2021 CITY COUNCIL FINANCIAL FORECAST STUDY SESSION

GENERAL FUND FINANCIAL FORECAST

2021-2032

INTRODUCTION

The past year has been an unprecedented time with the Covid-19 pandemic. Every key trend that was expected in 2020 was in flux as the Nation dealt with the ever changing environment economically. Early economic forecasts predicted growth in the economy to continue into the beginning of 2020, but things quickly changed with business closures effecting different regions across the U.S. Unemployment levels took a sharp upswing from 4.4 percent in March to 14.4 percent in April. This change had a direct negative effect on the market, which dropped 20 percent initially to a bear market for the first time in eleven years. Markets stabilized at the end of the second quarter back to a bull market, attributed in part to the stimulus package and optimism about vaccine development. The US economy expanded 33.1 percent in the third quarter after dropping significantly in the second quarter. While this is a good sign, it is mainly attributed to household goods and technology. Small businesses and those in the hospitality sector have not fared as well.

Throughout the pandemic, the Federal Reserve has kept interest rates historically low, which have trickled down to historic low mortgage rates. The housing market set a record for home sales and overall the US housing market gained about $2.5 trillion in value. This trend is expected to continue into 2021. San Diego County saw an overall increase of 9.3 percent in valuation in 2020. Property assessed valuations in La Mesa were not as robust and had the lowest overall increase in the County at 4.4 percent. With the change in ownership rules with Prop 19 that went into effect in 2021, La Mesa could see the number of residents who own property under Prop 13 start to reduce in the coming years, which would increase the City's overall property valuation.

After showing positive growth over the past several years, sales tax revenues slowed the last two years and with the pandemic, decreasing 7.2 percent from the previous year. While brick and mortar sales decreased, online sales saw a robust increase of 80 percent in sales tax revenue pool sharing, which helped mitigate extreme losses for the City. Online sales trends will be watched closely as the pandemic could be the catalyst that changes the overall shopping trend of the consumer. As the economy stabilizes and more businesses are allowed to open, we expect a surge in brick and mortar shopping. Whether or not consumers give up online vs. brick and mortar remains to be seen and will be analyzed post pandemic. Cannabis related sales tax came in better than expected as well and will be continued to be analyzed to determine if these numbers are due to the pandemic or consumer acceptance of cannabis.

Overall, La Mesa continues to benefit from the current economic environment with increases in property values and property tax revenues and the consistent levels of sales and Proposition L transaction tax revenues. In 2008, the residents of La Mesa approved the Proposition L Sales Tax Measure, a general ¾ cent sales tax, in order to maintain vital city services while helping rebuild depleted General Fund reserves. Since that time, revenue received from the Proposition L Sales Tax has become an essential component of the General Fund revenues and allowed the City to maintain operations without declines in service levels. Proposition L is set to sunset in Fiscal Year 2029.

Consistent with previous forecasts, rising pension obligation costs remain the single fastest increasing expenditure for the General Fund. Anticipated increases in pension contributions based on all information available from CalPERS are included in the forecast. Helping to offset the rising pension obligation costs are negotiated cost sharing agreements that went into effect during Fiscal Year 2019 and anticipated contributions from the Section 115 Retirement Trust Fund, included in the forecast to begin in Fiscal Year 2026. Finally, General Fund reserve balances reflecting the net effects of anticipated revenues and expenditures are projected through Fiscal Year 2032.

Included in this report is the base forecast prepared using the most current information available at the time.

ECONOMY

The U.S. Leading Economic Indicator (“LEI”) increased 0.6 percent in January 2021, following a steep decline from March through May, with small increases throughout the rest of the year. “While the pace of increase in the U.S. LEI has slowed since mid-2020, January’s gains were broad-based and suggest economic growth should improve gradually over the first half of 2021,” said Ataman Ozyildirim, Senior Director of Economic Research at The Conference Board. “As the vaccination campaign against COVID-19 accelerates, labor markets and overall growth are likely to continue improving through the rest of this year as well. The Conference Board now expects the U.S. economy to expand by 4.4 percent in 2021, after a 3.5 percent contraction in 2020.”

The national unemployment rate drastically increased to a high of 14 percent in the second quarter of 2020 but rebounded significantly by the end of the third quarter and has remained consistent at 6.3 percent going into January. Notable job gains occurred in the leisure and hospitality, with smaller gains in temporary help services, health care and social assistance, retail trade and manufacturing. San Diego County’s unemployment rate ended 2020 at 8 percent, well over the 3.4 percent from a year ago but much better than the high of 16 percent in April. After an increase to 15.5 percent unemployment rate in May, La Mesa ended 2020 with an unemployment rate of 8.1 percent, which is still significantly higher than 2.8 percent at the end of 2019.

THE STATE OF CALIFORNIA

A year into the pandemic brought many challenges to the State of California and its residents. The pandemic disrupted the livelihoods of millions of Californians economically. The overall concern of lower tax revenues, rising costs, and making budget cutbacks have not come to fruition as initially feared. California ended up with a $15.5 billion windfall that enables the Governor to allocate into the Fiscal Year 2022 budget. States revenues are nearly back to pre-pandemic levels.

On January 10, 2021, Governor Newsom presented his proposed state budget for Fiscal Year 2022 to the Legislature. Under the administration's budget estimates and proposals, General Fund revenues would total $158.4 billion in Fiscal Year 2022 and spending would total $164.5 billion. Under the Governor's proposed budget, the state would end Fiscal Year 2022 with $18.9 billion in total reserves, a decrease of $3.1 billion from the Fiscal Year 2021 enacted reserve level as required by the State Constitution but in smaller amounts than previous years. The Legislative Analyst's Office ("LAO") estimates the Governor has a $12.2 billion surplus to allocate in the Fiscal Year 2022 budget process. The Governor's office has made housing and homelessness, Covid-19, and the environment as essential needs of the State. A one-time $600 stimulus payment was directed to qualifying California residents as part of a $7.6 billion coronavirus relief package. As the pandemic continues, the finance team will continue to monitor continuing developments from Sacramento and how they will impact La Mesa.

FUNDING OF THE CALPERS RETIREMENT SYSTEM

Even before the pandemic, CalPERS readjusted its way of investing and developed a strategy that gives its members security for the future. The recent economic downturn due to the pandemic threw a fresh spotlight into the challenges of the public pension fund. In the past 18 months, CalPERS has made some key changes to the investment office, such as:

- Improving its liquidity management by increasing cash coming into the fund to ensure payment of benefits and take advantage of downturn events.
- Centralizing its governance by conducting a comprehensive evaluation of its portfolio to prudently manage risk.
- Focusing on comparative advantage by utilizing its size, influence, and long-term investment horizon that provides an advantage in the market to implement positive changes.
- Eliminating costly fees by terminating external relationships to save $115 million a year in costs and bringing in more of an in-house investment management team.

At the end of the 2020 audit, the City of La Mesa has a cumulative underfunded pension liability totaling $98.5 million. The City opened a Section 115 Retirement Trust Fund in 2016 to help mitigate future costs. Based on actuarial valuations, the payments towards the City's unfunded liability is expected to reach the highest point by Fiscal Year 2026 and remain at these high levels before beginning to decline in 2035-2036. Making additional investments today will ease the financial strain in later years by depositing the amount of annual interest into the trust fund and making a one-time payment to CalPERS as opposed to monthly payments, saving $200k a year.

FINANCIAL FORECAST BACKGROUND

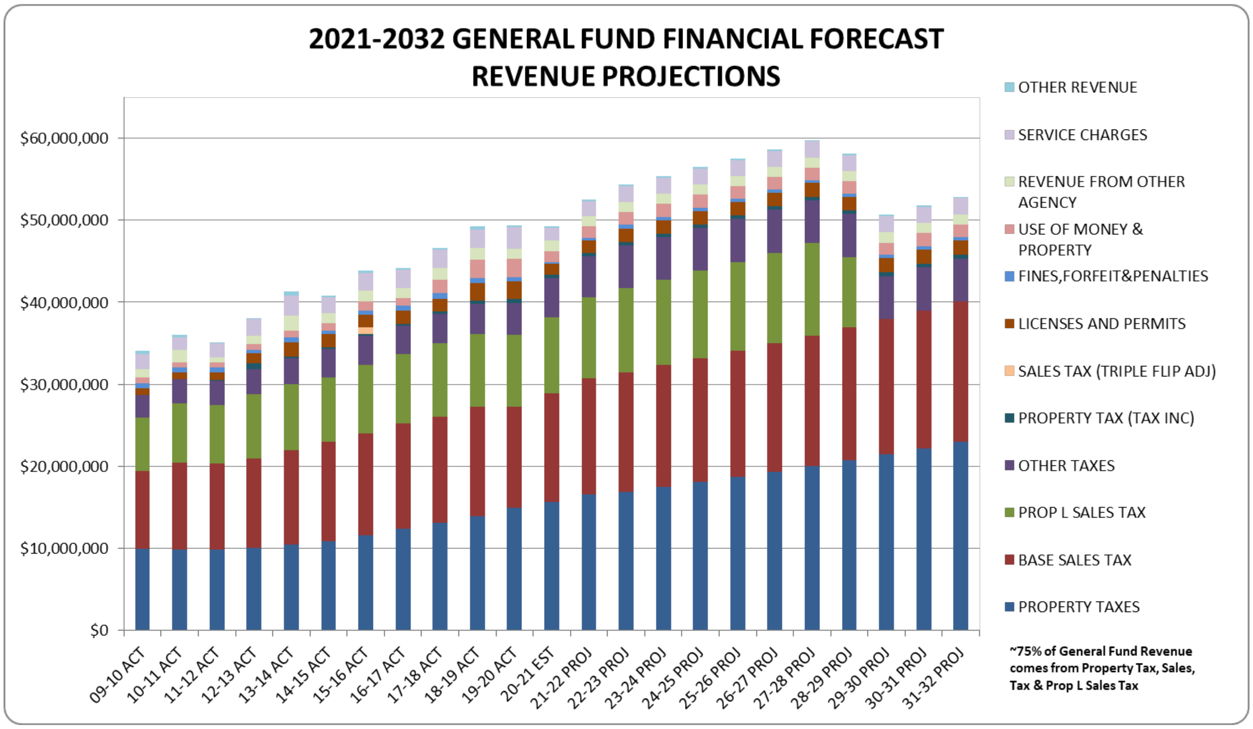
The General Fund Financial Forecast is a tool that focuses attention on the longer-term impacts of policy decisions on the City's primary operating fund. The General Fund is the City's largest fund and provides funding for the majority of the day-to-day services of the City to its residents. The "forecast" is not intended to be a prediction of a particular outcome but rather to be used as a model to test reasonable scenarios the City could expect in the coming years. These scenarios are intended to assist in setting realistic expectations in matching revenues with programs and projects that will meet Council objectives.

The Forecast Model is a spreadsheet-based model that projects the City's current mix of revenues and expenditures through the upcoming budget year and then ten years into the future. The forecasting model uses a variety of information and techniques, including historical trend analysis, projections from local and regional sources, and various economic data. The Financial Forecast builds off the actual prior fiscal years' revenues, expenditures, and ending reserves, projects the estimated 2021 revenues, expenditures, and ending reserves, and incorporates known factors (such as the increase in pension costs) into the 2032 projections. Revenues, expenditures, and ending reserves are then projected using the base assumptions as detailed below.

GENERAL FORECASTING ASSUMPTIONS

The Financial Forecast assumptions are based on the most current information available. Revenue assumptions are generally moderate with particular attention given to the top three revenues that represent approximately 75 percent of total revenues. Expenditure assumptions are based on maintaining current service levels while containing cost increases where possible. The Forecast assumes the continuation of Council adopted fee cost recovery policies and the retirement of Prop L in 2029.

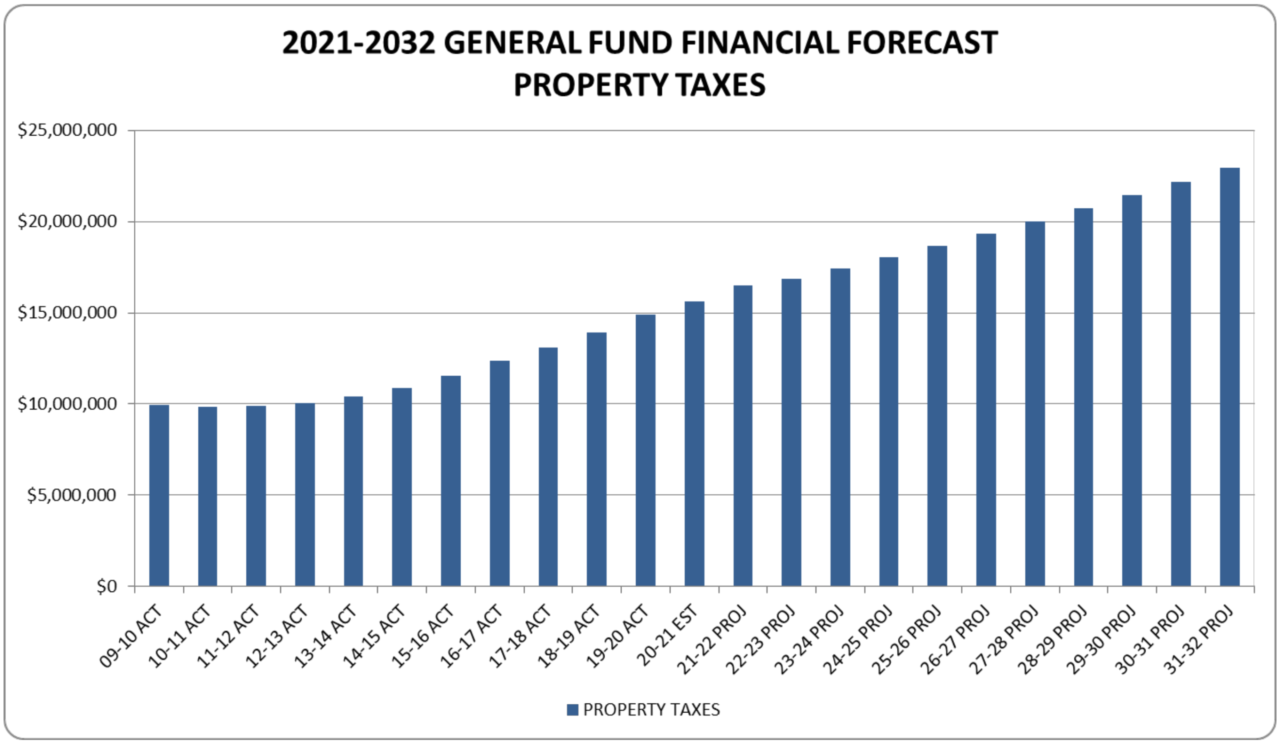
BASE REVENUE ASSUMPTIONS



PROPERTY TAX

Property tax has traditionally been the General Fund's most stable and consistent revenue and accounts for roughly 30 percent of the total General Fund revenues. In recent years, property assessed values have increased between 5.0 to 7.5 percent each year with the current 2020-2021 tax year increasing 4.4 percent, slightly below the countywide increase of 5.5 percent over the same tax year. In 2020, sale prices have risen as the number of sales declined significantly due to the stay at home orders. Overall, prices continued to increase in response to lower inventory and lower interest rates. The median detached single family residential home in La Mesa from January through September 2020 was $630,000, which represents a 10 percent increase in 2019 median home prices.

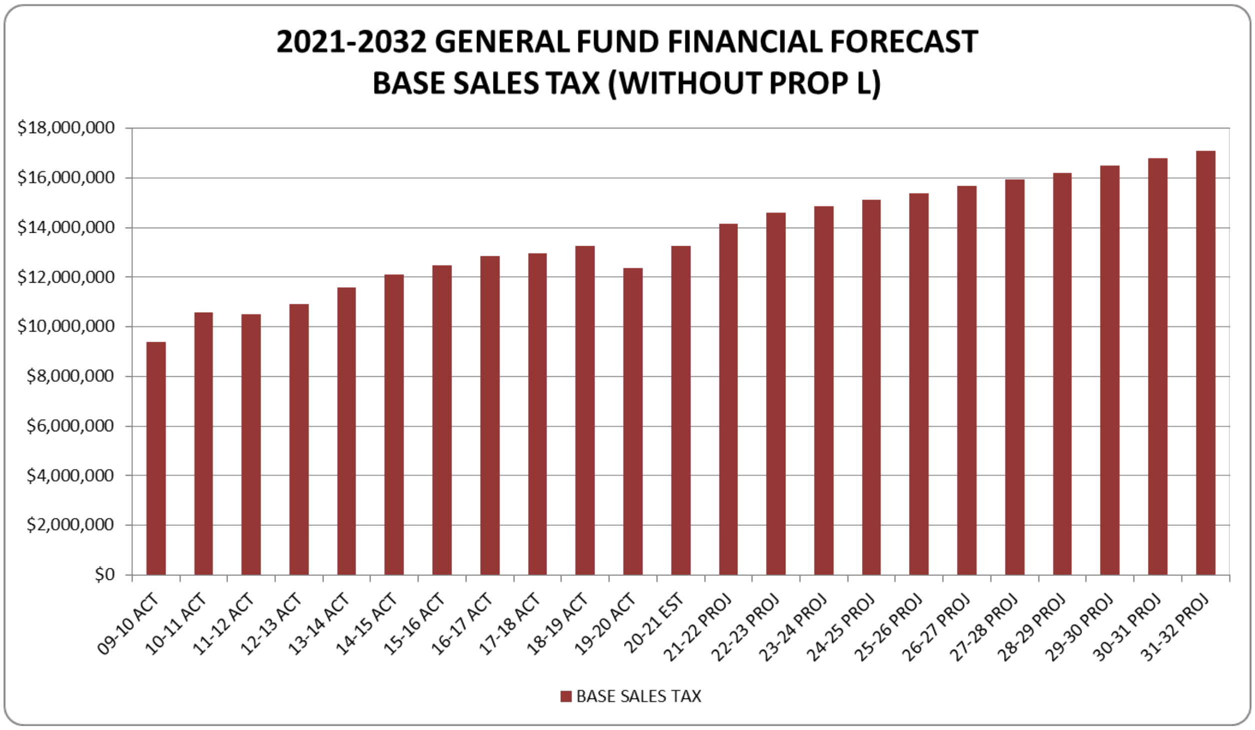
The pandemic event is not something seen before and there are various unknowns in how these conditions will affect the housing market both short and long term. While median home prices have increased, overall sales have declined in Southern California. Tax revenues will need to be monitored closely for post pandemic concerns such as foreclosure activity and increased property tax delinquency.



BASE SALES TAX

At roughly 25 percent of total General Fund revenues, the 1% Base Sales Tax is the second biggest General Fund revenue source behind property tax revenue. Base Sales Tax is also the most volatile and economically sensitive revenue source. Further complicating the future of sales tax revenues is the rapidly changing nature of taxable transactions: not only is "*what is purchased"* changing, but "*how it is purchased"* is also changing. Consumers are spending more on non-taxable items such as services, social networking, and education and less on traditionally taxable items. Further contributing to the issue is that sales are increasingly shifting from traditional brick-and-mortar stores to online sales transactions and distributed via the County Pool. The 2018 *South Dakota v. Wayfair* decision further increased the tax revenues collected and allocated to local agencies through the County Pool. The City's overall share of the pool increased dramatically during the pandemic as these allocations are based on brick and mortar spending. As openings of business increase and local shopping picks up, we will see a shift in sales tax revenue as county pool amounts will adjust accordingly and show a decrease as brick and mortar shopping increases in other parts of the State that had significant declines in 2020.

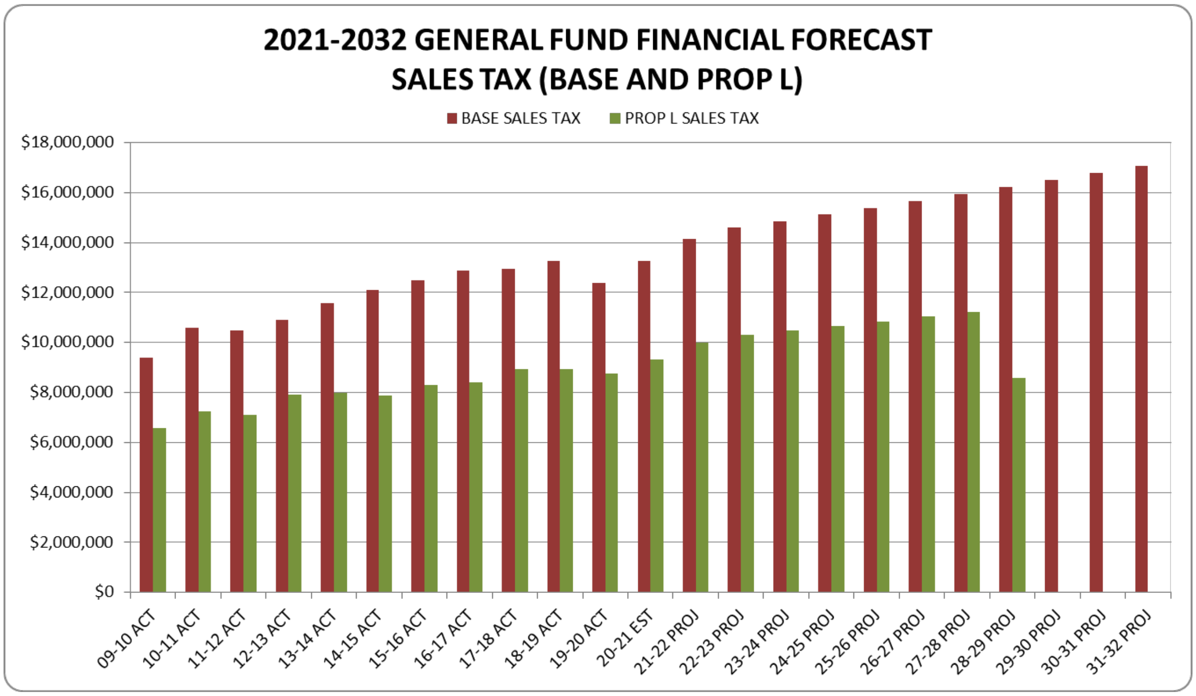
Post pandemic should see a significant gain in consumer spending that will again cause fluctuations in the economy, but the general consensus from most economists is that this will be a short time period and the economy will adjust to pre-pandemic numbers and grow at moderate gains.



PROPOSITION L SALES TAX

In November 2008, the voters of La Mesa approved the temporary ¾ cent (0.75%) Proposition L transactions and use tax (commonly referred to as a sales tax) which became effective on April 1, 2009. The City began receiving payments from the State Board of Equalization in fourth quarter 2009.

Since 2009, Prop L Sales Tax revenue growth has consistently followed the Base Sales Tax growth trends and received at 65 to 67 percent of the Base Sales Tax receipts. Prop L tax revenues now account for roughly 17 percent of the total General Fund revenues and contribute approximately $9 million to funding General Fund operations annually. By Fiscal Year 2028, the last full fiscal year of Prop L revenues under the current proposition, Prop L Revenues are estimated to exceed $10 million. Proposition L is set to sunset in Fiscal Year 2029, when the City will receive the remaining three quarters (roughly $7.7 million) of tax revenues and then absent any further action by the City Council and voters, cease receiving any revenues. The forecast assumes the same factors as the Base Sales Tax through Fiscal Year 2028, before tapering off to zero in subsequent years.



ALL OTHER REVENUES

All other revenues combined constitute roughly 28 percent of total General Fund Revenues. The largest components of all other revenues include Other Taxes, Licenses & Permits, and Service Charges. Other sources include Property Tax (Tax Increment), Revenue from Other Governmental Agencies, and Use of Money & Property.

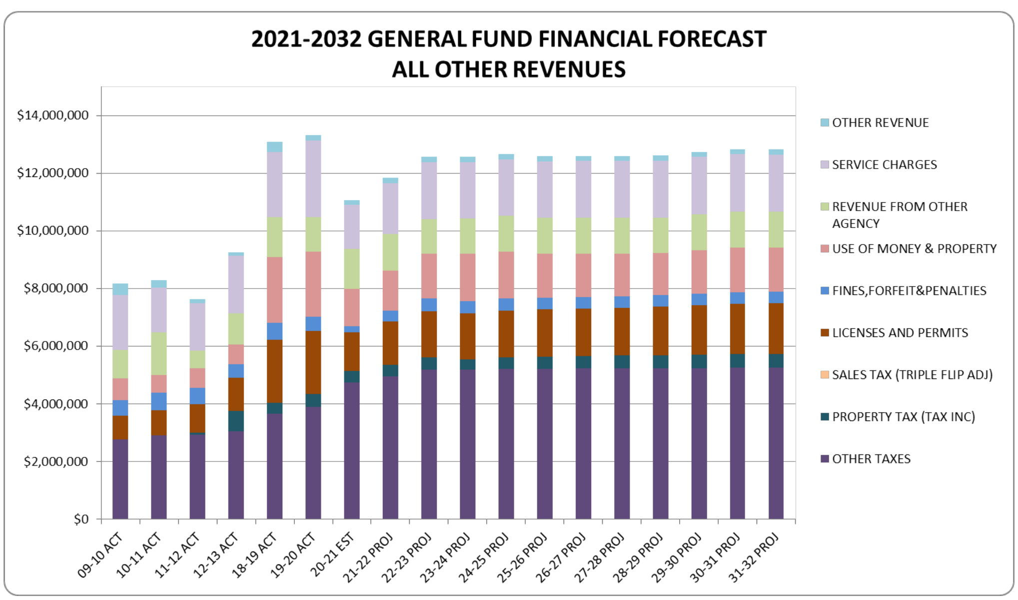
With the approval of the Cannabis Business Tax in November 2018, All Other Taxes (also including Franchise, Property Transfer, and Transient Occupancy Tax), become a more significant component of the total General Fund revenues. Beginning with Fiscal Year 2020, the total of All Other Taxes comprises roughly 9 percent of the total General Fund revenues, up from 6 to 7 percent in previous forecasts. Other Taxes are historically a stable source of revenue with most revenues increasing 1 to 2 percent overall over the past five years. Transient Occupancy Tax (“TOT”) declined 18.2 percent in 2020 due to travel restrictions and closures. Gas & Electric, Cable, and Refuse franchise taxes remain fairly stable. The forecast also includes the approved Cannabis Business Tax and phases in these revenues as more cannabis-related business begin operating and paying the tax. The forecast estimated revenues of $500,000 in 2019-2020, but came in 20.6 percent higher than expected. The Finance team will continue to monitor Cannabis tax to determine if revenue fluctuations are due to the pandemic or future forecasting needs to be revised. For forecasting purposes, all other taxes are assumed to be fairly flat over the forecast period.

Licenses and Permits represent roughly 4 percent of total General Fund revenues and are very sensitive to fluctuations in economic conditions. The City waived business license fees beginning April 2020 to help businesses affected by the pandemic closures. As construction and home improvement increased, permits saw a significant increase in revenue. These fluctuations balanced one another and as a sense of normalcy returns, the finance team expects to see the numbers be more truly reflective going forward. Licenses and Permits are assumed to remain fairly consistent between $1.5 million and $1.8 million through 2032.

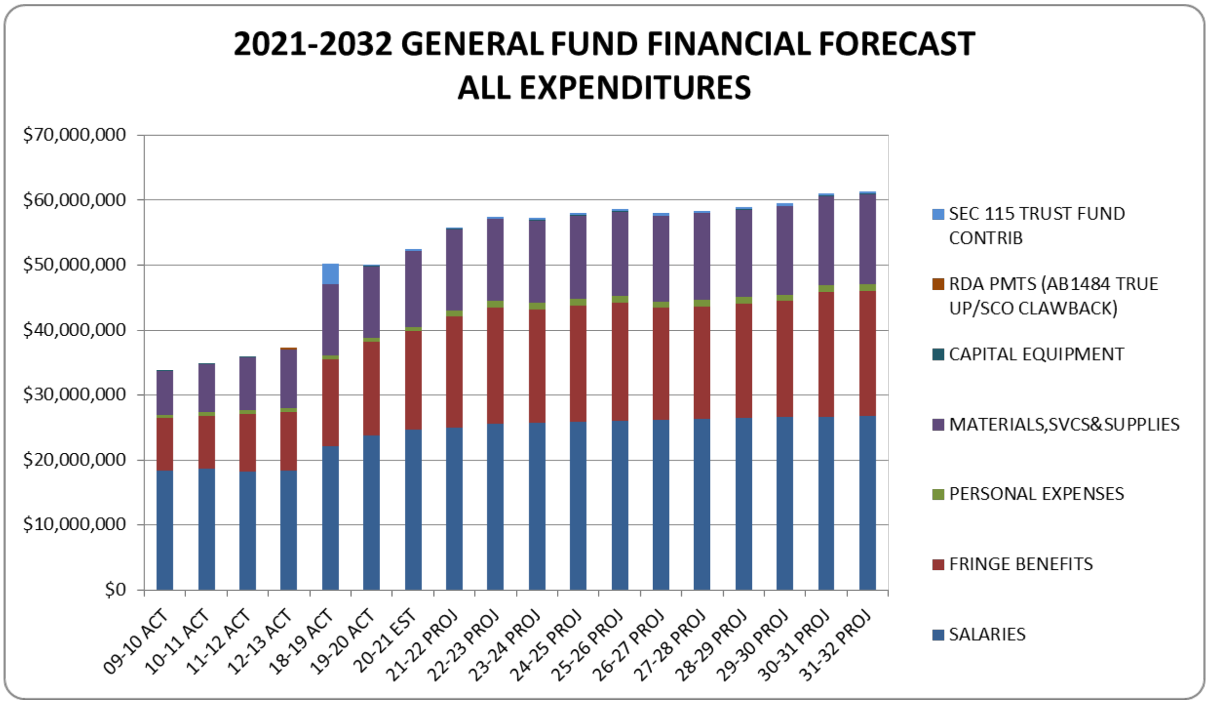
Revenue from other agencies comprises roughly 2 percent of total General Fund revenues. Ongoing revenues from other agencies include reimbursements for costs related to the Heartland Fire JPA consolidation and funding to cover expenses incurred as a result of public safety realignment (AB109 R3 public safety realignment funds). The AB109 R3 public safety realignment funds and reimbursement for costs related to the Heartland JPA are now ongoing revenues and included in the future years forecast.

Service Charges represent roughly 5 percent of total General Fund revenues. Recreation fees went down 23 percent, but engineering, planning, and zoning fees increased 28 percent. Paramedic fees increased 50 percent that can be directly attributed to the pandemic and will readjust accordingly going forward.

Use of Money & Property includes revenue to be received from the long-term land use lease at Briercrest Park. Beginning in Fiscal Year 2021, the City will receive ongoing revenues of approximately $415,000 per year as ground rent and park maintenance revenues to help offset the cost of maintaining Briercrest Park. These revenues will be received annually throughout the 55-year agreement. Additional revenue sources are rents of buildings owned by the City and interest earned in LAIF and other investments.



BASE EXPENDITURE ASSUMPTIONS



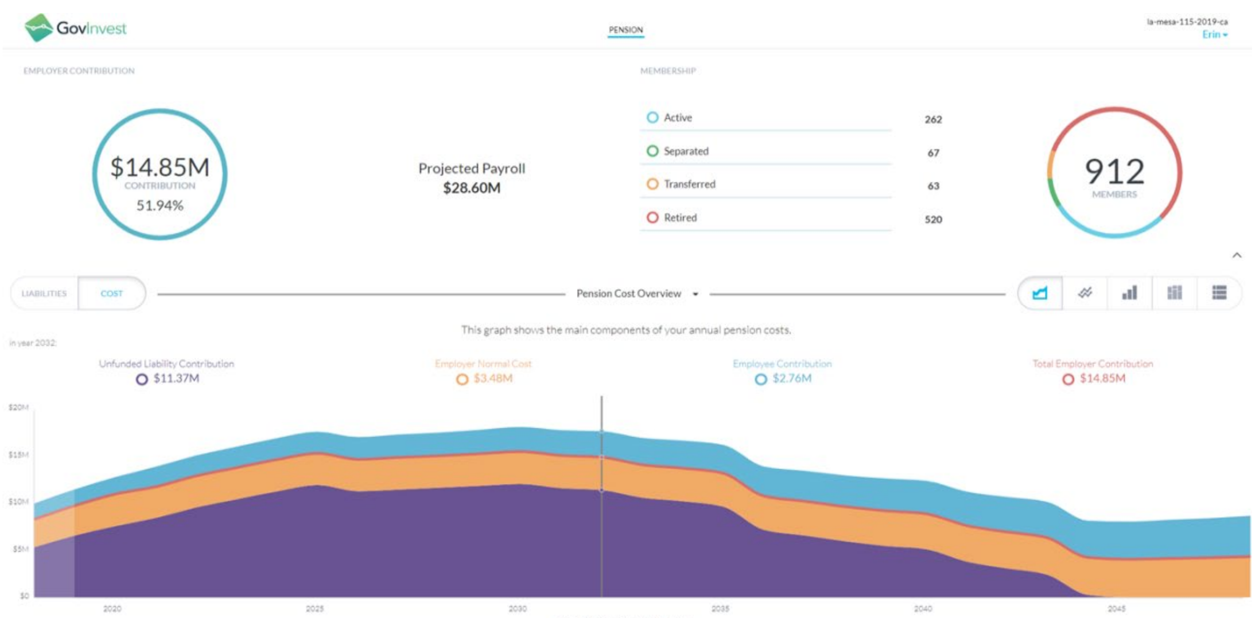
When developing the expenditure assumptions, as with the revenue assumptions, historical data, projections from outside sources, and economic trends are all considered. Salaries and fringe benefits comprise the majority of General Fund expenditures at roughly 80 percent, with the PERS underfunded liability making up 17 percent of the total, increasing to 23 percent in 2025-26. The City plans on adding a new position, Communications Manager, in 2021-22. From there, staffing levels are assumed to remain constant and only merit increases are considered in the salary assumptions for future years beyond fiscal year Fiscal Year 2022. Fringe benefits include retirement contributions for the normal cost and unfunded liability, contributions to the Section 115 Pension Trust Fund, health insurance contributions, workers' compensation, social security, and other types of benefits. Fringe benefits not related to pension are assumed to remain fairly flat with increases tied to merit increases or inflation. Pension benefits are projected to increase at a far greater rate than all other benefits and are discussed in a separate section below. Materials, Services & Supplies, Personal Expenses, and Capital Equipment are anticipated to decrease slightly over 2020-2021 levels due to cutbacks attributed to the pandemic. Normal operations are expected to resume into the 2021-22 fiscal year with increases in cost due to inflation. Additionally, the City Council adopted a Climate Action Plan that will generate new projects and ongoing programs that need be funded.

CALPERS RETIREMENT COSTS AND OTHER BENEFITS

As noted earlier, the fastest growing category of the General Fund's expenditures continues to be fringe benefits, specifically pension costs. Based on the most recent CalPERS projections and the anticipated impacts of the recent changes including the reduced discount rate and fixed unfunded liability contributions, pension costs are projected to increase roughly 10 percent each year.

This increase began with the Fiscal Year 2018 and continues through the forecast period. These increases reflect the cumulative changes enacted by the CalPERS Board in recent years to incorporate pension reform, change the smoothing method for the unfunded liability, adopt revised actuarial assumptions, and most recently reduce the discount rate and add a fixed amount contribution toward the unfunded liability. The future projections include estimated increases from the reduced discount rate on the "normal cost" rate (increase of 1 to 2 percent) and the Unfunded Liability fixed amount (12 percent each fiscal year through 2023, with additional increases between 5 and 8 percent each year through 2026).

The City currently has 257 enrolled employees, of which 107 are in PEPRA and 150 are Classic members. While PEPRA employees make up 42 percent of the enrolled members, they only represent 34 percent of the annual payroll. All newly eligible CalPers employees are automatically enrolled in PEPRA effective January 2013.



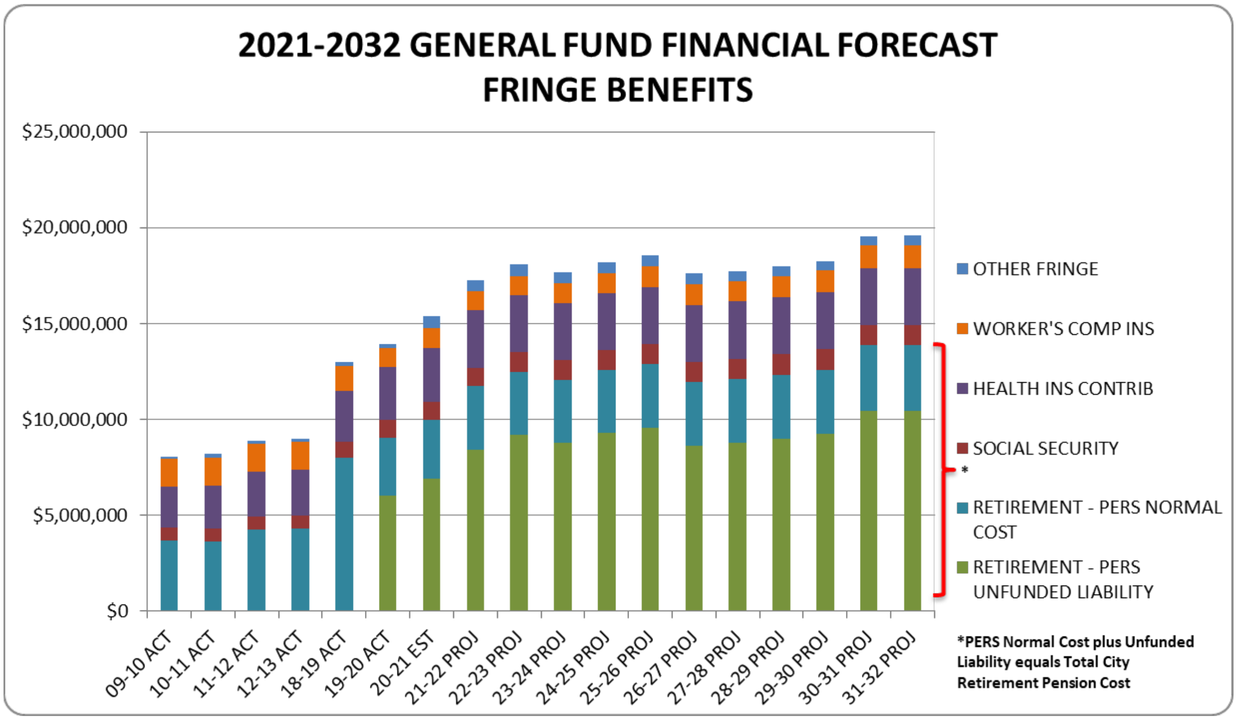
Beginning in Fiscal Year 2016, the City Council approved the establishment of a Section 115 Pension Trust Account and authorized an initial contribution of $1.5 million. Additional one time contributions were authorized in 2017 ($600,000) and most recently

2019 ($3 million). Ongoing contributions of approximately $250,000 to $350,000 each fiscal year through 2032 are included in forecast. City Council approved these contributions with the expectation that these would offset future unfunded liability contributions beginning in 2025-2026 when the current increases are expected to peak. The Section 115 Pension Trust Fund has a current balance of $7.7 million at January 31, 2021. Based on current projections, the Section 115 Pension Trust Fund will have approximately $10 million by fiscal year 2025-2026, the time at which the pension contributions are at their highest levels. Also reflected as an offset to the City's pension costs are negotiated cost-sharing agreements with City employees. These cost sharing agreements were agreed upon by the City and the employees in 2018 that provide the City an annual savings of just over $300,000 in City pension costs.

City contributions to health insurance are the second largest segment of Fringe Benefits. Historically, these costs would have been increasing due to the increase in employee premium costs. Beginning in 2016, these costs reverted to a fixed cost as part of the 2014-2016 MOU's and any increases are negotiated as part of the bargaining process. Worker's Compensation insurance rates are approximately $1 million each year and assumed to increase 1 to 2 percent each year beginning 2021-2022. Finally, the City's contribution to its Other Post-employment Benefits is expected to increase beginning 2018-2019 by approximately 2.5 percent through 2024. All other fringe benefits are assumed to remain constant through the forecast period.

ALL OTHER NON-PERSONNEL OPERATING COSTS

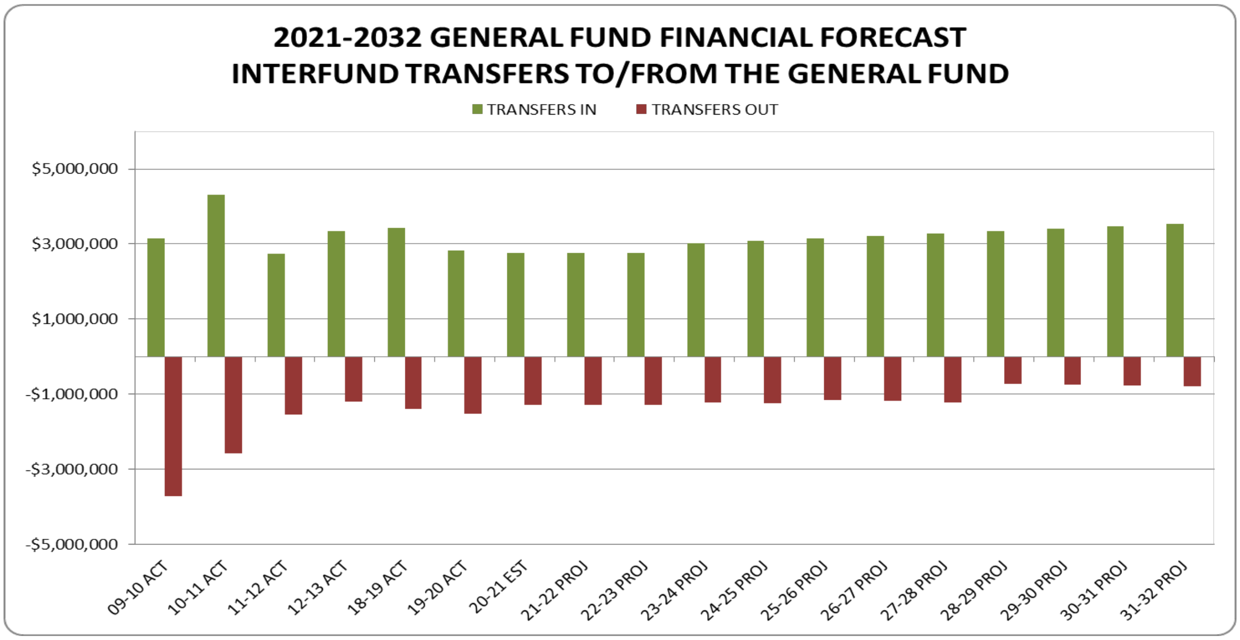
Other non-personnel operating costs include personal expenses such as memberships, training, conferences, and uniform/boot allowance as well as material, services, and supplies needed to maintain the city. Costs to the City significantly decreased in 2020-21 due to travel restrictions and safety concerns caused by the pandemic. Most materials, services & supplies are assumed to remain constant or increase slightly due to inflation once the pandemic is over and a normal working environment resumes. Consistent with prior years' forecasts, exceptions to these assumptions are in Communications and Technology Maintenance, Maintenance of Buildings & Grounds, Contributions to Other Agencies, Equipment Replacement Expense, and all Utilities, including gas, electric and water. Increases in maintenance of buildings and grounds are estimated to increase 2 percent throughout the forecast period in order to maintain and replace as needed the City's public spaces. Communications and technology maintenance are anticipated to increase 5 percent in 2020-2022 and 2 percent through the end of the forecast period in order to maintain and operate the city's increasing technologies. Increases in Equipment Replacement Fund Expense are necessary to maintain the city's replacement of equipment, vehicles and technology. Increases in Utilities, specifically electric and water usage are assumed to increase 2½ percent through 2024 as the City works to implement energy and water savings devices as outlined in the Climate Action Plan.



INTER-FUND TRANSFERS TO/FROM THE GENERAL FUND

Inter-fund transfers are transactions between the General Fund and other City funds for items such as support services provided by the General Fund, debt service payments, and contributions to the Capital Improvement Fund.

Transfers in for support services are projected to increase as personnel costs increase. Transfers out for debt service payments are reduced as those debts, namely capital equipment leases for the purchase of fire apparatus and Certificates of Participation for the construction of the Post Office and Library are paid in full. The forecast assumes no new long term liabilities are incurred. A nominal transfer of $62,500 per year from the General Fund to the City's Capital Improvement Parks Fund is included throughout the forecast period.



GENERAL FUND RESERVES

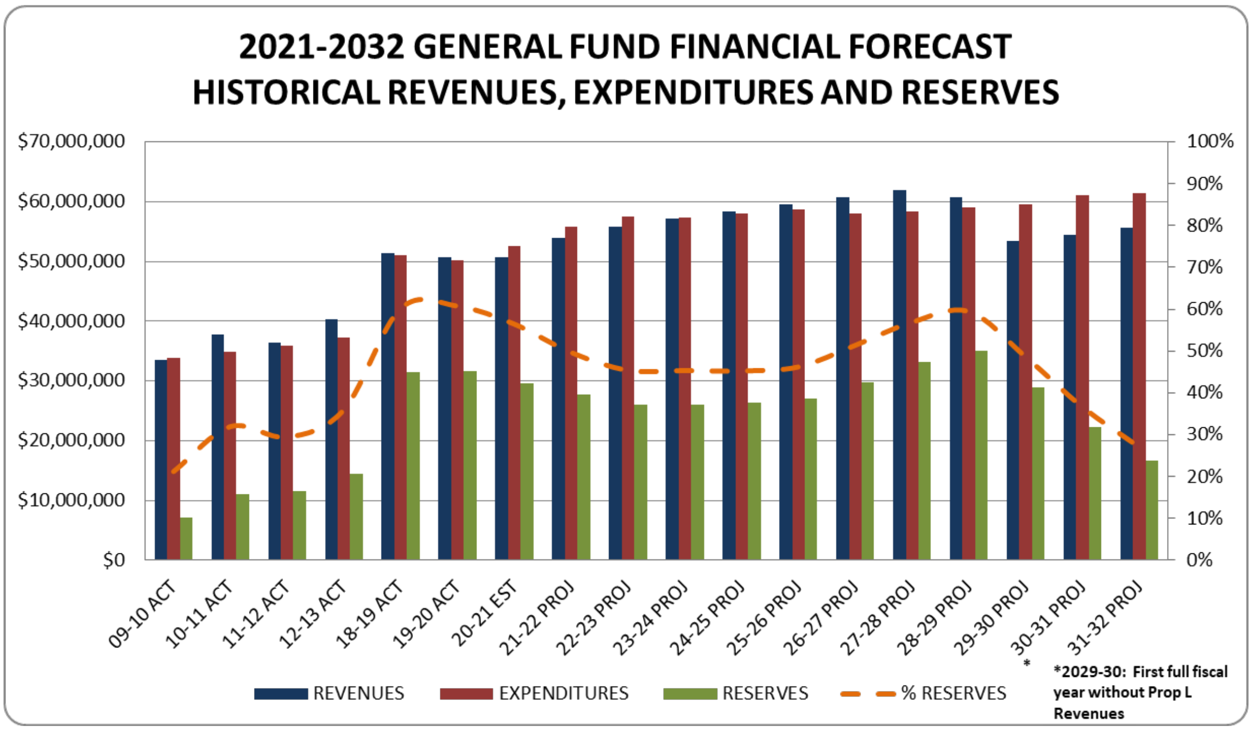
General Fund reserves have been in the 60 percent range since 2018-19 due to proceeds from the sale of two City-owned properties, "one-time" revenues from the Briercrest litigation, repayment of funds advanced to the Successor Agency for enforceable obligations, repayment of Prop L Sales Tax revenues that were diverted to the City of Filmore, repayment of the "Triple Flip" Sales Tax revenues from the State of California, and improved property tax revenues and development-related permits and fees.

The 2019-2021 Biennial Budget Update adopted in June 2019 projected a budget deficit of $3.5 million with estimated ending reserves at June 30, 2020 of $25.5 million or 49.2 percent. Due to the pandemic, measures were put in place to cut expenses to help mitigate possible losses in revenues. Negotiations with the employee associations were also deferred by all parties in agreement. By being fiscally responsible to weather the uncertain times, City reserves were maintained at a 60 percent rate at the end of the 2020 fiscal year.

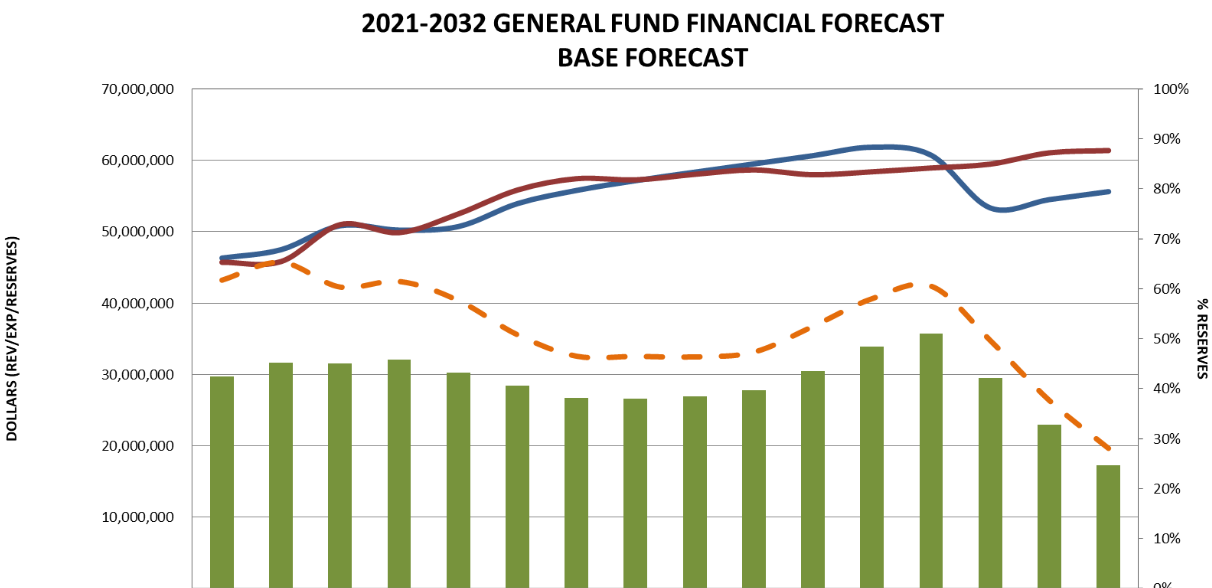
The 2032 General Fund Forecast further revises the estimated ending reserves for June 30, 2021, down 4.3 percent to $27.7 million or 56.43 percent. This downward trend continues as the City faces increased costs of labor, materials and supplies, and contracted services. Reserves start to rapidly decline when Prop L ends in 2029.

2031-2032 GENERAL FUND FORECAST

The current forecast extends the view to 2031-2032, three years beyond the sunset of Proposition L. Based on revenue and expenditure projections, expenditures will exceed revenues in each fiscal year through 2023-2024 requiring the use of reserves to "balance the budget". Beginning 2024-2025 this trend reverses with revenues beginning to exceed expenditures and reserves beginning to increase through 2028-2029. However, this all changes in 2029-2030 with the sunset of Proposition L and the elimination of more than $10 million annually in General Fund Revenues.



The City Council's current reserve policies are to establish a "Rainy Day Reserve" of 15 percent of budgeted expenditures and a "Cash Flow Reserve" of 25 percent of budgeted expenditures.



	FY 16-17 ACT	FY 17-18 ACT	FY 18-19 ACT	FY 19-20 ACT	FY 20-21 EST	FY 21-22 PROJ	FY 22-23 PROJ	FY 23-24 PROJ	FY 24-25 PROJ	FY 25-26 PROJ	FY 26-27 PROJ	FY 27-28 PROJ	FY 28-29 PROJ	FY 29-30 PROJ	FY 30-31 PROJ	FY 31-32 PROJ
Reserves (dollars)	29,696	31,578	31,481	32,051	30,271	28,365	26,712	26,610	26,913	27,759	30,436	33,882	35,666	29,526	22,975	17,216
Revenues/Transfers	46,307	47,485	50,841	50,228	50,720	53,940	55,784	57,163	58,347	59,508	60,663	61,845	60,719	53,333	54,505	55,620
Expenditures	45,715	45,817	50,996	49,871	52,500	55,845	57,437	57,265	58,044	58,661	57,986	58,399	58,935	59,474	61,056	61,379
% Reserves	62%	65%	60%	61%	58%	51%	47%	46%	46%	47%	52%	58%	61%	50%	38%	28%