STAFF REPORT

MEETING DATE: 9/14/2022 **Staff Report No.** 22-505

TO: AC Transit Board of Directors

FROM: Michael A. Hursh, General Manager

SUBJECT: Seven Year Financial Projection

BRIEFING ITEM

AGENDA PLANNING REQUEST: ☐

RECOMMENDED ACTION(S):

Consider receiving a report on updated operating financial projections.

STRATEGIC IMPORTANCE:

Goal - Financial Stability and Resiliency
Initiative - Financial Efficiency and Revenue Maximization

This report presents updated financial projections to inform the Board, staff, and the public of the District's financial future.

BUDGETARY/FISCAL IMPACT:

There is no budgetary impact from this informational report. Implementation of initiatives to reduce deficits would have budgetary impacts, but additional analysis is needed to determine changes to cost.

BACKGROUND/RATIONALE:

AC Transit has faced turmoil and uncertainty resulting from the COVID pandemic over the last two and a half years. The pandemic has impacted everything from how and where employees work to how much service the District is able to provide. A tight labor market and spikes in COVID cases have made hiring operators and increasing service levels very difficult. Supply chain problems and the war in Ukraine are causing sharp increases in the price of fuel and other goods.

High inflation is increasing the price of many goods and services, and the initial hopes for "transitory" inflation have been dashed. Federal Reserve officials are adamant that inflation must be brought under control. However, the tools proposed by the Federal Reserve to curb inflation could potentially cause a recession and result in the reduction of many of the District's revenue sources.

A significant amount of federal emergency operating funds have and continue to support the District and allow for the continuation of bus service, albeit at a lower level compared to pre-pandemic conditions. Unfortunately, this operating support will not continue, and the District may be heading toward financial deficits once all these funds are exhausted. The District must decide how best to move forward and balance restoration of service while still keeping a balanced budget.

District Challenges

There is still significant uncertainty about the long-term economic impacts of the pandemic and how inflation and a possible recession will play out in the near-term. The District has received $286 million in federal emergency funds over the past two and half years. Funding from the third measure, the American Rescue Plan (ARP) Act, is very likely the last significant amount of federal operating support. Once the ARP Act funding is spent, regular sources of subsidy and farebox revenues may not be enough to match the District's projected expenses.

While some revenue subsidies have already reached pre-pandemic levels, farebox revenues are still depressed and may well take years to return to prior levels, if at all. Reduced ridership overall is the primary culprit, and in Transbay service in particular, but the District's farebox recovery ratio has also been reduced which means less revenue for the same ridership. The District is fortunate to have seen other subsidy levels return, but their decline during the pandemic caused them to lose ground compared to expenses. This has further thrown off the delicate balance of revenues and expenses the District needs to maintain to have a balanced budget.

The war in Ukraine, supply chain issues, and COVID lockdowns in China have caused inflationary pressures on prices. Fuel costs have reduced somewhat recently but are still very high after increasing 90% during FY 2021-22. These increased supply costs are placing additional pressure on the budget and forcing the District to use up more ARP Act funding sooner than staff had planned.

Restoring service is a high priority for the District. The communities in the District's service area rely on us for their transportation needs, and that need will only increase as more people go back to work and commute. The primary obstacle to increasing service is the challenge we face hiring and training new operators at a rate above normal attrition. Hiring challenges are a nationwide problem for transit agencies, and particularly in the Bay Area as we are competing with many other transit agencies in the same labor pool.

Financial Projections

Staff has created four financial projections that illustrate what deficits the District might face after ARP Act funding is used up using differing potential economic scenarios. The projections are shown in the attached presentation and are summarized below:

Projection	**Recession Assumption**	**Max Service Level**	**Total ($M)**
Best	None	90%	$58
Expected 1	Mild	90%	$122
Expected 2	Mild	100%	$155
Worst	Significant	90%	$314

These scenarios project the growth of regular (non-supplementary) revenues and expenses through FY 2028-

29. Expense growth is primarily driven by the operator headcount increases required to sustain the identified service levels, as well as regular contractual wage increases. Revenues are driven by subsidies growth and farebox growth from increasing ridership. The $114 million in Coronavirus Aid, Relief, and Economic Security (CARES) Act funds are shown in FY 2019-20 and FY 2020-21, and the $56 million in Coronavirus Response & Relief Supplemental Appropriations Act (CRRSA) funding is shown in FY 2021-22. ARP Act funding of $10 million was used in FY 2021-22 and the remaining $106 million will be used in FY 2022-23 and FY 2023-24 to offset deficits. All four scenarios assume continued high inflation at 9% through this fiscal year.

Projection: Best Scenario

The Best scenario assumes no recession in the coming years along with reduced inflation. In FY 2023-24 inflation and prices reduce to a more normal 3% annual increase. Future year expenses are driven by an increase in service levels from 85% currently to 90% by mid-FY 2023-24. This service level increase will require 1300 active operators, an increase of approximately 110 operators from the current level. Regular subsidies revenue increases by 3% to 4% annually. Farebox revenue gradually returns to 100% of pre-pandemic levels by FY 2026-27.

Under this scenario, ARP Act funding is used up in FY 2024-25 and the District would experience deficits totaling $58 million in the following three years. The District pension contribution expenses will reduce by approximately $30 million per year beginning in FY 2027-28 resulting in no deficits in the following years.

Projection: Expected 1 and 2 Scenarios

These scenarios assume continued high 9% inflation in FY 2022-23 followed by a mild recession lasting one year. The recession causes a reduction in consumer demand for goods and services and a corresponding reduction in sales tax revenues. Total Subsidies revenue reduces by 1% in FY 2023-24 but increases back up to 3% average growth by FY 2025-26. Farebox revenue returns to 100% of pre-pandemic by FY 2028-29.

The Expected 1 scenario assumes a service level increase to 90% in FY 2023-24 and remains flat after. The Expected 2 scenario assumes a service level increase to 100% by FY 2024-25. The increase from 90% to 100% service adds approximately $5 million per year to the deficit.

Under Expected Scenarios 1 and 2, ARP Act funding is used up mostly in FY 2023-24 and the District will likely experience deficits totaling $122 million and $155 million respectively over the following 5 years. The District pension contribution reduction in FY 2027-28 will significantly reduce deficits in the following years but will not be enough to completely solve the problem.

Projection: Worst Scenario

The Worst scenario assumes continued high inflation in FY 2022-23 followed by a significant recession starting in FY 2023-24 and lasting two years. Revenue from subsidies decline 6% and gradually recover to 3% growth by FY 2026-27. Farebox revenue does not return to pre-pandemic levels until FY 2029-30. Service levels increase to 90% in FY 2023-24 and remain flat.

Under the Worst scenario the District is expected to experience deficits totaling $314 million over the following 5 years. The District pension contribution reduction will only reduce deficits by a mild amount in the following years.

Next Steps

These projections show that even under the Best scenario it is likely that expenses will surpass regular revenues once the ARP Act funding is used up. The District must weigh the need to bring back service against the possibility of an economic downturn which might then require service reductions to balance the budget. Restoring service while solving the deficit problem will not be easy but staff has been working on solving this problem.

Staff believes the Best scenario deficits can be handled by using a combination of expense management, use of cash reserves, and smoothing out the timing of pension contribution payoff. Controlling expenses now will increase the ARP Act funding available to reduce deficits in later years. Once ARP Act funding is used up, use of cash reserves should be able to fill in the gap until the pension contribution expenses decrease in FY 2027-28. Smoothing the timing of pension contribution payoff would spread out the impact of deficits over multiple years and reduce the impact on any single year. The District and the Pension System would need to come to an agreement for any smoothing to be implemented.

The Expected and Worst scenarios would be much more difficult to solve. The initiatives used to solve the Best scenario deficits would need to be supplemented with other measures. In the ideal case that would include new and ongoing operating funding source(s), such as a regional measure that continues to be discussed. AC Transit could also consider a local ballot measure to support operations, although the District's more recent polling analyses have focused on capital funding needs. The federal Bipartisan Infrastructure Law (BIL) as well as the recently passed Inflation Reduction Act (IRA) may help the District's Capital needs but neither contain any significant operating support amounts.

Staff is not yet recommending freezing or reducing service but will keep a close eye on revenue levels and changes in the economy. The currently slow pace of growth in operator headcount is for better or worse giving staff time to monitor expense and revenue trends and attempt to strike the necessary balance of service provided at a sustainable level financially.

ADVANTAGES/DISADVANTAGES:

There are no advantages or disadvantages to this briefing item.

ALTERNATIVES ANALYSIS:

The report presents various alternative financial projections.

PRIOR RELEVANT BOARD ACTION/POLICIES:

SR 21-140b FY 2021-22 Operating and Capital Budgets
SR 22-158c FY 2022-23 Operating and Capital Budgets
SR 22-162 Board Financial Workshop

ATTACHMENTS:

1. Financial Projection Presentation

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