

ALAMEDA-CONTRA COSTA TRANSIT DISTRICT



STAFF REPORT

MEETING DATE: 4/26/2023

Staff Report No. 23-244

TO: AC Transit Board of Directors
FROM: Michael A. Hursh, General Manager/Chief Executive Officer
SUBJECT: Financial Projections

BRIEFING ITEM

AGENDA PLANNING REQUEST:

RECOMMENDED ACTION(S):

Consider receiving a report on updated operating financial projections.

Staff Contact:
Chris Andrichak, Chief Financial Officer

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. The implementation of initiatives to reduce deficits will have budgetary impacts.

BACKGROUND/RATIONALE:

The COVID pandemic is winding down and California has ended the state of emergency that was in place since March 2020. As AC Transit takes steps to adapt to a new normal, it also must deal with COVID's economic impact. The turmoil of the pandemic has not only resulted in a massive cultural change in the workplace, but also massive changes to the economic environment as well.

Many economic issues that impacted the District during the last financial presentation to the Board in September 2022 continue to affect the District's finances. The economy is taking longer to improve, and the likelihood of a recession has increased. Inflation has not reduced as quickly as the Federal Reserve hoped and so they have continued to increase interest rates, which may lead to a harder economic landing. Recent stress in the banking sector and commercial real estate could act as potential leading indicators of further economic downturn.

Fortunately, a significant amount of federal emergency operating funding has continued to support the District and allowed for the continuation of bus service, albeit at a lower level compared to pre-pandemic conditions. Unfortunately, California's previous budget surplus has morphed into a \$22.5 billion deficit due to sharp declines in revenues. This does not bode well for the future of operating support from the State. The District continues to use the remaining American Rescue Plan (ARP) Act funding for now, but this funding is projected to be used up by the end of FY 2024-25. The District must decide how best to move forward and manage service levels 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 three years. Funding from the 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 surpassed 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. Farebox revenue is about \$30 million below annual pre-pandemic levels.

The District is fortunate to have seen other subsidy levels return. Funding from sales taxes has shown strong growth over the last two years due to the strength of consumer spending. Property and parcel tax funding also continue to increase due to the strength of personal and commercial property values. These increases have had a positive impact on District revenues. But if a recession reduces consumer spending, District funding from sales taxes could be negatively impacted very quickly.

Inflationary pressure on prices and supply chain issues are a major concern to the District and the prices the district must pay for goods and services remains high. An example of this is a recent significant increase in bus prices. Recent quotes for buses include increases ranging from 35% to 40% over 2021 prices. Existing grant funding is fixed and cannot cover the increase so additional grant funding from other sources or District capital (District cash) will need to make up the difference.

Employer pension contribution increases have become an issue for the District. The Pension System experienced a substantial reduction in asset portfolio value in 2022 which will result in a substantial increase to future year District contributions to maintain the pension funding ratio. These increased contributions in turn cause increases to the District's projected deficits and will make recovery from a potential economic downturn that much more difficult.

Despite all this, service realignment remains a high priority for the District. The communities in the District's service area rely on AC Transit for their transportation needs and deserve convenient and reliable service. Beyond the necessary operating funding, the primary obstacle to managing service is difficulty hiring and training new operators at a rate above normal attrition. Hiring challenges are a nationwide problem for transit agencies and many service-oriented industries in general. The District has implemented multiple initiatives to

attract and retain bus operators and mechanics including sign-on bonuses, referral bonuses, and has launched a recruitment campaign.

Financial Projections

Staff has updated its financial projections to illustrate what deficits the District might face after ARP Act funding is used up under three potential economic scenarios. The projections are shown in the attached presentation and are summarized below:

Projection	Service Level	Recession	Farebox Revenue	Subsidy Revenue	Deficit Five-year total
Best	85%	Mild	10% Annual Increase	2% to 3% Annual Increases	\$64 Million
Expected	85%	Moderate	10% Annual Increases	2% Reduction, Recover FY26	\$143 Million
Worst	85%	Severe (Stagflation)	5% Annual Increases	5% Reduction, Recover FY27	\$226 Million

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 service levels, as well as regular contractual wage increases. Revenues are driven by subsidy growth and farebox growth from increasing ridership. So far \$203.5 million of the total \$285.9 million emergency COVID funding has been spent. The \$82.4 million remainder will be used to reduce deficits over the next two to three years.

Future year expenses in all scenarios are driven by an 85% service level which will be implemented for the August 2023 signup and the need to increase the District extraboard to 38% to increase service reliability. This service level will require 1211 active operators, an increase of approximately 25 operators from current levels.

Projection: Best Scenario

The Best scenario assumes a mild recession in FY 2023-24 along with some reduction of inflation from current levels. This contrasts with the September 2022 financial presentation to the Board which assumed no recession in the Best scenario and normal economic growth. A mild recession is assumed to have a minor impact on subsidy revenues and ridership. Regular subsidy revenues are assumed to increase by 2% to 3% annually. Farebox revenue gradually increases by 10% annually initially but do not return to pre-pandemic levels in this projection. No fare increases are assumed based on the Board's actions over the past couple years to defer existing fare increases.

Under this scenario, deficits increase in FY 2025-26 when ARP Act funding is used up, and then reduce significantly in FY 2027-28. The District would experience deficits totaling \$64 million over four years. The reduction in FY 2027-28 is due to a planned reduction in pension contribution by approximately \$27 million, which will reduce deficits in the following years to manageable levels.

Projection: Expected Scenario

This scenario assumes a moderate recession lasting over a year with a full recovery in FY 2025-26. The recession causes a reduction in consumer demand for goods and services and a corresponding reduction in sales tax revenues. Average subsidies revenue reduces by 2% with a full recovery back up to 3% average growth by FY 2025-26. Farebox revenues maintain at a 10% annual increase initially but do not return to pre-pandemic levels.

Under the Expected Scenario, ARP Act funding is used up in FY 2024-25 and the District will likely experience deficits totaling \$143 million over 5 years. The same pension contribution reduction in FY 2027-28 will significantly reduce deficits in the following years but from a larger baseline and so will not be enough to reduce the deficits to manageable levels.

Projection: Worst Scenario

The Worst scenario assumes continued high inflation and a significant recession starting in FY 2023-24 and lasting two years. Revenue from subsidies decline 5% annually and recover to 3% growth by FY 2026-27. Farebox revenue increases at a reduced 5% level recovering to 10% in FY 2025-26 but as in the other scenarios does not fully return to pre-pandemic levels.

Under the Worst scenario, the District is expected to experience deficits totaling \$226 million over five years. Even with the pension contribution reductions starting in FY 27-28, significant deficits will remain.

Next Steps

These projections continue to show that even under the Best scenario it is likely that expenses will surpass regular revenues for at least two years 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 continues to work on solving this problem.

The Best scenario deficits could be mitigated using a combination of expense management, use of cash reserves, and possibly conversion of some capital funds to operating. 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. Staff has also had discussions with the Pension System over "smoothing" the pension contribution payoff to reduce the near-term impacts on any single year and further mitigate this scenario. The District and the Pension System would need to come to an agreement for this 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 "bridge" funding from the state in combination with a follow-on regional transit funding measure. 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.

A significant challenge to any cost reductions is the District's cost structure. Over 70% of operating expenses

are labor. Most labor expenses are driven by wage negotiations, healthcare increases, and changes to pension contributions. Most Non-labor expenses are fixed and include fuel, paratransit, and insurance. These expenses are very hard to change in the short run. This makes solving a deficit very difficult. Staff is beginning the hard work required with an FY 2023-24 budget that includes only operationally necessary increases and extra scrutiny on controllable costs. This includes no new positions and extra scrutiny of vacancies and filling existing positions.

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. The District has so far been successful at stretching out the ARP Act funds, providing staff more time to analyze the potentially harder future decisions about how to reduce costs to overcome the challenges discussed.

ADVANTAGES/DISADVANTAGES:

There are no advantages or disadvantages to this briefing item.

ALTERNATIVES ANALYSIS:

There are no alternatives associated with this briefing.

PRIOR RELEVANT BOARD ACTION/POLICIES:

SR 22-505 Financial Projection

ATTACHMENTS:

1. Financial Projection Presentation
2. Financial Projection Impact of Great Recession

Prepared by:

Richard Oslund, Director of Management and Budget

In Collaboration with:

Mary Archer, Budget Manager

Evelyn Ng, Capital Planning & Grants Manager

Approved/Reviewed by:

Chris Andrichak, Chief Financial Officer