CITY OF NEWPORT BEACH
FINANCE COMMITTEE
STAFF REPORT

Agenda Item No. 5B
January 12, 2023

TO: HONORABLE CHAIR AND MEMBERS OF THE COMMITTEE

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

SUBJECT: LONG-RANGE FINANCIAL FORECAST (LRFF) UPDATE

EXECUTIVE SUMMARY

The City's fiscal policy is guided by the Long-Range Financial Forecast (LRFF), which is a planning tool that encompasses the long-term operating and capital needs of the General Fund over the next 20 years. The forecast projects an operating surplus (revenues net of expenditures) in each year over the next 20 years. The City is projected to maintain long-term fiscal sustainability, 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.

DISCUSSION

Strategic planning begins with determining the City's fiscal capacity based upon long-term financial forecasts of recurring operating revenues and future financial obligations. Prior to the adoption of the annual budget, staff prepares a Long-Range Financial Forecast (LRFF) for the General Fund (the City's primary operating fund) in order to assess internal and external issues impacting the City's financial condition. The LRFF is intended to ensure the City's maintains long-term fiscal sustainability, to guide fiscal policy decisions, and to ensure that the City has sufficient resources to continue to provide high quality programs and services for the community.

Methodology

The Finance Department utilizes a multifaceted 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 based on current economic conditions and other factors. Revenues and expenditures 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 Financial 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 as needed.

Major Assumptions

Projected Revenues for Fiscal Year 2022-23, excluding one-time items, serves as the basis for amounts projected for Fiscal Year 2023-24 and each subsequent fiscal year. The Amended Budget for Fiscal Year 2022-23, excluding one-time items and capital projects carried-over from the prior year, serves as the basis for amounts projected for Fiscal Year 2023-24 and each subsequent year. It should also be noted that expenditure savings are not reflected in the forecast, such as savings from vacancies, which are typically realized each year.

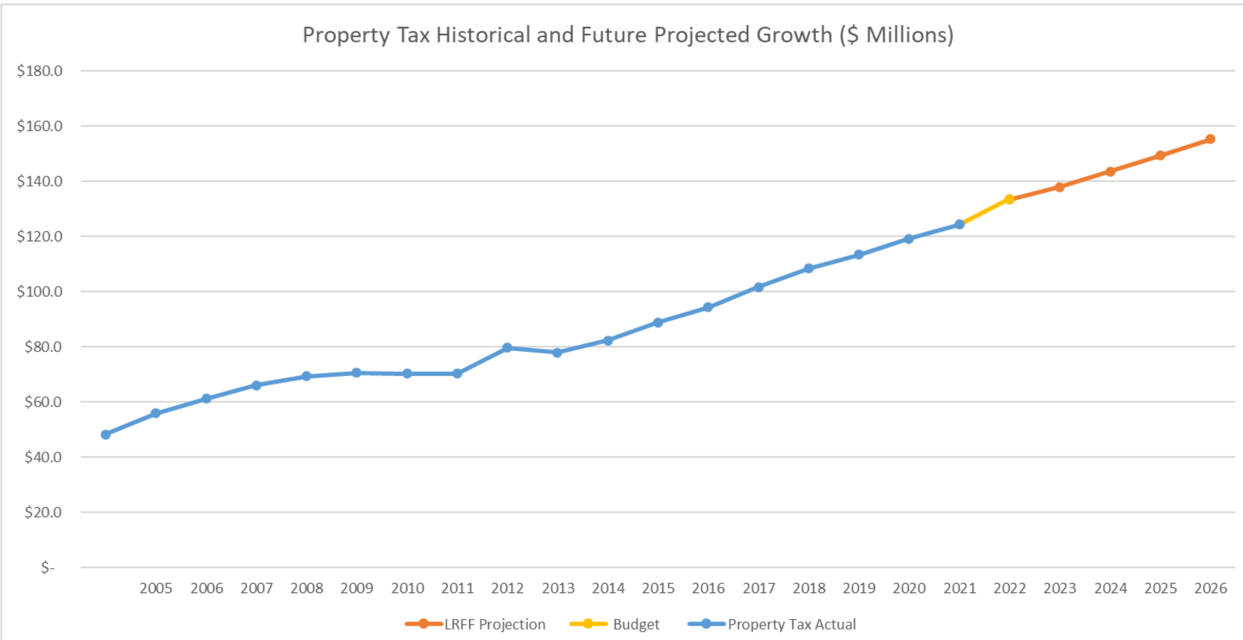
Revenue Assumptions

The General Fund's revenues are primarily derived from Property Tax, Sales Tax, and Transient Occupancy Tax, which accounts for approximately 73% of total General Fund revenues. The growth assumptions for these revenue categories are as follows:

<u>Property Tax</u>

Property tax revenues are primarily dependent on the assessed valuation established in January of each year. Projections for Fiscal Year 2022-23 property tax revenues reflect a 7.6% increase in assessed property values, with the City's local assessed value projected to grow from $66.2 billion to $71.2 billion. Property tax revenues are projected to increase by $4.5 million or 3.4% in Fiscal Year 2023-24, which is largely related to the inflation adjustment indexed at the 2% cap allowed by Proposition 13, and due to changes in ownership, which is partially offset with an anticipated decrease in supplemental property tax revenue as home sales slow due to rising interest rates. It should be noted that the increase in assessed values for Fiscal Year 2023-24 related to changes in ownership is based on homes sales data received from the County for the 10-month period from January 2022 through October 2022 - homes sales data for November and December 2022 was not available at the time of projection. Therefore, the amount projected for Fiscal Year 2023-24 is conservative considering additional increases in assessed values related to homes sold in November and December 2022 are expected.

In outer years of the forecast, staff continues to project consistent and vigorous demand for Newport Beach's coastal 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 with its number one revenue source. The average annual 18-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 5.8%. Beyond FY 2023-24, staff conservatively forecast 4% annual growth for property taxes as a whole.



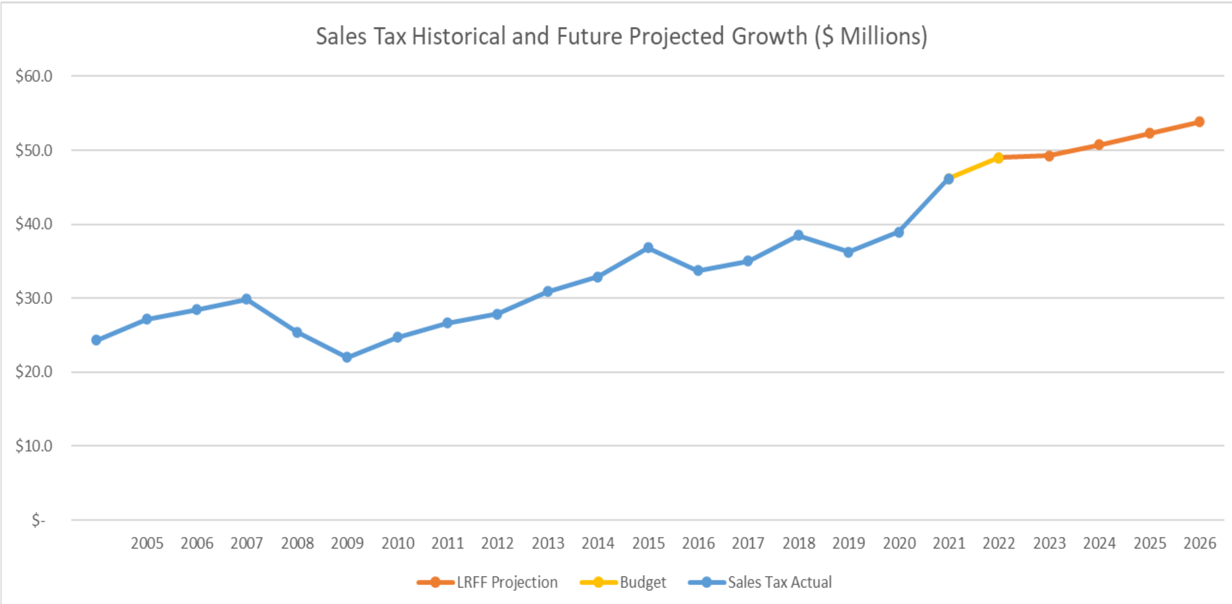
<u>Sales Tax</u>

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 and hotels. These industries are also heavily impacted by tourism and were impacted by the effects of the COVID-19 pandemic.

For Fiscal Year 2023-24, sales tax revenue is projected to increase approximately $260 thousand or 0.5% due to modest growth projected in sales tax revenue from restaurants and hotels, and the State & County pools, which is partially offset with projected decreases in general consumer goods and autos & transportation. This forecast is based on the sales data over the past two years, which has reflected a significant shift in spending from tangible goods to spending on travel, dining and leisure and entertainment. It is also expected that the auto industry may face challenges in the years ahead due to a combination of high prices, rapidly escalating costs to finance a vehicle purchase and a slowing economy.

The economic outlook for the City’s largest industry segments generally appears positive for the foreseeable future, albeit growing at a slower rate for the next fiscal year. Beyond

Fiscal Year 2023-24, a conservative 3% annual growth rate is generally assumed for sales tax.



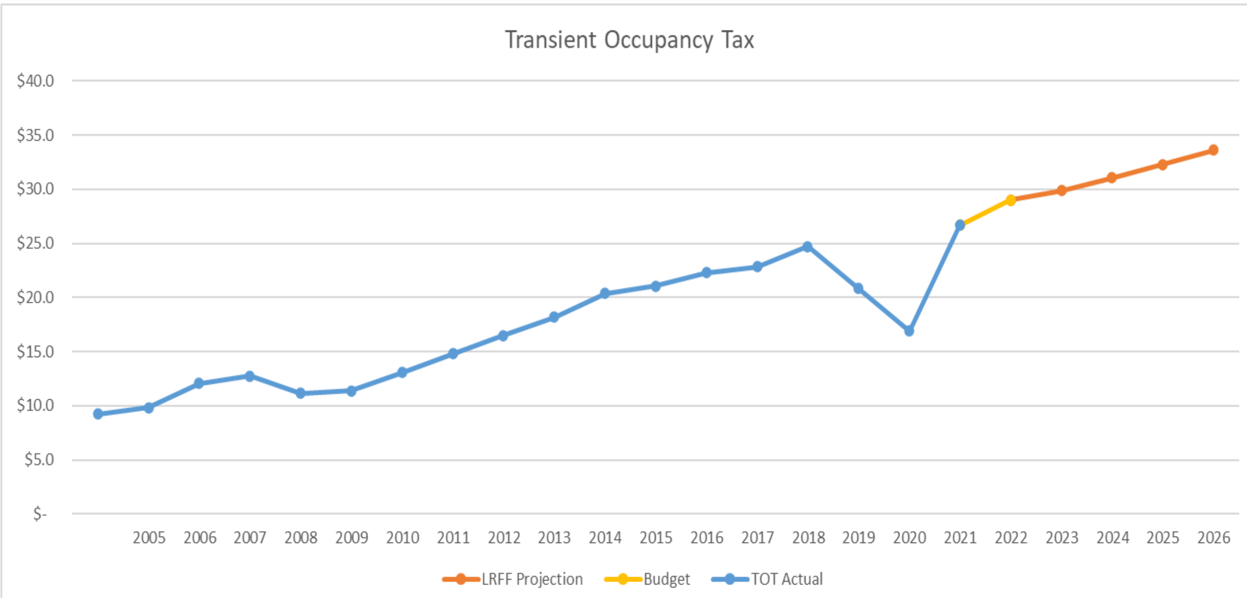
Transient Occupancy Tax

Transient occupancy tax (TOT) was the City's most severely COVID-19 impacted revenue source; however, the City has seen a steady rebound as the effects of the pandemic receded. The TOT budget for Fiscal Year 2022-23 was developed in anticipation of full recovery of TOT revenues. Revenue from short-term lodging businesses, which grew throughout the pandemic, is at a record high level. Additionally, 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 room rates.

An updated analysis of the City's TOT revenues shows an expected increase in TOT due largely to strong short-term lodging businesses, which increases the current year projection to approximately $29 million. This projection is based on actual hotel tax revenue through October 2022 and conservatively assumes hotel tax revenue for November 2022 through June 2023 consistent with the figures generated from November 2021 through June 2022. While the VEA Newport Beach is now operational – 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 beginning with Fiscal Year 2022-23. Similarly, while 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, staff has conservatively not included any revenue from the hotel in the TOT revenue 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 in the years ahead.

For Fiscal Year 2023-24, staff projects receipts of $29.9 million, representing a conservative 3% increase compared to the FY 2022-23 revised projection. Staying generally consistent with historical trends, staff projects 4% annual growth thereafter.



Other revenues (service fees and charges, fines and penalties, property income, transfers in, and other miscellaneous revenues) which make up 27% of the City's total revenues are projected to grow modestly at 2.9% on average over the next 20 years. This assumption is based on the average growth from the preceding 18 years. Starting in Fiscal Year 2023-24, the forecast includes $1.5 million in annual lease revenue from the 1201 Dove Street property. The forecast also accounts for a slight decrease in revenues from building and planning fees as a result of the City Council's extension of the fee waiver for accessory dwelling unit and junior accessory dwelling unit projects. However, no further decrease in these revenues is anticipated – while a potential recession could result in a slowing of planning/construction activity, higher costs from rising interest rates, inflation, and materials are anticipated to balance out any slowdown in construction.

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 (certification pay, bilingual pay, motor office pay, scholastic achievement, etc.) is projected to grow at 3% annually. In FY 2023-24, a one-time allocation of $880,000 to assist in the recruitment of full-time vacant police officer positions is included.

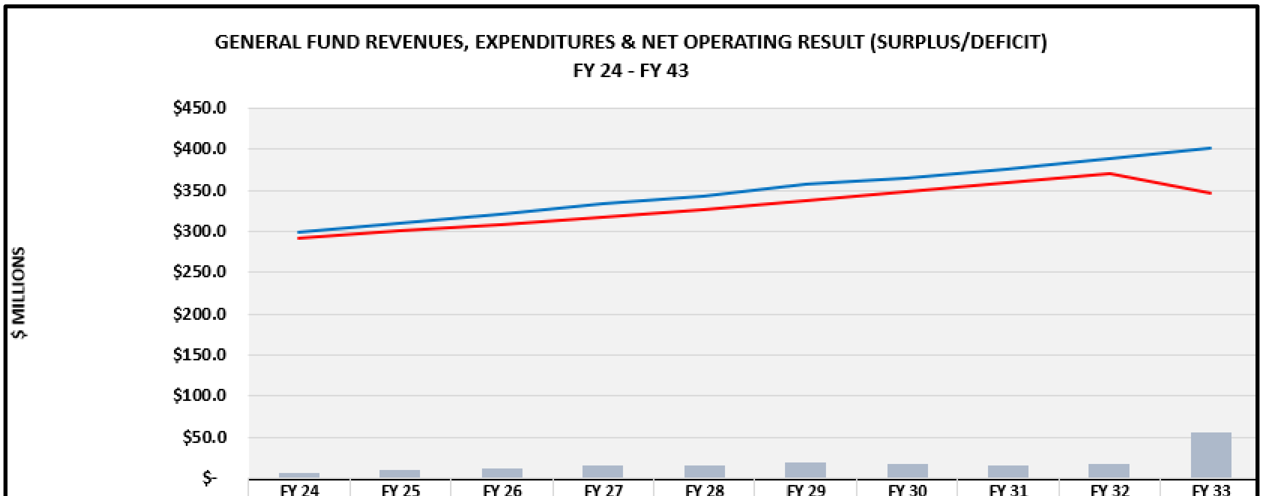
The benefits category which consists of various stipends, life insurance, Medicare, retiree health plan contribution, and the City's pension contributions to CalPERS among other miscellaneous benefits is generally projected to grow at 2% annually. This category includes the recently approved 1.5% reduction in the employee's share in pension contributions to CalPERS through Fiscal Year 2024-25. The benefits category also includes contributions towards the unfunded pension liability at the $45 million level citywide (General Fund portion is $42 million) through Fiscal Year 2031-32, after which the liability is eliminated assuming CalPERS earns 6.8% on average each year. This assumes that the City Council continues authorizing additional contributions through this period consistent with City Council action in recent years with the recommendation of the Finance Committee.

Non-personnel costs include contract services, utilities, supplies and materials, and maintenance and repair. These expenditures are projected to grow an average of 5.1% 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. It should also be noted that additional funding for homelessness has also been included in the forecast starting in Fiscal Year 2023-24.

Transfers Out
Per City Council Policy F-28, General Fund contributions to the Facilities Financial Plan (FFP) Program is based on the annual sinking fund contribution that has been established to amortize the cost of critical City facilities (such as, but not limited to, the Civic Center, Police Department buildings, Fire Stations, Library Branches, and other Facility Improvement Projects) or three percent (3%) of total General Fund Revenue, whichever is greater. Annual General Fund Transfers to the FFP range from $8.6 million to $15.4 million over the next twenty years. In addition, annual General Fund Transfers consists of $5 million for the Capital Improvement Program (CIP), $2.5 million for Facilities Maintenance, and $4.5 million to the Tidelands Harbor Capital Fund indexed at 2.5% annually through Fiscal Year 2029-30 and reduced to $4.5 million thereafter.

Conclusion

The forecast projects an operating surplus (revenues net of expenditures) in each year over the next 20 years. In addition, it is important to note that the City currently has a contingency reserve of $58.8 million, which represents 25% of operating expenditures. This reserve serves as a means to respond to unexpected deviations in operating trends for the next twenty years. The City is projected to maintain long-term fiscal sustainability, 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.



	FY 24	FY 25	FY 26	FY 27	FY 28	FY 29	FY 30	FY 31	FY 32	FY 33
NET OPERATING RESULT	$6.9	$9.6	$12.0	$15.6	$16.2	$20.2	$17.7	$16.5	$17.8	$55.7
TOTAL REVENUES	$299.2	$309.8	$320.6	$333.5	$343.8	$358.0	$366.0	$375.8	$388.6	$402.1
TOTAL EXPENDITURES	$292.3	$300.2	$308.6	$317.9	$327.6	$337.8	$348.3	$359.3	$370.8	$346.4

Submitted by:

/s/ Jason Al-Imam

Jason Al-Imam
Finance Director/Treasurer

Attachment:

A. 20-Year LRFF Table and Associated Graph