DATE: April 13, 2020

SUBJECT

Update to Preliminary Ten-Year General Fund Forecast considering potential financial impacts associated with COVID-19

RECOMMENDATION

By motion, accept the revised Preliminary Ten-Year General Fund Forecast.

STRATEGIC PLAN GUIDING PRINCIPLE

Excellence in Government Operations

BACKGROUND

Each year, staff prepare a mid-year budget update to the City Council that includes a preliminary ten-year General Fund forecast. This year, the mid-year budget update and preliminary ten-year General Fund forecast were presented to the City Council on February 24, 2020 (Attachment 1).

Subsequent to the presentation on February 24, 2020, the novel coronavirus (COVID-19) has caused a worldwide pandemic, resulting in the City having to re-examine prior forecasts. At the April 6, 2020 City Council meeting, staff provided a preliminary assessment of financial impacts associated with COVID-19. Staff committed to return on April 13, 2020 with a revised preliminary ten-year General Fund forecast. The revised preliminary ten-year General Fund forecast (Revised Forecast) is included as Attachment 2 and primarily reflects updates to revenue projections based on the estimated impacts from the COVID-19 public health emergency. Notably, the Revised Forecast does not reflect potential impacts to the City of small businesses deferring sales tax payments or increased pension payments necessitated to offset anticipated investment losses in the California Public Employees Retirement System (CALPERS). The
ANALYSIS

The City Council has a history of taking intentional, proactive, and strategic steps to ensure fiscal sustainability, including adopting a structurally balanced annual budget, funding long-term needs, and maintaining a 15 percent General Fund reserve level. In continuing these steps, staff is providing the revised preliminary ten-year General Fund forecast. This report focuses on the notable changes in assumptions from the February 24, 2020 Forecast for FY 2019-20.

In addition to continuing current City operations, the February Forecast included numerous one or two-year General Fund expenditures to address City Council priorities. The Forecast indicated a FY 2019-20 net surplus of $916,000, with operating balances in FY 2020/21 and FY 2021/22. At this time, staff currently estimates a net surplus of $7,000 for FY 2019/20, and deficits beginning in FY 2020/21 if expenditures are not modified. The chart below displays a reconciliation of the change in net surplus from February to April.

<table>
<thead>
<tr>
<th>Reconciliation of net operating balance</th>
<th>$ 916,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduction in revenue</td>
<td>(6,142,000)</td>
</tr>
<tr>
<td>Added COVID-19 costs through 3/31/20</td>
<td>(159,000)</td>
</tr>
<tr>
<td>Reduced additional discretionary CalPERS payment</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Reduction in reserve requirement</td>
<td>765,000</td>
</tr>
<tr>
<td>Reduction in department expenditures due to vacancies</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Reduced transfer out of UUT revenue to align with actuals</td>
<td>127,000</td>
</tr>
</tbody>
</table>

The Revised Forecast has been developed during a time of extreme uncertainty and does not include additional expenditures associated with the City’s response to the emergency incurred after March 31, 2020, which could be significant but are still unknown. Also, the Forecast does not assume additional Federal, State, or County revenues to offset COVID-19-related operating costs or revenue losses. Assumptions regarding revenues and expenditures are described further below.

Revenue Update
FY 2019-20 General Fund revenues and transfers in were forecast to be $165.3 million in February, but are now estimated to be $159.2 million, a decrease of $6.1 million. The chart below displays the primary variances.
Sales tax is the second largest contributor to the City’s revenue stream, representing 21 percent of General Fund revenue. Due to the Shelter in Place Order, it is anticipated that sales tax revenue could be the most negatively affected by the COVID-19 pandemic. For example, auto sales are among the top 10 sources of sales tax paid to the City and dealerships currently are permitted to repair cars, sell auto supplies, and only sell vehicles online or by phone. Restaurant activity also contributes significantly to the City’s sales tax base, and restaurant sales are expected to plummet due to requirements to provide food only for take-out or delivery. However, due to Redwood City’s diverse sales tax base, the negative impacts are partly offset by the City’s large retailers that have been deemed essential during the Shelter in Place Order, online retailers with headquarters located in Redwood City, and online retailers complying with new legislation related to the South Dakota v. Wayfair case.

Additionally, on April 2, 2020, Governor Newsom announced the State will allow small businesses (less than $5 million in taxable annual sales) to defer payment of sales and use taxes of up to $50,000, for up to 12 months. The Revised Forecast does not include the potential negative impact that this policy may have on the City’s sales tax revenue. Staff is currently analyzing impacts on sales tax revenue, in coordination with the City’s sales tax consultant and will provide an update with the Recommended Budget submitted to the City Council for discussion on June 8, 2020. At this time, a 7.6% revenue decrease is anticipated in FY 2020-21 and modest recovery after that.

Other Taxes are primarily transient occupancy tax (hotel tax) and business license tax revenue. Staff is estimating a reduction of $2.7 million in this category this year, the largest projected change in FY 2019-20. This is primarily due to reduced occupancy rates and reduced room rates currently being experienced by local motels/hotels/inn operators. Revenues are expected to increase in FY 2021-22, with an assumed 2% increase in FY 2022-23 after that.

Licenses and Permits are primarily development-related revenues, including building permits. Due to restrictions on construction activities during the Shelter in Place Order, staff is estimating a reduction in permit activity, resulting in lower-than-expected revenue of $1.2 million in FY 2019-20. Staff estimate a revenue decline in FY 2021-22 and then assume a 2% annual increase in FY 2022-23 and beyond.

Interest earnings/rentals revised revenue estimate for FY 2019/20 adjusts for an expected loss in investment earnings/fair value of $843,000. This is partly due to the current volatility in the economy and the rate of return in investments. This revenue estimate has been compiled from the respective departments and is assumed to be flat in FY 2022-23 and after.

Recreation revenues are program fees in the Parks, Recreation, and Community Services Department. Staff is estimating a reduction of $1.0 million in this category for FY 2019-20, due to the closure of facilities...
and cancellation of classes in compliance with the Shelter in Place Order. Staff anticipate revenue will return to near-recent levels in FY 2021-22 and assume a 1% increase in FY 2022-23 and beyond.

**Expenditure Update**

After accounting for mid-year budget adjustments approved by the City Council, FY 2019-20 General Fund expenditures and transfers out were forecast to be $164.4 in February, but are now estimated to be $159.3 million, a decrease of $5.1 million. Significant expenditure changes are detailed below.

- Savings associated with maintaining employee vacancies are estimated to be $3.0 million
- Contributions toward City reserves, which are determined by the amount of next fiscal year’s projected revenue, are decreased by $765,000 as projected revenue has decreased
- Added current city-wide COVID-19 operating costs through March 31, 2020 of $159,000
- Added $693,000 for additional contributions to Emergency Rental Assistance and a Small Business Assistance program
- Reduction by $127,000 of transfer out of Utility Users’ Tax revenue to align with actuals

Based on a positive operating position projected in February, staff recommended and the City Council approved several one-year or two-year expenditures to advance policy priorities, particularly around addressing unfunded liabilities, infrastructure maintenance needs, and to address increased community impacts associated with individuals living in recreational vehicles. The Revised Forecast includes most of these expenditures at the level presented in February, however, in light of the anticipated budget deficit beginning in FY 2020/21, these expenditures may need to be revisited with the Recommended Budget to be considered by the City Council on June 8, 2020. A summary of these policy-related expenditures is below and both Forecasts are provided as Attachments 1 and 2.

<table>
<thead>
<tr>
<th>Special Expenditures to Address Policy Priorities</th>
<th>February 24, 2020 Forecast</th>
<th>April 9, 2020 Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 115 Pension Trust Contribution</td>
<td>$1.1 million</td>
<td>$1.1 million</td>
</tr>
<tr>
<td>Section 115 Other Post-Employment Benefits (OPEB) Retiree Health Trust Contribution</td>
<td>$0.3 million</td>
<td>$0.3 million</td>
</tr>
<tr>
<td>Direct additional payment to CalPERS</td>
<td>$3.0 million</td>
<td>$1.5 million</td>
</tr>
<tr>
<td>Homeless/Healthy Streets/Safe Parking Initiative</td>
<td>$1.5 million</td>
<td>$1.5 million</td>
</tr>
<tr>
<td>Americans with Disabilities Act (ADA) Transition Plan</td>
<td>$1.5 million</td>
<td>$1.5 million</td>
</tr>
<tr>
<td>Climate Adaptation Initiatives</td>
<td>$1.0 million</td>
<td>$1.0 million</td>
</tr>
<tr>
<td>Transfer to Capital Improvement Program Budget for Transportation Projects</td>
<td>$2.0 million</td>
<td>$2.0 million</td>
</tr>
</tbody>
</table>

As was discussed at the April 6, 2020 City Council meeting, to develop the FY 2020/21 Recommended Budget staff will roll over the current base budget and include employee compensation changes which are effective July 1, 2020 under current bargaining agreements. Bringing together the current assumptions on revenues and expenditures, the Revised Forecast results in a deficit operating position beginning in FY 2020/21. As more is known on revenues and expenditures in the coming months, staff will recommend a Mid-year budget update to the FY 2020/21 budget by December 2020.
Potential Impacts Associated with CALPERS Investment Losses

As was noted in the April 6, 2020 report, the City can anticipate increased pension contribution requirements as a result of anticipated investment losses. The Revised Forecast has not been adjusted to address these requirements. CALPERS assumes 7 percent annual investment returns in determining the City’s annual required pension contributions. However, CalPERS is reporting a rate of return of -4.0 percent for the current year-to-date. The City’s annual required contributions will not be impacted by this potential 11.0 percent reduction until FY 2022-23.

Staff has estimated scenarios utilizing the CalPERS pension outlook tool to assist in forecasting the potential magnitude on the amount of future required contribution amounts. Three scenarios are presented below. None of these scenarios were used in developing the Revised Forecast: the Forecast will be updated later this year when CALPERS year-end investment returns are known. CALPERS will determine future City pension contributions in the annual valuations which typically are received in November.
The chart below compares the funded status of the City’s pension plans – assumed rate of return of 7 percent versus a projected rate of return of -4 percent. The initial drop in the funded status of the pension plans would be 6.8 percent, if a negative 4 percent rate of return is realized in FY 2019-20.

<table>
<thead>
<tr>
<th>Rate of Return</th>
<th>Effect on Annual Contribution Amounts</th>
<th>Effect on Total Contributions (over 20 years)</th>
<th>Effect on Funding Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>Increases from $840,000 to $4.2 million annually</td>
<td>$75.8 million</td>
<td>Decrease from 65.5% to 61.2%</td>
</tr>
<tr>
<td>-4%</td>
<td>Increases ranging from $1.3 million to $6.6 million annually</td>
<td>$119.2 million</td>
<td>Decrease from 65.5% to 58.7%</td>
</tr>
<tr>
<td>-5%</td>
<td>Increases ranging from $1.4 million to $7.2 million annually</td>
<td>$130.0 million</td>
<td>Decrease from 65.5% to 58.1%</td>
</tr>
</tbody>
</table>

The chart below displays the increase in annual required contribution amounts if a negative 4 percent rate of return is realized. Higher annual contribution amounts would begin in FY 2022-23 at $1.3 million, increasing to $6.6 million in FY 2026-27. This would result in total additional required contributions of $119.2 million over a 20-year period.
These estimated increased annual required contribution amounts will make it significantly more challenging to proceed with the City Council’s priority to pay down pension liabilities within 18 years. Given the current uncertainties related to the COVID-19 pandemic, it is expected that this priority will need to be revisited once the total economic impact of COVID-19 is quantifiable.

Summary
Ultimately, the duration and depth of the downturn will be determined by the effort required to contain the spread of the COVID-19 virus and the economic disruption that occurs during this period, both of which are unknown at this time.

Staff will continue to refine fiscal year-end projections and will include the final General Fund 10-Year Forecast in the Recommended Budget in May for City Council consideration on June 8, 2020. To the greatest extent possible, staff will continue to address the City Council’s Strategic Plan in the Recommended Budget and in the months ahead, however, ensuring essential service delivery and support for vulnerable residents will dominate staff efforts for several months to come.

FISCAL IMPACT

As described above, the City can expect significant negative impacts on City revenue related to COVID-19 and the ongoing financial implications.
ENVIRONMENTAL REVIEW

This activity is not a project under California Environmental Quality Act (CEQA) as defined in CEQA Guidelines, section 15378, because it has no potential for resulting in either a direct or reasonably foreseeable indirect physical change in the environment.

PUBLIC NOTICE

Public notification was achieved by posting the agenda, with the agenda items being listed, at least 72 hours prior to the meeting.

ALTERNATIVES

The City Council could request that staff consider additional information and assess whether adjustments are needed to the Revised Preliminary Ten-Year General Fund Forecast.

ATTACHMENTS

Attachment A – Preliminary Ten-Year General Fund Forecast presented February 24, 2020
Attachment B – Revised Preliminary Ten-Year General Fund Forecast to be presented April 13, 2020

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