with this report when it is provided to the City Council to obtain authorization for increasing revenues and expenditures related to overtime associated with mutual aid to other organizations for fire strike teams.

On October 26, 2021, the City Council approved \$31.0 million of recommended appropriations from prior year unrestricted General Fund resources as follows:

1. **CalPERS Unfunded Liability** – \$5.0 million to bring the City's annual unfunded liability contribution to CalPERS up from \$35 million to \$40 million, consistent with recent years and the recommendation of the Finance Committee.
2. **Facilities and Infrastructure Replacement Liabilities** – \$10.5 million toward additional contributions to long-term infrastructure liabilities within the Facilities Financial Plan and Harbor and Beaches CIP. Funds were set aside, with specific allocations being recommended as part of the upcoming Fiscal Year 2022-23 budget process.



3. **CIP and Neighborhood Enhancements** – \$15.5 million toward the Fiscal Year 2022-23 capital improvement program, to include neighborhood enhancement projects. Funds were set aside with specific allocations being recommended as part of the upcoming Fiscal Year 2022-23 budget process.

Other than the previously discussed appropriation toward the City's CalPERS unfunded liability, the remainder of these appropriations are reflected in the budget as transfers out of the General Fund.

### General Fund Sources, Uses, and Projected Surplus

As a result of the strong revenue growth seen year-to-date and projected continued strong revenue growth through the end of the fiscal year, a budget surplus is anticipated based on the additional revenues alone. Projected expenditure savings, which based on prior year trends will likely exceed what is currently projected, will add to that surplus. While this is all good news, the year is only 75% complete and staff remain cautious. Staff will continue to revise these projections as the year progresses, with a final update to be provided to the Finance Committee and City Council following the conclusion of the fiscal year.

The table below illustrates the prior year sources and uses of funds as compared to the adopted budget, the revised budget, and the projected year-end results:

### Fiscal Year 2021-22 Projected General Sources, Uses, and Budget Surplus

Category	FY 2020-21 Actual	A FY 2021-22 Adopted	FY 2021-22 Revised	B FY 2021-22 Projected	C=B-A Variance	D=C/A % Variance
<b>BEGINNING UNRESTRICTED FUND BALANCE</b>	<b>\$24,081,225</b>	<b>\$31,036,884</b>	<b>\$ 31,178,957</b>	<b>\$ 31,178,957</b>	<b>\$ 142,073</b>	<b>0.5%</b>
<b>SOURCES:</b>						
Operating Revenues	235,934,635	234,126,964	253,370,149	253,370,149	19,243,185	8.2%
Less: Restricted Revenues	(957,206)	(1,128,513)	(1,128,513)	(1,128,513)	-	0.0%
Prior Year Resources Carried Forward	2,075,632	-	3,072,666	3,072,666	3,072,666	---
Release of Restricted Funds	2,403,303	1,220,000	1,220,000	1,220,000	-	0.0%
Transfers In from Other Funds	21,526,628	11,977,157	11,977,157	10,492,133	(1,485,024)	-12.4%
<b>TOTAL SOURCES</b>	<b>260,982,992</b>	<b>246,195,608</b>	<b>268,511,459</b>	<b>267,026,435</b>	<b>20,830,827</b>	<b>8.5%</b>
<b>USES:</b>						
Operating Expenditures	220,647,754	225,963,632	238,851,567	233,302,236	7,338,604	3.2%
Transfers Out	27,467,575	20,200,000	47,030,300	47,030,300	26,830,300	132.8%
Resources Carried Forward to FY 2021-22	3,072,666	-	-	-	-	---
Addition to 25% Contingency Reserve	2,697,265	-	-	-	-	---
<b>TOTAL USES</b>	<b>253,885,260</b>	<b>246,163,632</b>	<b>285,881,867</b>	<b>280,332,536</b>	<b>34,168,904</b>	<b>13.9%</b>
<b>ENDING UNRESTRICTED FUND BALANCE</b>	<b>\$31,178,957</b>	<b>\$31,068,860</b>	<b>\$ 13,808,549</b>	<b>\$ 17,872,856</b>	<b>\$ (13,196,004)</b>	<b>-42.5%</b>
<b>CHANGE IN FUND BALANCE</b>	<b>\$ 7,097,732</b>	<b>\$ 31,976</b>	<b>\$ (17,370,408)</b>	<b>\$ (13,306,101)</b>	<b>\$ (13,338,077)</b>	

As can be seen in the table above, even with the sizable appropriations earlier this year that allocated three prior years' budget surpluses, current projections now reflect a \$17.9

million budget surplus for the current fiscal year. As discussed in prior quarterly reports, it is quite possible that additional budget savings will be identified in the final quarter of the year that may increase the surplus. However, it should again be noted that the City's financial situation can change based on economic forces outside of our control. Prudence is therefore dictated until the year is complete and the actual budget surplus is calculated.

One item of note in the above table, is that the transfers in from other funds has decreased by \$1.5 million. This is due to an updated projection of the activity in the Tidelands Operating Fund, which will require a higher subsidy from the General Fund than was anticipated when the budget was developed. In January, staff brought a report to the Committee to recommend changing the budget presentation format for the Tidelands Operating Fund. That change has been incorporated into the FY 2022-23 Proposed Budget, but the current year's budget retains the old format reflecting the difference between the cost allocation plan charges and the subsidy revenue to the Tidelands Operating Fund as a net transfer into the General Fund. The primary reasons for the projected \$1.5 million reduction to the transfer in are that 1) the historical methodology for calculating the subsidy when the budget was presented to the City Council did not properly take into account planned capital expenditures from the Tidelands Operating Fund or accurately project available fund balance and 2) the historical methodology utilized in these quarterly reports did not include the impact of Tidelands Operating Fund budget amendments in the current fiscal year that draw from unappropriated fund balance, which must be backfilled by the General Fund. Staff has identified these issues as part of the ongoing Fiscal Year 2022-23 budget process and has implemented revisions to the budget process and the quarterly reporting process to properly account for these variables in the Tidelands Operating Fund that indirectly impact the General Fund through an increase in the subsidy required. While these variances were realized at year-end in prior fiscal years, they will now be accounted for and recognized on a timelier basis. The projection of the year-end surplus for the General Fund will therefore be more accurate in the future as it relates to these Tidelands issues.

Lastly, as discussed in the revenues section of this report, the impact from adjusting the value of the City's investments to fair value is anticipated to negatively impact revenues by a currently unknown amount. As of April 30, 2022, this amount is \$2.9 million, so the actual surplus is likely to be reduced to \$15.0 million based on current information.

### **Other Funds**

Staff have evaluated the fiscal condition of the City's other major operating funds (Tidelands, Water, and Wastewater). An analysis of the budget performance for the Water and Wastewater funds through the third quarter of this fiscal year indicates that no budget adjustments are necessary and variances between budgeted and actual amounts are within reason.

An analysis of the Tidelands fund has demonstrated that a higher than budgeted subsidy will be necessary to fund the current activity in the fund. There is no budgetary impact due to the current presentation format of the Tidelands Fund, but this is reflected in the

General Fund sources and uses as a reduced transfer in as previously discussed.

<b>Tidelands Operating Fund Activity</b>	<b>FY 2021-22 Projected</b>
Available Beginning Fund Balance	2,390,852
Projected Revenues	12,691,599
Total Sources	15,082,451
Operational Expenses	(3,237,680)
Capital Improvement Projects	(3,887,269)
Cost Allocation Plan	(17,300,724)
Total Uses	(24,425,672)
<b>Deficit (Subsidy)</b>	<b>(9,343,221)</b>
Projected Net Increase to GF (CAP less Subsidy)	7,957,503
Budgeted Net Increase to GF (CAP less Subsidy)	9,442,529
Impact on General Fund	(1,485,026)

### Conclusion

As a result of conservative budgeting and sound financial policies, the City remains well positioned to continue delivering a high level of service to the community while targeting surplus resources to key priorities at year-end as has been the case for a number of consecutive years. Staff recommends that the Finance Committee review and discuss this report and provide any recommendations for City Manager and City Council consideration prior to the May 24, 2022, City Council meeting, at which time this report will be presented.

Prepared and Submitted by:

/s/ Shelby Burguan

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Shelby Burguan  
Budget Manager