CITY OF WALNUT CREEK

Agenda Item No. 3a

Agenda Report

DATE: APRIL 16, 2019

TO: CITY COUNCIL

FROM: ADMINISTRATIVE SERVICES – FINANCE

SUBJECT: 2019 FINANCIAL FORECAST – SCENARIOS

STATEMENT OF ISSUE:
The City has a history of undertaking multi-year financial forecasts as a planning tool, and at the request of City Council a new more comprehensive model has been developed. Based on direction from the Finance Committee, a forecast scenario is recommended for adoption by the City Council.

RECOMMENDED ACTION:
Receive an overview of the forecast scenarios and assumptions and adopt Scenario FC3 as recommended by the Finance Committee.

BACKGROUND:
On January 28, 2019, the Finance Committee was introduced to the new financial forecasting model and provided staff with direction on assumptions and variables to be used in building scenarios. Subsequently, on February 19, the City Council was presented with an updated pension forecast by Bartel and Associates. The Bartel information was incorporated into most of the forecast scenarios developed for Finance Committee and are further detailed below.

In the interim, staff worked with the consultant, Bob Leland of Management Partners, to develop scenarios for the Committee's consideration on April 4. Mr. Leland was hired based on his deep knowledge of economic trends facing California cities, and his expertise in building complex forecast models for many communities.

At the April 4 Finance Committee meeting, five scenarios were discussed. One scenario (Scenario A) was eliminated from consideration, given that it used CalPERS information from before the updated Bartel Associates analysis was presented to Council. The Committee selected Scenario FC3 (formerly known as Scenario B) to recommend to the Council.

DISCUSSION:
Based on Committee feedback, the remaining four scenarios have been renamed to reduce confusion. The following chart details the new naming format:

Former Name	New Name
Scenario A	None, eliminated
Scenario A.2	FC1
Scenario A.3	FC2
Scenario B	FC3
Scenario B.2	FC4

The discussion of how to best utilize the pension trust and reserves will be brought to the Finance Committee on May 7, presuming a scenario is adopted by the Council this evening. Using this two-step approach first allows the Council the opportunity to agree upon the most likely economic and expense conditions to be encountered in the next 10 years. In effect, this sets the baseline and clearly defines the budget challenges to be solved. This allows the Committee and Council to more fully explore the policy issues surrounding the use of the pension trust and reserves with more complete context. Staff found that mixing the forecast scenarios with the options for using the pension funds quickly became very complex.

Changes from the Prior Model and Forecast

The new model provides more precision within assumptions and gives more flexibility in evaluating changing trends than the prior staff-built model. Additionally, the new model is based on updated financial information inclusive of budget and labor decisions made in recent years.

When the prior forecast assumptions were loaded into the new model, the model produced comparable results with differences mainly driven by the newer base data.

Generally, the model produces scenarios reflecting an improved outlook from the forecast adopted in 2018. This is the result of several factors, primarily:

- Strong tax and departmental revenues with improved projections,
- Closing the FY 2018-20 $2M budget gap,
- New employee labor agreements which help contain salary and pension costs,
- Updated pension valuations which included investment gains, and
- Better than projected financial position at FY18 year-end close.

Assumptions

As the Committee was shown during the overview of the new model, assumptions drive the model. In addition to the detailed assumptions about CPI and other specific numbers, some key functional assumptions are noteworthy.

1. Base Data Sets Updated. All scenarios are based on up-to-date budget information, including the FY 2018-20 adopted budget, year-end results from FY18, and recently adopted labor agreements.

2. Discount Rate. As was shared with the Council, CalPERS' new Risk Mitigation strategy effectively lowers the discount rate over time, even if the actual discount rate is not officially changed. All scenarios use the updated guidance from Bartel.

3. Property and Sales Tax Projections and Recessions. In the past, the model utilized the more conservative projections for both property and sales tax created by the City's consultant,

Avenu. A separate recession model was then built to look at the impact of an economic downturn, though it was not adopted as the City's forecast. In contrast, the new model weaves a full recession into the estimate starting in FY2021, and includes the start of a second recession in FY2028. By including recession assumptions in the model, the recommended approach is to use a more moderate estimate for these key revenues, so as not to over-amplify the projected impact of a recession.

4. New Development. In the near term, projections provided by the Community and Economic Development Department were utilized. This includes the Marriott Residence Inn (160 rooms) anticipated to open in January 2020. The future Hilton Garden Inn (124 rooms) is not included in the scenarios as the anticipated opening date is uncertain at this time. For future development, the historical average number of housing units is used in all scenarios.

5. Pension Payments. The current practice of prepaying the annual amount of unfunded pension liability due to CalPERS is projected to continue. This practice secures a discount on the amount due each year it is implemented. This prepayment is from annually budgeted amounts. As noted above, no use of the pension trust or reserves are included in the scenarios. This discussion will be brought back to the Committee and Council as a separate item.

6. Reserves and Pension Trust. All scenarios presume that all current reserve policy guidelines are met, and no reserves or pension trust balances are used. This practice exceeds industry standards. This is done to illustrate the trends before any budget balancing strategies are applied, including any use of reserves or the trust.

7. Does not include Your Parks, Your Future. Given that this process is still in its formative stages, it is unknown how large a cost and over how many years it might be spread. The model is capable of adding in this or other costs as they develop.

Detailed assumptions are provided in Attachment 4 and are sorted based on the underlying driver.

Scenarios

While Scenario FC3 is recommended by the Finance Committee, Management Partners, and staff, all four scenarios are being shared with the Council to provide context about the impact a small change in assumptions can have on the scenarios. The primary factors driving cost changes are the level of cost of living adjustment (COLA) on an annual basis, and whether or not new employees (FTEs) are added.

1. COLAs: 2.0% reflects a possible scenario based on recent history of wage increases in the City, while 2.6% is the long-term average of salary increases in the Bay Area. Management Partners recommends using 2.6% as a more realistic economic assumption, given the area's high housing costs. 2.6% is also the assumption that was utilized in the prior forecast.

2. FTEs: Scenarios are presented that reflect both the option of keeping staffing levels flat and adding one new FTE each year of the forecast. This gives perspective on the range of impact to future deficits. Over time, increased population growth will likely drive demand

for services, which will increase the need for additional staff, unless service level expectations are altered. These scenarios presume no change in service levels.

The chart below maps the assumptions on COLAs and FTEs to the appropriate scenario.

FTEs	**COLA 2%**	**COLA 2.6%**
No FTE	Scenario FC1	Scenario FC3
+1 FTE	Scenario FC2	Scenario FC4

The following information is provided for each scenario in the attachments:

- Bar charts illustrating the total annual surpluses and deficits over a 10 year period (Attachment 1)
- A grid chart showing all four scenarios based on where they fall on COLAs and FTEs (Attachment 2)
- Summary of major categories of revenues and expenses (Attachment 3)
- Comparison of assumptions used in all scenarios sorted by the driver of the factor (Attachment 4)

For each scenario, a bar chart shows the 10-year trend of annual operating surpluses or deficits. It is important to note that these are not cumulative, and permanent changes made in any given year ripple through the remaining years of the forecast (the "ripple effect"). Attachment 5 is a bar chart showing how the deficit in later years is reduced by eliminating the deficit in the FY20-22 budget cycle. The budget balancing impact ripples through to FY28. This analysis is provided for the recommended option of FC3, but the principle applies to all scenarios.

For the recommended Scenario FC3, a rainbow-colored chart shows a possible range of outcomes based on varying recession strengths (Attachment 6). Green is a weak recession, yellow represents a moderate recession (which is what is assumed in the bar charts), and red is a strong recession. This demonstrates the power of the model, as well as the reality that the model illustrate trends, not fixed numbers.

The summary table gives greater detail on the changes in major categories of revenues and expenses. Again, these numbers are annual operating deficits, and are not cumulative. Part of the discussion around the trust and use of reserves will be examining the cumulative impacts and the strategies to approach them.

Recommendation

Overall, the forecast is improved and as such, Walnut Creek is in an improved position to weather the upcoming pension cost increases compared to the prior forecast. The City's healthy reserves and pension trust provide time to consider courses of action.

Scenario FC3 is recommended for Council adoption as the most likely combination of economic conditions and anticipated revenues and expenditures.

FINANCIAL IMPACTS:

Adoption of a forecast will have no direct financial impact; however, the forecast will assist in guiding future budget and financial decisions.

ALTERNATIVE ACTION:

1. Direct staff to return to Finance Committee to study additional forecast scenarios.
2. Decline to adopt a forecast scenario.

DOCUMENTS:

Attachment 1: Charts for all scenarios
Attachment 2: Grid of the scenarios
Attachment 3: Summaries for all scenarios
Attachment 4: Assumptions by driver
Attachment 5: Ripple effect for FC3
Attachment 6: Recession impact for FC3

CITY COUNCIL ACTION RECOMMENDED:

Move to adopt Scenario FC3 as the most likely combination of economic conditions and anticipated revenues and expenditures.

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