QUARTER ENDING MARCH 31, 2023

CITY OF RIVERSIDE FISCAL UPDATE

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EXECUTIVE SUMMARY

The past few years have presented a unique and mixed economy at all levels – global, national, and local, with varying impacts depending on the characteristics at hand. As a major supplier of essential commodities, education, housing, and workforce for the Southern California region, the City of Riverside experienced a temporary drawback in some revenue streams, offset by a significant growth in sales tax. The new basis of sales tax revenue has corrected a years-long structural deficit in the General Fund and is allowing the City to look toward the future and address neglected critical needs such as streets projects, vehicle and equipment replacement, and maintenance of City facilities.

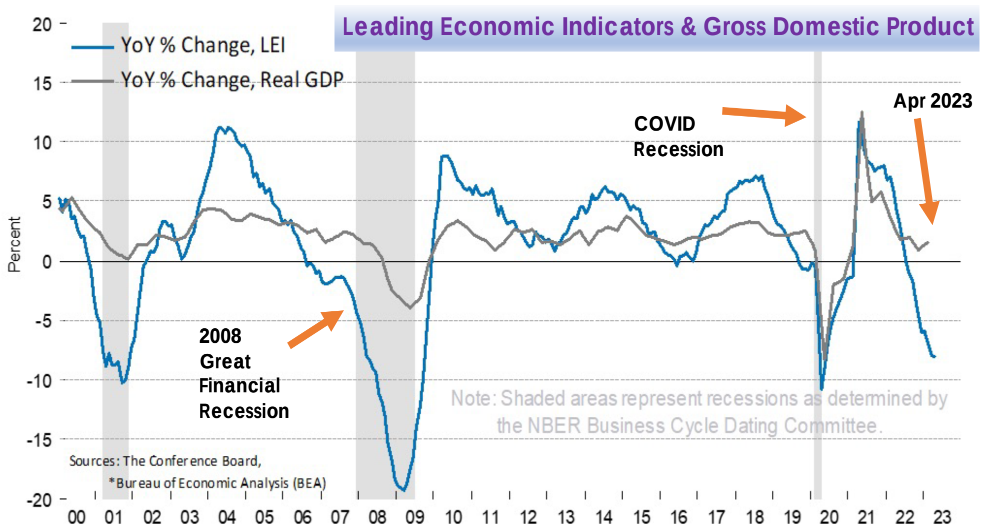
The economy remains mixed, with the traditional indicators of inflation behaving unlike anything seen in past recessions. The Federal Reserve has continued to increase interest rates in an attempt to curb inflation, with some success, although the correction has been gradual thus far. Prices remain high in food, housing, and healthcare, placing pressure on the general population. Spending is shifting from high-cost items to necessities; this change is expected to cause sales tax to flatten. The Fed is currently warning of a mild recession later this year.

At the State level, California is projecting a significant budget deficit following two years of record surpluses. The deferral of income tax filings to next fiscal year is playing a part in the projected deficit. California's largest revenue sources are personal and corporate income tax, followed by sales tax. The State's budget issues are unique to the State level; the City's largest revenue sources are property and sales tax, neither of which are impacted by the State's income tax extensions.

ECONOMIC INDICATORS

THE ECONOMY: TAKING A BREATHER

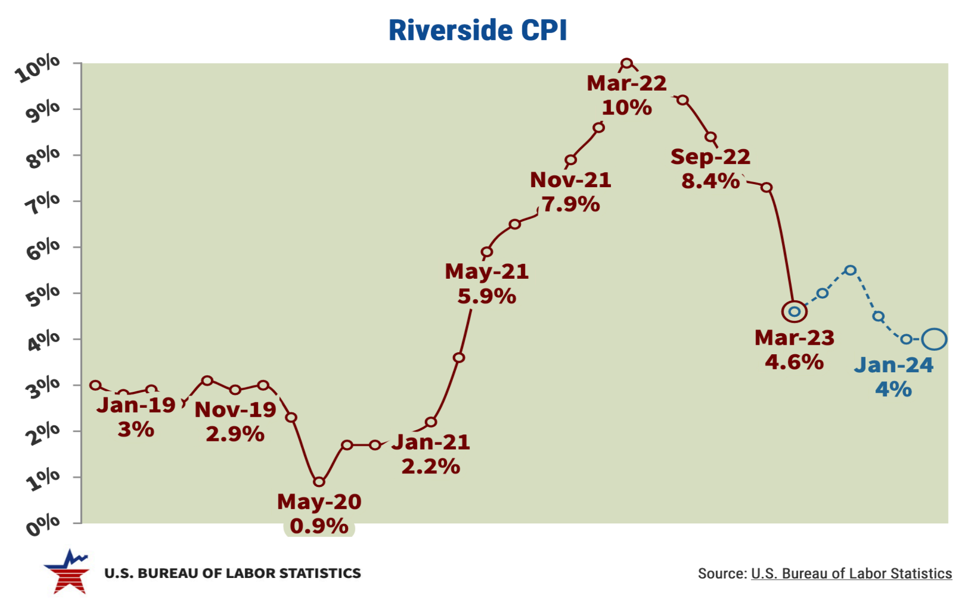
The years leading out of the COVID recession illustrated that the pandemic has thrown this global economy a major curveball. Having never gone through this in a modern world, substantial fiscal and monetary measures were implemented to support the **global economy**. While these actions successfully supported fragile markets, the consequences of excessive spending and borrowing are now becoming evident, both on the government spending side of the equation, and on consumers' pocketbooks through inflation. The Federal Reserve (Fed) has undertaken a strong position against the increasing backdrop of inflation; however, the goal of overall economic slowdown has been illusive and slow to materialize.



An index that has very good forecasting track record of economic output is the Conference Board's Index of Leading Economic Indicators (LEI). **This is a very early measurement of significant turning points in the business cycle that can indicate where the near-term direction of the economy is heading**.

In the graphic on the left, the LEI is plotted against the Gross Domestic Product (GDP), which is a measure of the total value of goods and services produced within a country. The graphic shows a very severe slowing of the business cycle and the subsequent lagging of the GDP following closely behind this trend. While not a surefire predictor of what will come, it is important to grasp and understand the potential implications of a contracting business cycle and its ripple effects on the economy as a whole. The Federal Reserve Bank of Chicago has released its Beige Book[1], a bimonthly summary of economic condition on May 31, 2023. The picture was mixed. Four of the Federal Reserve Districts showed a slight increase in economic activity, two showed a slight decrease, and six showed no change. The **overall measure of inflation suggests some easing of pressures on supply chains and manufacturing activity. One positive factor contributing to the inflation picture is employment, indicating an area of tight supply.** Employment remains a priority for the Fed in assessing how inflation will move in the near future. With tight supply in the job market, there is little reason for wage pressures to decrease, thereby holding the inflation figures higher than their target rate of 2%.

Another factor that is being watched is residential housing prices. While the lifting of interest rates capped the price growth that was the norm over the past few years, the supply of available housing remains extremely low, not just in costly real estate centers like California, but nationwide. Any future easing of interest rates will most likely trigger higher home prices, building on the pricing advances the housing market experienced during the Covid rebound.

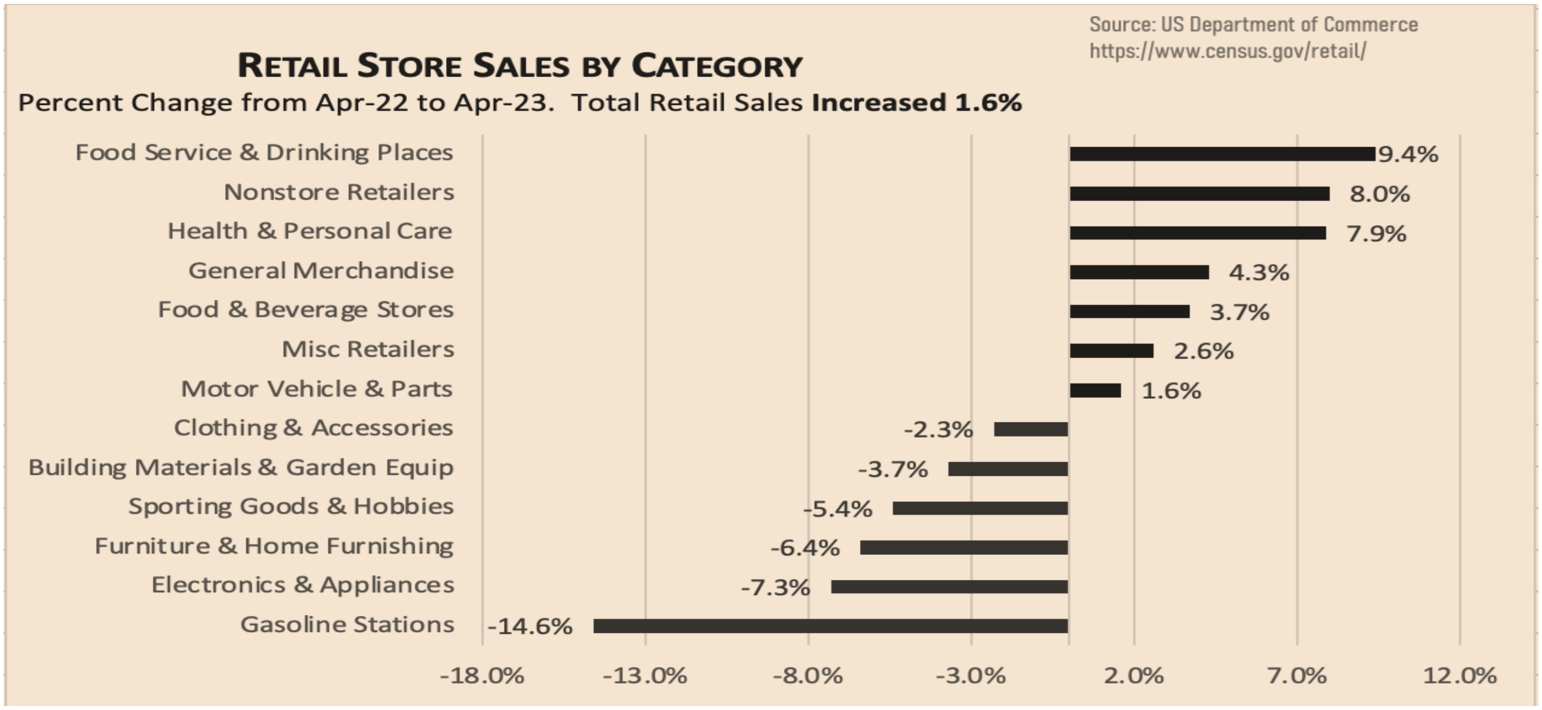


The Consumer Price Index (CPI) pictured at the right is continuously on the minds of the government and public alike. The CIP growth rate of previous highflyers of inflation (energy, food, & transportation) have slowed as compared to the previous year. While not yet in the realm of deflation, a leveling off in the growth rate is welcome news. One of the risks that the Fed must balance is entrenched inflation alongside a sputtering economy, commonly known as stagflation. This is the worst of both worlds as the buying power of businesses and consumers is eroded alongside an economy that shows little to no growth. It is something to watch out for in the near future.

[1] https://www.federalreserve.gov/monetarypolicy/beigebook202305-summary.htm

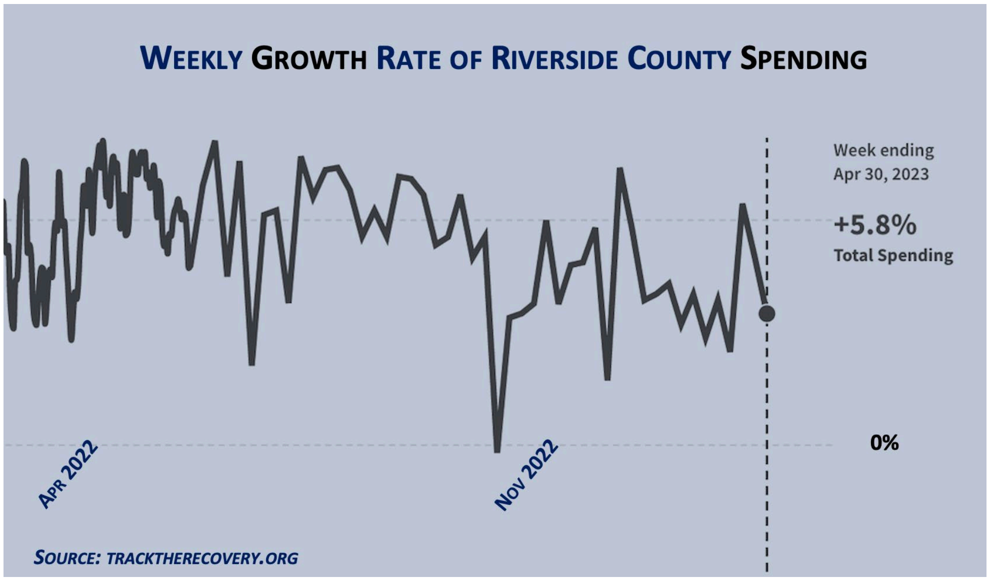
SALES TAX OUTLOOK: A PAUSE IN GROWTH OR DECLINE?

Sales tax revenue for the City is maintaining the large gains starting from the COVID lows. Currently, Fiscal Year (FY) 2022/23 is on track to post a 2.6% increase over the prior fiscal year. The current outlook for Riverside, the state of California, and the United States economy is that consumer spending should hold up and sustain the gains made during the pandemic. HdL has projected with the most recent quarter of data (Oct-Dec 2022) that the next fiscal year (2023/24) may present a flat or nominal gain in sales tax revenue for the City. The chart below shows that overall retail sales are up nationwide 1.6% as compared to April 2022. While these gains appear large, a tired consumer is beginning to pull back on spending.



While spending in some of the categories listed in the chart above has flatlined, the overall prices have declined from their red-hot increases over the past 24 months. The Consumer Price Index (CPI) is beginning to pull back from the effects of a slowing economy thrust forward with the Federal Reserve's aggressive interest rate increases. The cooling of inflation should continue; however, that is all data dependent. The Fed's continued tightening policies will impact sales tax outlook for the next six to twelve months. While there appears to be a slowing in consumer spending, the overall spending picture in Riverside County is flat to low spending growth.

The chart on the right shows the overall spending picture in the County, and while the trend is definitely slowing, we have not seen a negative weekly growth rate number since November 2022. This illustrates that, even though the consumer is tiring, they are not putting a stop to spending. With the two data pieces above, we can see that overall spending is still there. Dollars are being shifted to other parts of the economy in order for consumers to get more bang for their buck and shifting away from big ticket items (furniture, electronics, etc.) towards consumption items like restaurants, non-store retailers (Amazon), and health and personal care. Consumers have not stopped spending, but rather are just being more selective about where they spend their money.

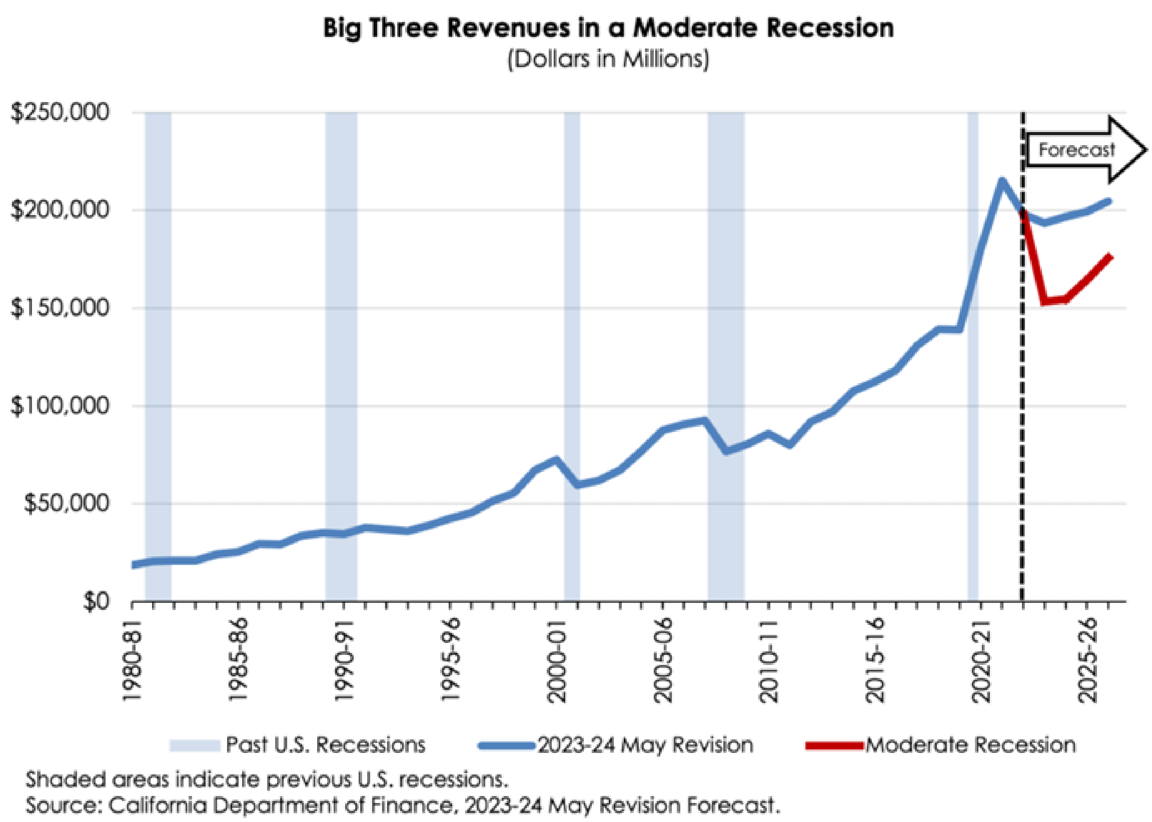


STATE BUDGET UPDATE

STATE BUDGET UPDATE

On May 12, 2023, the State of California provided a revision of the Governor's budget for FY 2023/24. The overall message was one of revenue that is projected to miss the budgeted targets. The current projected deficit shown in the latest update points to a $31.5 billion shortfall from a previously projected $22.5 billion in January 2023. The State's issues arise from a lowered outlook of Personal Income Tax, Corporate Income Tax, and an extension from April 15, 2023 to October 15, 2023offered by the Internal Revenue Service (IRS) for tax filings. Subsequently, California offered the same extension for state income tax filing for those impacted by the severe winter storms experienced by Californians in December and January. This has had an effect of delaying some of the revenue that the State would have normally collected by this time in the fiscal year. Personal Income Taxes accounts for 40% of the total state revenue, making it the largest portion of the state's revenue stream. The State attributed the revenue shortfalls to continued pressure on high earners and a significant downturn in the stock market which have negatively impacted the Personal Income Tax receipts in FY 2023/24 (and most likely the upcoming Corporate Income Tax Receipts to be received in October 2023).

Two of the State's top three revenue sources (Personal Income Tax & Corporate Income Tax) have been delayed until October (the third revenue source is Sales Tax). The City's revenue stream differs greatly from the State, in that Property and Sales Tax, both of which are not impacted by the IRS directives, have had no delays, and run on a completely predictable schedule, which allows for a smooth revenue forecast and collection. **Based on the City's major revenue sources, there is no expectation that the City could follow the same deficits that the State is currently experiencing.**



The budget update can be read in its entirety on the state of California's Budget webiste:

https://ebudget.ca.gov/budget/2023-24MR/

GENERAL FUND

Overview

The third quarter analysis presents a positive outlook for the General Fund for FY 2022/23 which will assist the City with confronting an expected flattening and potential downturn in revenues in the next fiscal year. With the second quarter financial report, staff increased General Fund revenue projections by 5% based on a two-year shift in sales tax revenues produced by the pandemic and change in consumer spending, as well as the recovery of other revenues to pre-pandemic levels. Current year revenues are expected to grow by 4% over the prior fiscal year and flatten next year.

In April 2023, the Federal Reserve cautioned that the U.S. economy is headed for a "mild recession" and further stated in May 2023 that "Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation." While sales tax revenue is still buoyed by inflation this year, the Federal Reserve continues to take action to correct inflation through the adjustment of interest rates. Higher interest rates make borrowing more expensive for individuals, dampening the prospects for large purchases, such as housing, home improvements, vehicles, and travel, all of which are factors that impact the City's property and sales tax revenue. These two revenue sources account for more than half of the General Fund's annual revenue.

As of the third quarter end, the General Fund appears poised to end the fiscal year with a net gain of approximately $13.85 million, inclusive of American Rescue Plan Act revenue replacement funds totaling $15.9 million. Staff recommends replenishing the Infrastructure Reserve ($7 million) and establishing a Technology Reserve ($3 million) from the projected gain.

GENERAL FUND OUTLOOK

(in millions)	**Adopted Budget**	**Quarter 2 Projection**	**Quarter 3 Projection**
General Revenues	$ 310.63	$ 325.04	$ 325.13
American Rescue Plan Act	-	-	15.91
Use of Infrastructure Reserve	-	-	7.00
Total Revenues and Other Resources	**$ 310.63**	**$ 325.04**	**$ 348.04**
General Expenditures	(305.67)	(311.42)	(314.10)
Fund Subsidies	(12.70)	(13.09)	(13.09)
Use of Infrastructure Reserve	-	-	(7.00)
Total Expenditures and Transfers Out	**$ (305.67)**	**$ (324.51)**	**$ (334.19)**
Surplus/(Deficit)	**$ 4.96**	**$ 0.53**	**$ 13.85**
Replenishment of Infrastructure Reserve			$ (7.00)
Establish Technology Reserve			(3.00)
Projected Fiscal Year End Surplus/(Deficit)	**$ 4.96**	**$ 0.53**	**$ 3.85**

Revenue

Revenue projections were increased in the second quarter by $14.41 million based on FY 2021/22 fiscal year end results that provided a new foundation for current year revenue projections. However, the one-time anomaly in the sales tax trend has concluded, with the current year expected to produce much slower growth as compared to the previous two years, and zero growth expected next year. In total, current year revenues are anticipated to grow by 4% over prior year actuals. The third quarter update adds $15.91 million in American Rescue Plan Act revenue replacement funds to the revenue projections.

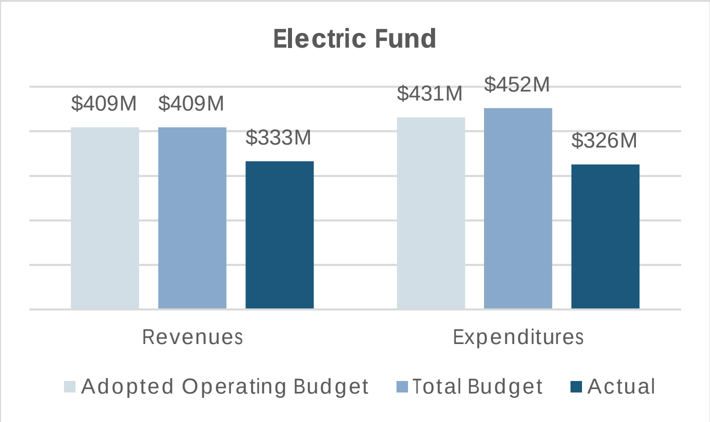
Expenditures

The second quarter update leveraged higher revenue projections and projected personnel savings to fund $16.02 million in additional spending. The allocation allowed the City to address rising costs and capital needs, including $10 million toward street projects. The City Council also approved the allocation of $7 million of the General Fund's Infrastructure Reserve to support the capital needs of the Refuse Fund ($5 million for refuse trucks and sweepers) and the Parking Fund ($2 million structural maintenance).

ENTERPRISE FUNDS

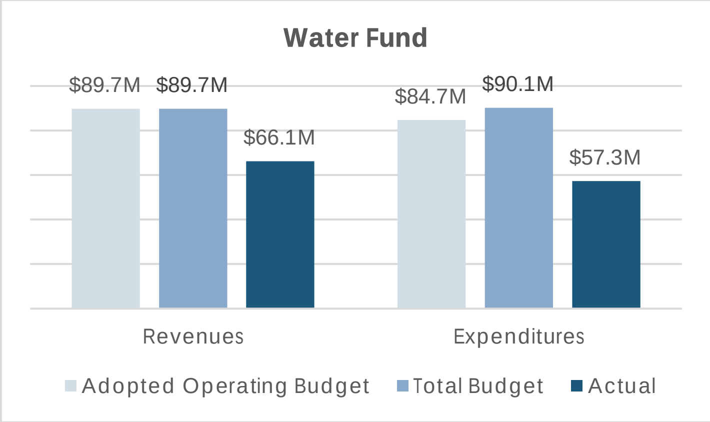
Electric Fund

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 third quarter, Electric operating revenues are at 81% of budgeted projections and expenditures are 72% of the total budget. Personnel savings due to a high vacancy rate are anticipated to offset excess power supply costs which are rending 12% higher than budget.



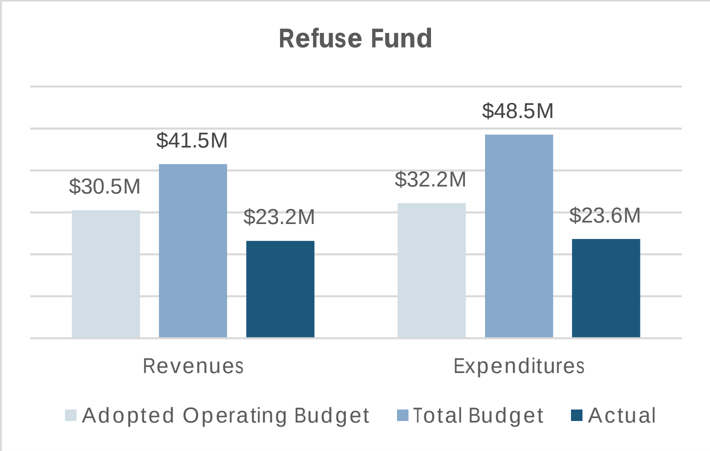
Water Fund

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 lagging through the third quarter as drought conservation and increased precipitation are causing reduced demand from other utilities. Revenues are currently 74% of budgeted projections; expenditures are 64% with projected personnel savings due to a 10% vacancy rate. The lower revenue projections are expected to be largely offset by personnel savings.



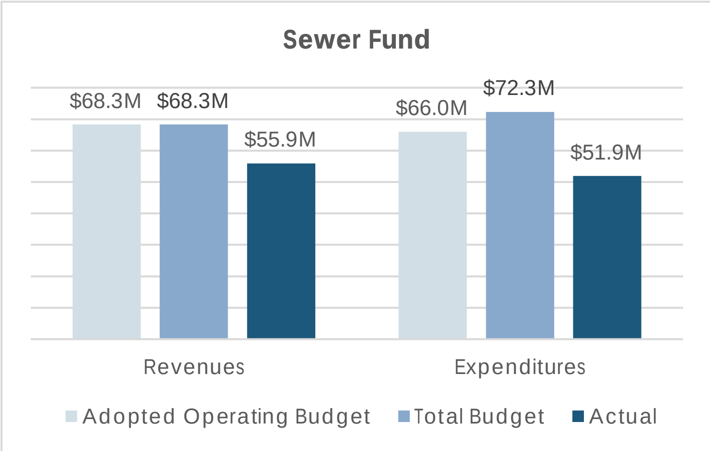
Refuse Fund

The adopted budget for the Refuse fund projected a draw on fund reserves of approximately $1.7 million due to a decline of recycling revenues precipitated by a reduction in industry demand, rising recycling costs, increased tonnage, and anticipated increases in parking fines assessed for street sweeping; updated projections as of the end of the third quarter present a net operating loss of $2.4 million with the addition of the fiscal impact of MOUs. On February 7, 2023, the City Council approved an allocation of $2 million in American Rescue Plan Act (ARPA) revenue replacement funds, which will partially offset the projected loss.



Sewer Fund

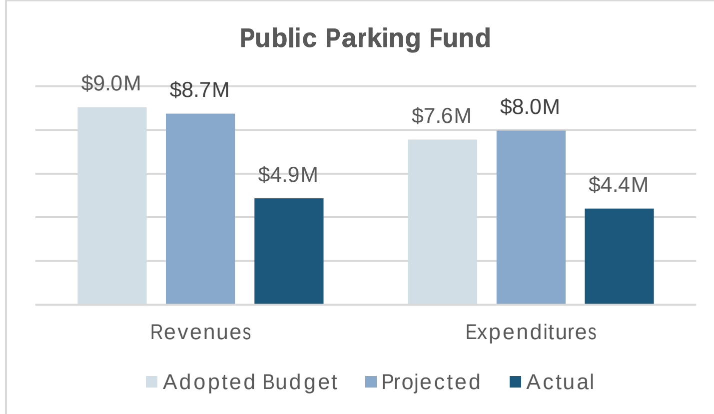
The FY 2022/23 adopted budget projected a net operating gain of $2.3 million. Based on an analysis of performance to date, the Public Works Departments projects that the Sewer Fund is on track to exceed revenue projections by $6.7 million, primarily attributable to higher than anticipated sewer connection fees from two large housing developments. At the end of the third quarter, 82% of projected revenues have been recorded. Operating expenditures are 72% of total budget at the end of the third quarter. Personnel savings of approximately $3 million are anticipated due to a vacancy rate of nearly 21%, partially offset by overtime costs.



OTHER FUNDS

Public Parking Fund

Parking Fund reserves at the beginning of FY 2022/23 total $3.1 million. Third quarter analysis presents a net loss for the fiscal year of nearly $500,000. On February 7, 2023, the City Council approved an allocation of $1.5 million in ARPA revenue replacement funds. On April 18, 2023, the City Council approved a new Parking Rate and Hour Schedule effective July 1, 2023 which is expected to begin generating a net gain for the fund in FY 2024/25. Parking revenues were adopted with the new rates and were subsequently reduced by $2.6 million to account for the rescinded rate increase. Third quarter projections reveal a potential shortfall of $700,000 in projected revenues due to the negative impact of a high vacancy rate on parking citation revenues.



Measure Z Funds

Measure Z has benefitted from the two-year anomaly in sales tax growth produced by a shift in consumer spending habits during the pandemic and bouyed by inflation. The adopted revenue projections were based on the FY 2020/21 sales tax growth of 15%. Since budget adoption, FY 2021/22 sales tax grew another 15%; incorporating this growth into the revenue projections for the second quarter report resulted an estimated $32 million in new revenue through FY 2026/27. Recommendations for the use of the new revenue are forthcoming in the FY 2023/24 proposed amended budget and stand-alone reports to City Council. If all proposed adjustments are approved, unallocated fund reserves will be drawn down to an estimated $8.61 million by the end of FY 2027/28 as shown below.

MEASURE Z SPENDING PLAN

(in millions)	2023 Projected	2024 Projected	2025 Projected	2026 Projected	2027 Projected	2028 Projected
Revenue	$ 84.43	$ 84.46	$ 86.69	$ 88.41	$ 90.18	$ 91.97
Expenditures	(96.51)	(96.25)	(92.54)	(96.82)	(99.15)	(95.22)
Net Change in Fund Balance	**$ (12.08)**	**$ (11.79)**	**$ (5.85)**	**$ (8.41)**	**$ (8.97)**	**$ (3.25)**
Beginning Unallocated Fund Reserves	$ 58.96	$ 46.88	$ 35.09	$ 29.24	$ 20.83	$ 11.86
Net Change in Fund Balance	(12.08)	(11.79)	(5.85)	(8.41)	(8.97)	(3.25)
Ending Unallocated Fund Reserves	**$ 46.88**	**$ 35.09**	**$ 29.24**	**$ 20.83**	**$ 11.86**	**$ 8.61**

Public Safety & Engagement Team Program (PSET) - Urban & Wildlands

Individuals Accepted Service	**756**	Tons of Debris Removed by Contractors	**657**
Citations Issued	**197**	Yards of Debris Removed by Parks Staff	**161**
Arrests	**487**	Contacts with Homeless	**5,679**
Vehicles Towed	**82**	Code Enforcement Notices Issued	**1,976**