CITY OF RIVERSIDE FISCAL UPDATE

2022 Festival of Lights

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EXECUTIVE SUMMARY

The closure of Fiscal Year (FY) 2021/22 presented good news for the General Fund and Measure Z in the form of extraordinary gains in sales tax revenue. The strong performance resulted in surplus reserves in the General Fund, allowing the City to employ some long-term fiscal strategies such as increasing funding in the Section 115 Pension Trust for the long-term management of rising retirement costs and the Infrastructure Reserve to address critical infrastructure needs. The increased resources in the Measure Z Fund presents the opportunity to fund new spending initiatives.

The FY 2021/22 results provided a new basis for revenue projections in FY 2022/23. Although sales tax growth has slowed in the current fiscal year, the gains from the previous three years are intact, and General Fund and Measure Z revenues are expected to exceed budgeted revenue estimates. The Public Parking and Refuse Funds are burdened by rising costs and aging infrastructure, with current user rates unable to sustain the respective funds' operations and capital needs. In other news, recent and projected CalPERS investment losses are expected to significantly increase the City's required UAL contribution and retirement costs, casting on a pall on the positive revenue results.

One of the most widely watched and often-cited economic outlooks for California and the nation, the UCLA Anderson Forecast, anticipates the U.S. economy is likely to muddle along with below-trend growth and continued high inflation over the next 12 months. In it's December 2022 update, the panel cited "a lot of uncertainty", followed by a 54% chance of recession in calendar quarter two of 2023, and a 46% chance of a recession occurring after twelve months. The outcome is highly dependent upon the actions of the Federal Reserve, the panel stated, citing a likely recession if interest rates were to increase above 5%. It also noted that historically, a recession followed interest hikes 75% of the time, and this series of interest hikes is occurring at the fastest pace since 1983. As of February 2023, the rate is 4.75%, with the Fed signaling more increases to come.

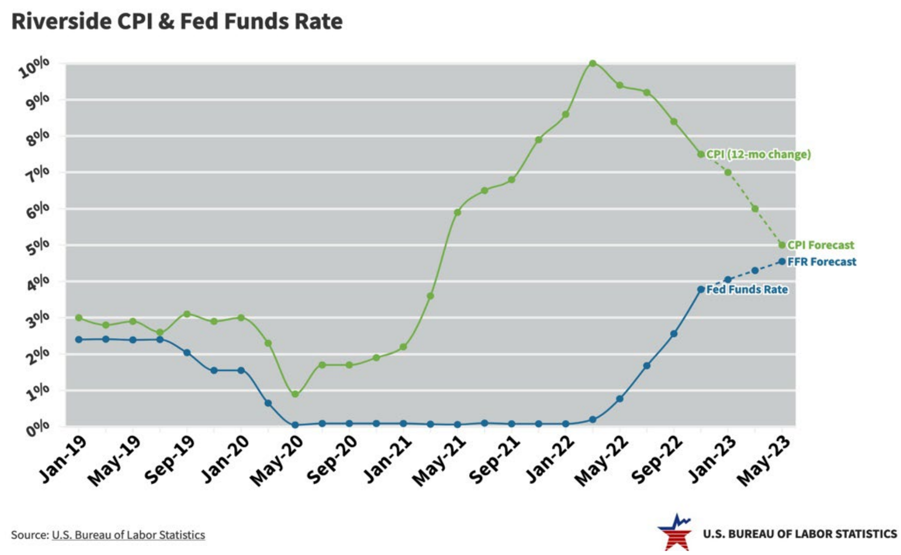
ECONOMIC INDICATORS

INFLATION & THE FEDERAL RESERVE

The major factor that is continuing to trouble the economy is the growth rate of inflation, as measured by the Consumer Price Index, or CPI. The CPI has been rising at a rapid rate after the influx of trillions of dollars by the Federal government since the COVID onset in March 2020. Coupled with very low interest rates guided by the Federal Reserve (Fed) over the past two years, the American consumer is facing inflation growth rates that have not been seen in forty years. In an effort to battle this inflationary spike, the **Fed has ratcheted up interest rates 4.5% since March 2022**, the fastest pace since the early 1980s. This has implications across the economic spectrum, but the main goal of this action is to slow a superheated economy and lessen demand in an effort to slow the growth rate of inflation.

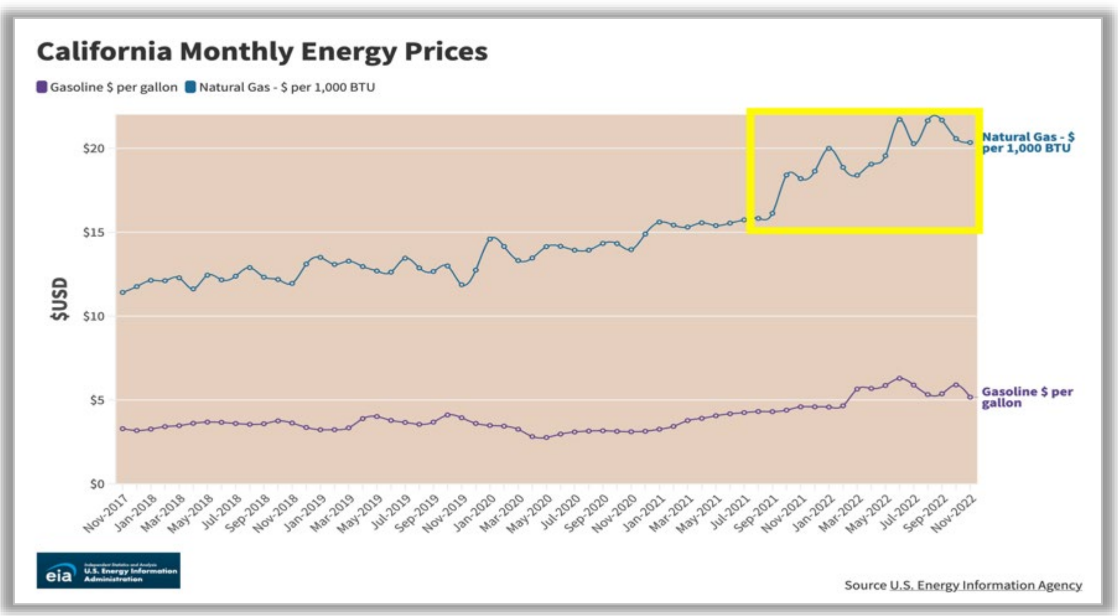
The localized CPI in the Riverside area is hovering around 7% as compared to last January when it neared 10%. While we are seeing the beginning of a "cooling" effect on inflation, the Fed has repeatedly stated that the rate increases are not over. As Fed Governor Waller stated on February 8, "we could be seeing interest rates higher for longer". Bottom line: **higher inflation & higher interest rates are here to stay**.

The continued upward pressure on interest rates, or the cost of money, leads to a "squeezing" effect on all other areas of the economy. Credit is prevalent in all areas of the global economy and is essential for further growth. By raising rates, this has the effect of slamming on the brakes on economic output by raising the cost of doing business and creating higher barriers for businesses and consumers to continue their current spending pace.



Energy is another headwind facing the economy now. The Ukraine conflict has continued to exert pressure on the energy markets as financial and economic sanctions take a bite out of the Russian energy supply chain. The additional effect of the sanctions is to create more scarcity, not just in the oil markets (of which Russia is the number 3 global supplier), but also as in the natural gas markets. Natural gas has seen a meteoric rise in the prices, both on the wholesale and the retail levels, not experienced in a decade. While the United States is the top global producer of natural gas (23%), Russia is a close second (17%)[1], and there is upward pricing pressure on supply chains for those countries looking to supplant their Russian supplies with other less volatile and stable sources.

This scramble for additional supply has the American natural gas market, as well as the **California retail consumer seeing a tripling of monthly gas bills as compared to 2022 prices**. The good news is that the California Public Utilities Commission (CPUC) has released the annual natural gas climate credit two months early[2] and this should appear on consumers bills in the next one or two billing cycles. This will give some much-needed temporary relief that will ease the pain caused by the global squeeze on natural gas.



Gasoline prices, as pictured in purple in the accompanying graph, continue their modest decline as oil prices have retreated from their highs north of $100 per barrel and are forecasted to continue to moderate. However, any step up in the Ukraine conflict could erase these savings and we could see prices north of $5 per gallon rather quickly.

[1] Statista: https://www.statista.com/statistics/265363/top-producing-countries-of-natural-gas/
[2] CPUC: https://www.cpuc.ca.gov/news-and-updates/all-news/cpuc-accelerates-climate-credit-to-provide-utility-bill-support-to-customers-2023

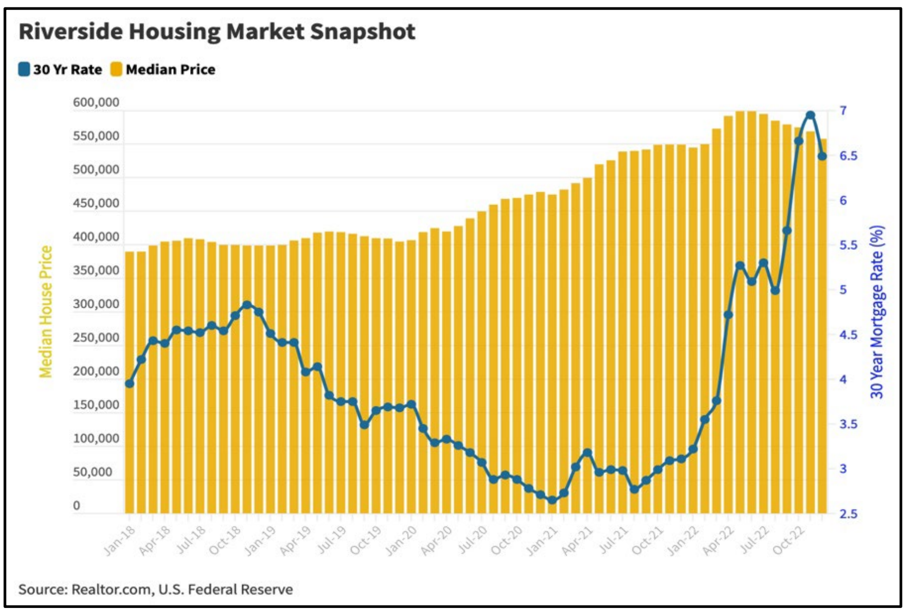
HOUSING & INTEREST RATES

Housing has been the one area of the economy that has held up well even with the large increases in the borrowing rate initiated by the Federal Reserve in the Spring of 2022. The unprecedented speed at which the increases have hit the economy have not only slowed down the pace of gains in housing prices, but have slowed transactions to a trickle over the past year. The chart below shows that **transactions of single-family residences (SFRs) in Riverside County are down 42% from last year, but prices are only down 1.8%** from prior year. This pricing reflects extreme resiliency in the housing market in Riverside County, even in the face of 30-year fixed rate mortgages rising to near 7%.

While there appears to be a slowing in the rate increases in mortgage loan rates, there does not appear to be a market crash in sight, and the most logical explanation is the lack of supply. While the numbers are beginning to show an increase in the market supply, sellers are still in the driver's seat, and since they had the ability to lock in mortgage rates at a much lower level, there is no reason for them to aggressively sell their homes if not needed. *What does this add up to?* **It adds up to slower markets with less available supply, and sellers not budging.** According to Rocket Mortgage, one of the largest mortgage originators in the United States, **Riverside County still lands in the "Seller's Market"** category, meaning that buyers are still having a tough time to locate affordable housing and find access to desirable homes.

To gain perspective on how housing has exploded in price over the past 30 months, according to Realtor.com the **median pre-pandemic price of a house in Riverside cost approximately $424,500 versus the current price of $558,000** (a 31% increase since the start of the pandemic). While some forecasters are predicting a 5% drop in prices[3] from current levels, that would still leave a large increase since the start of the pandemic. Whether or not those drops materialize is more related to interest rates than anything else. The Fed has increased the Fed Funds Rate, which is the basis for all other loans, and has signaled that additional increases are coming.

In its December 2022 forecast, UCLA Anderson gave two potential scenarios regarding the upcoming direction of the economy both in California and nationwide. At this point they have much uncertainty about the path that we will take and it is mostly based on the position of the Fed moving forward. **Should the Fed take a looser approach, with respect to easing of interest rates, UCLA predicts a lesser chance of a recession. However, should the Fed remain steadfast in the tighter monetary policy, with continued increases, then a recession is likely.**



Economists are torn as to what path the Fed will take and what reaction the markets and the U.S. economy will set on in the near future. At this point, until more data is known, specifically with respect to the jobs numbers, there is little to be gleaned from metrics that are out there. Everything being measured at this stage shows a very strong economy with little slow down happening at the moment.

In order for the Fed to flinch and change posture on their mission of raising interest rates, there needs to be a showing of slowdown in both the employment numbers and the wage growth rates. Without a slowdown in both of these metrics, there may be a continued march upward in the Fed Funds Rate and, subsequently, the cost of borrowing across all of the economy from mortgage rates to auto loans. The next few data points will be telling as to what path the Fed will take moving forward.

[3] Forbes: https://www.forbes.com/advisor/mortgages/real-estate/housing-market-predictions/

GENERAL FUND REVENUE

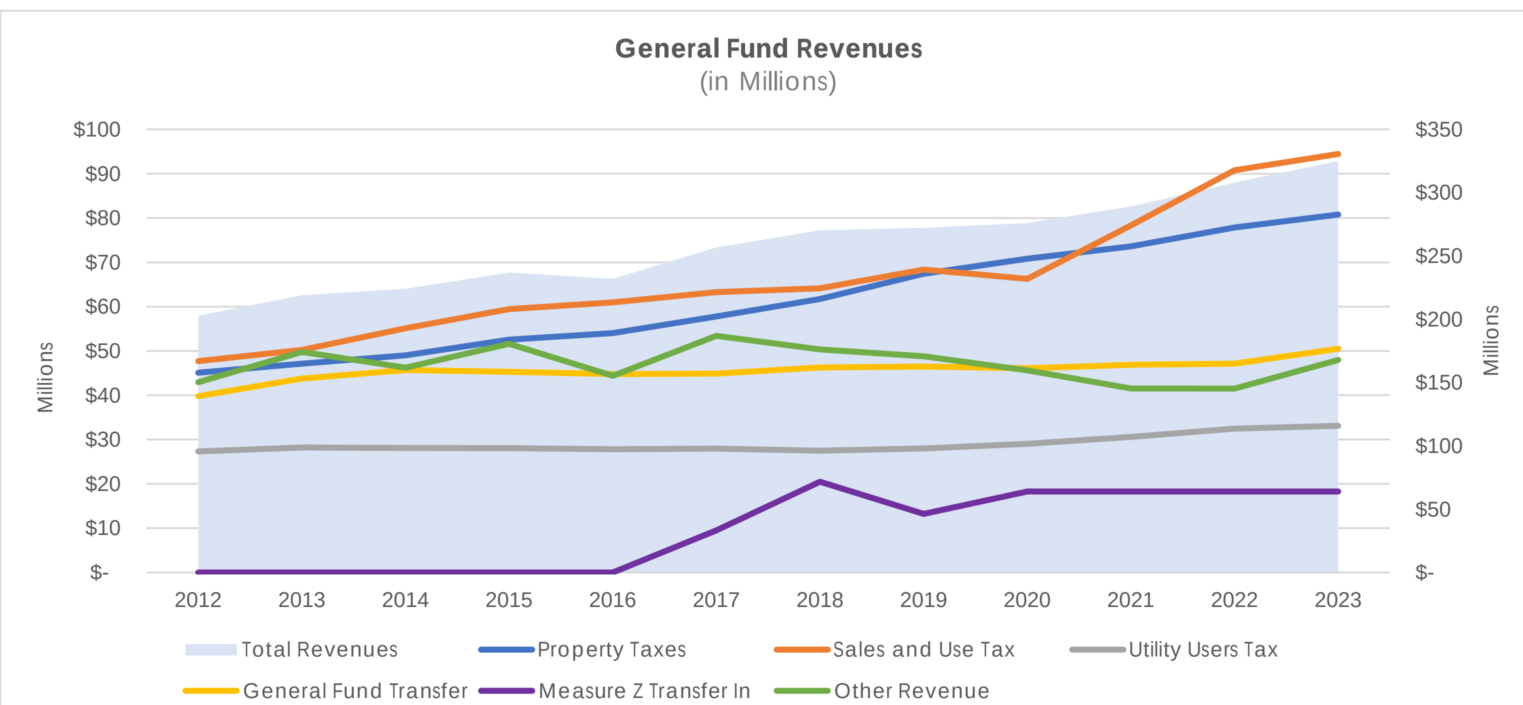
Budgeted revenue projections for FY 2022/23 were prepared in the Spring of 2022, several months prior to budget adoption in June 2022. Final sales and property tax payments for FY 2021/22 were received in late September 2022. The mid-cycle update of the FY 2023/24 budget began following an audit of the City's finances and considers FY 2021/22 actual revenues as well as fiscal year to date revenue performance.

Sales and property tax account for more than half of all General Fund revenues. Sales tax revenue in the General Fund has increased by 33% since FY 2018/19, an unexpected result of the shift in consumer buying habits during the Covid-19 pandemic, and more recently, inflation. Revenues through December 2022 show the increase remaining intact and HdL, the City's sales tax consultant, predicts a potential 4.1% growth over FY 2021/22 based on performance through September 2022. As a result, sales tax revenue projections have been increased by nearly $11 million. Property tax projections are adjusted upward by approximately 2% ($1.5 million) based on strong home sales and higher sales prices in the previous 18-24 months. In other revenues, Transient Occupancy Tax is trending 18.4% higher than original projections as travel and entertainment recover post-pandemic, and Business Tax revenue is continuing to perform well, trending 5% above prior year actuals. Overall, revenue projections for the General Fund are increased by 4.6%, or $14.41 million.

UPDATED REVENUE PROJECTIONS – FY 2022/23

(in millions)	Adopted Budget	Projected	$ Change	% Change
Property Taxes	$ 79.28	$ 80.78	$ 1.50	1.9%
Sales and Use Tax	83.51	94.44	10.93	13.1%
Utility Users Tax	32.80	33.10	0.30	0.9%
Transient Occupancy Tax	7.10	8.41	1.31	18.5%
Licenses & Non-Developer Permits	8.98	9.48	0.50	5.6%
General Fund Transfer	50.81	50.50	(0.31)	-0.6%
All Other Revenues	48.15	48.33	0.18	0.4%
Total Revenues	**$ 310.63**	**$ 325.04**	**$ 14.41**	**4.6%**

Revenue recovery from the Great Recession exceeded ten years and contributed to General Fund revenue growth not keeping pace with rising costs. For nearly all of the City's history, sales tax was the City's primary revenue source, but after years of stagnated growth, in 2020 property tax overtook sales tax as the City's largest revenue source. With the shift in consumer spending and recent inflation, sales tax is once again the General Fund's primary revenue source, but this may be a one-time shot in the arm; property tax is projected to grow at a faster pace than sales tax for the foreseeable future. The chart below demonstrates historical and projected growth (left axis) against a backdrop of total General Fund revenues (right axis).



GENERAL FUND EXPENDITURES

The adopted expenditure budget included appropriations of $306 million; this amount did not include the potential impacts of ongoing negotiations with the City's labor unions. Through December 2022, negotiations concluded with seven of the nine labor unions, with salary and benefit increases approved for each, as well as for the unrepresented employee groups. Projected impacts of nearly $17 million were recorded as of second quarter-end, inclusive of $9.8 million in one-time stipends. This projected increase is offset by anticipated personnel savings due to the average 18% vacancy rate General Fund departments experienced for the fiscal year to date. The Amended Budget in the chart below includes prior encumbrances and carryovers of $9.8 million. Projected savings as of the second quarter end total approximately $9 million. Recommended mid-cycle adjustments totaling $21.11 million are not included in the table below.

EXPENDITURE PROJECTIONS – FY 2022/23

(in millions)	Adopted Budget	Amended Budget	Projected	$ Change	% Change
Personnel	$217.56	$234.47	$224.47	($10.00)	-4.3%
CalPERS UAL	16.21	16.21	16.21	-	0.0%
Non-Personnel Costs	64.91	75.86	76.62	0.76	1.0%
Debt Service	32.94	32.94	32.94	-	0.0%
Charges To/From	-39.55	-39.58	-39.58	0	0.0%
Transfers & Subsidies	13.6	13.6	13.85	0.25	1.8%
Total Expenditures & Transfers Out	**$305.67**	**$333.50**	**$324.51**	**($8.99)**	-2.7%

MID-CYCLE ADJUSTMENTS

The $14.41 million increase in revenue projections and $8.99 million in projected expenditure savings presents an opportunity to allocate funding toward needs identified during the mid-cycle budget review, as illustrated below.

- **Utility costs** for water, natural gas, refuse, and fuel are trending higher than prior years; an additional appropriation of approximately $1.6 million will bring the budget in line with projected actuals.
- **General Fund capital investment** of approximately $12.55 million is recommended to be allocated to street projects, replacement of the City Hall transfer switch, and generator replacements at the City's fire stations and Magnolia police station.
- **Other needs** include increased costs in County Animal Control services and the fiscal impact of security, vandlism, and theft at the Hertigate House and City properties related to Parks.

$7 million of the General Fund's $20,6 million Infrastructure Reserve will be allocated to the Refuse Fund and Public Parking Funds for critical needs; the reserves and user fees of those funds are insufficient to support their needs. The $2 million to the Public Parking Fund wil be structured as an interfund loan.

Utilities
$1,595,000

$725,000

$120,000

$110,000

$640,000

Capital Investment
$19,550,000

$11,700,000
Streets & Medians

$850,000
Switch & Generators

$1,930,000
4 Refuse Trucks

$3,070,000
6 Street Sweepers

Other Needs
$1,875,803

$800,000
Animal Control

$900,000
Vandalism & Theft

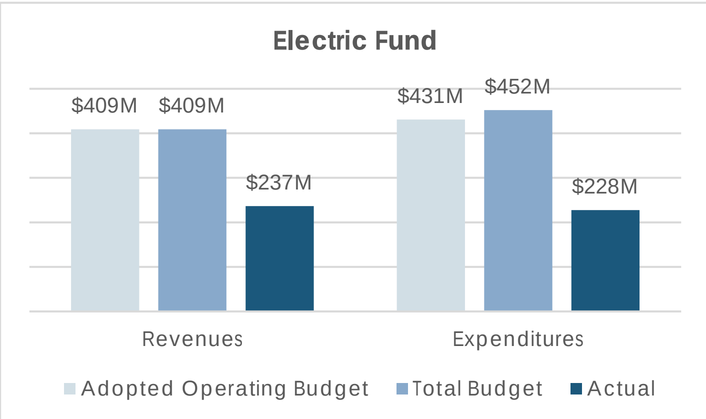
$175,803
Other Miscellaneous

$2,000,000
Parking Garage Maintenance

ENTERPRISE FUNDS

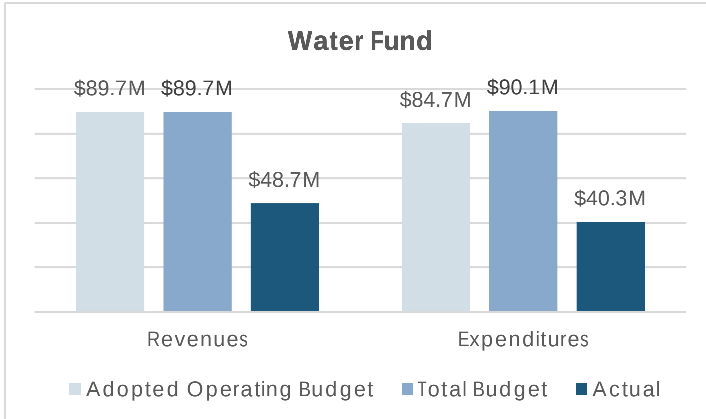
Electric Fund

The amended budget for the Electric Fund projects a $43.0 million draw on reserves. This is a financial strategy employed to draw reserves down to keep rate increases as low as possible; reserves are expected to remain within policy levels at fiscal year-end. As of the end of the second quarter, Electric operating revenues are at 57.9% of budgeted projections and expenditures are 50.3% of the total budget. Personnel savings are anticipated due to a 20% vacancy rate and will offset excess power supply costs. No mid-cycle adjustments are recommended.



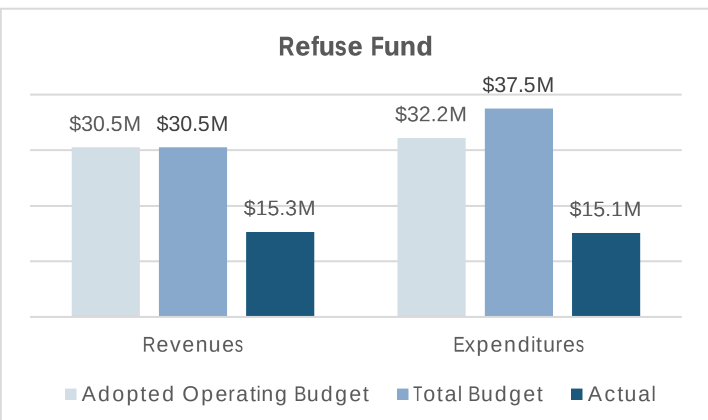
Water Fund

The Water Fund is projected to achieve an operating break-even at fiscal year-end, with revenues and expenditures nearly equal to each other. Revenues are currently 54.2% of budgeted projections; expenditures are 44.7% with projected personnel savings due to a 10% vacancy rate. A mid-cycle adjustment of $1.5 million is recommended to record the estimated impact of salary and benefit increases approved by the City Council during through the second quarter of the fiscal year.



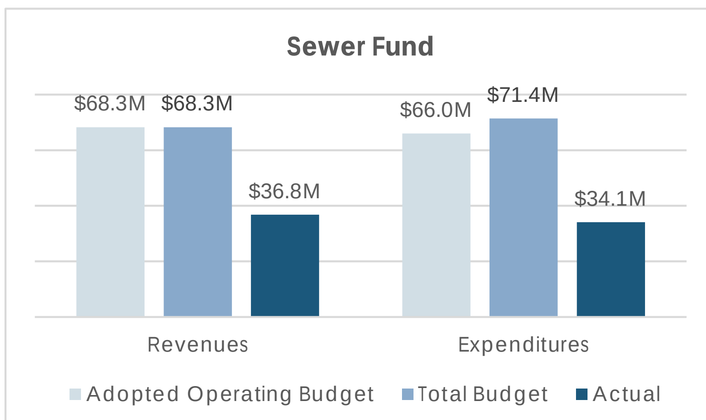
Refuse Fund

Second quarter analysis projects a potential $1.5 million operating loss for the Refuse Fund as user rates are not keeping pace with operating expenses. Approved by the City Council on February 7, 2022, a $2 million allocation of revenue loss funding from the American Rescue Plan Act (ARPA) will offset the operating loss; however, the structural deficit will remain in the absence of rate adjustments. Council also approved $4 million in ARPA funding to purchase refuse trucks. Staff recommends allocating $5 million from the General Fund Infrastructure Reserve toward the purchase of street sweeping and refuse trucks. The outcome of this action is that general tax revenue will be used to subsidize a rate-based service.



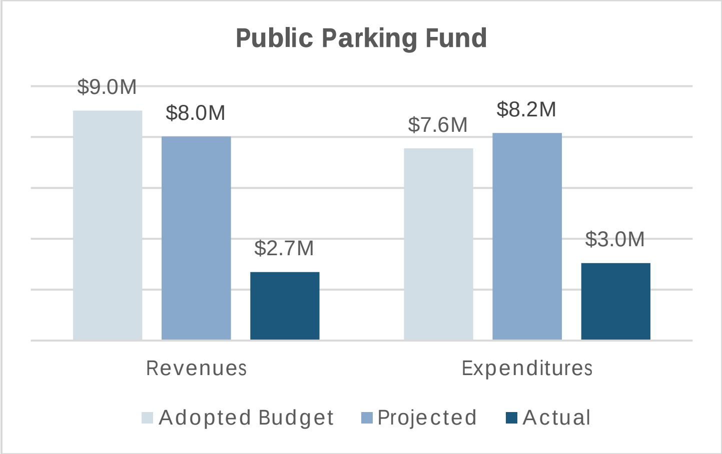
Sewer Fund

The FY 2022/23 adopted budget projected a net operating gain of $2.3 million. The amended budget projects a net operating loss of $3.1 million due to $3.8 million of encumbrances carried forward from FY 2021/22 and $1.6 million in increased appropriations from approved salary and benefit increases. There are sufficient reserves to cover the potential operating loss. Although inflation is negatively impacting contract costs related to construction materials, chemicals, and fuel, personnel savings resulting from a 19% vacancy rate are expected to offset the increased costs. Staff will monitor and rebalance spending as necessary to remain within the appropriations limit without impacting operations.



Public Parking Fund

Parking Fund reserves at the beginning of FY 2022/23 total $3.1 million. On July 19, 2022, the City Council directed staff to reinstate the parking program rates and hours of operation in place prior to July 1, 2022. On September 6, 2022, the City Council directed staff to bring back the amended parking rates and hours schedule by the end of March 2023. On February 7, 2023, the City Council approved an allocation of $1.5M in ARPA revenue replacement funds, which will help to maintain fund reserves while rate increases are reconsidered. Updated projections in the chart to the right reflect the rescinded rate increase, ARPA allocation, impact of salary and benefit increases, and deferred expenses. A $2 million interfund loan from the General Fund, repayable from future rate revenue, will allow staff to address critical structural and maintenance needs at Garages 1 and 2.



Measure Z Funds

Like the General Fund, Measure Z is benefitting from extraordinary sales tax gains, with FY 2021/22 revenues coming in 33.5% higher than FY 2018/19 pre-pandemic revenues. However, the revenue growth is expected to flatten: HdL projects a mere 1.2% growth in FY 2022/23 revenues as compared to the prior year. With this new basis and the future growth projections, staff is aniticipating an additional $32 million in sales tax revenue over the term of the five-year spending plan as compared to the Spending Plan projections presented with the adopted budget. Additionally, the $6.5 million in contingency funding set aside as a City match for a Library Infrastructure grant has been returned to unallocated reserves; the grant was not awarded to the City. City staff will return with a project update and a request to complete the anticipated Eastside Library project. As of the second quarter end and this mid-cycle update, unallocated reserves in the Measure Z fund are projected to reach $36.7 million by the end of FY 2026/27. Staff is evaluating citywide needs and will bring forth recommendations for the allocation of these reserves at a future date.

MEASURE Z SPENDING PLAN

(in millions)	2023 Projected	2024 Projected	2025 Projected	2026 Projected	2027 Projected
Revenue	$ 84.43	$ 84.45	$ 86.69	$ 88.42	$ 90.17
Expenditures	(89.55)	(90.80)	(90.16)	(92.42)	(93.53)
Encumbrances & Carryovers	(32.43)	-	-	-	-
Net Change in Fund Balance	**$ (37.55)**	**$ (6.35)**	**$ (3.47)**	**$ (4.00)**	**$ (3.36)**
Beginning Unallocated Fund Reserves	$ 91.39	$ 53.84	$ 47.49	$ 44.02	$ 40.02
Net Change in Fund Balance	(37.55)	(6.35)	(3.47)	(4.00)	(3.36)
Ending Unallocated Fund Reserves	**$ 53.84**	**$ 47.49**	**$ 44.02**	**$ 40.02**	**$ 36.66**

CalPERS and the Unfunded Accrued Liability (UAL)

In July 2022, CalPERS anounced prelliminary investment returns of -6.8% – a significant loss that will negatively impact employers' required UAL payments. CalPERS later disclosed its final 2022 investment losses at -7.5%. The losses will impact the City in FY 2024/25 and onward, with required UAL payments higher than those currently provided for in the General Fund five-year financial plan. The long-term plan includes contributions and withdrawals from the Section 115 Trust that smooths payments at $38 million annually for twelve years.

Required UAL payments are based on an assumed annual investment return of 6.8%, referred to as the discount rate. CalPERS' current year investment returns are currently lagging at 0% year-to-date. A second year of investment returns below the discount rate of 6.8% will further increase the City's required UAL payments. Staff is working with an actuary to identify potential funding scenarios to be included in the mid-cycle update of the adopted FY 2023/24 budget.