



City of Bothell™

Third Quarter 2019 Financial Report

December 17, 2019

City Council:

The following narrative and attached document are the budget status reporting for the third quarter of the 2019-2020 biennium, the period ending September 30, 2019. The purpose of this reporting is to ensure that the City Council is kept abreast of positive or negative trends impacting the financial condition of the City, to provide a snapshot of the City's period-to-date financial results, and to present other financial matters affecting the City.

In the first and second quarters of the year staff cautiously labeled differences between forecasted and budgeted revenue trends recognizing at that point that the duration of the anomalies was not long enough to be considered bona fide trends. At the end of the third quarter, however, many of the anomalies have continued and staff is now comfortable labeling them as trends. Unfortunately, the trends affecting the General Fund are negative. The following narrative includes a description of these items as well as a snapshot of the overall financial results from the third quarter.

Third Quarter Financial Report

The General Fund

The overall theme for the General Fund at the end of the third quarter is a continuation of the earlier themes presented at the end of the first and second quarters. No new trends were identified in the third quarter, but as described above confidence is rising that the anomalies reported in prior quarters are bona fide trends. General Fund revenues taken as a whole continued to lag budgeted amounts at the end of the third quarter. The result taken as a whole does not tell the story of two more concerning trends: sales tax and utility tax under performance. A discussion of these items follows.

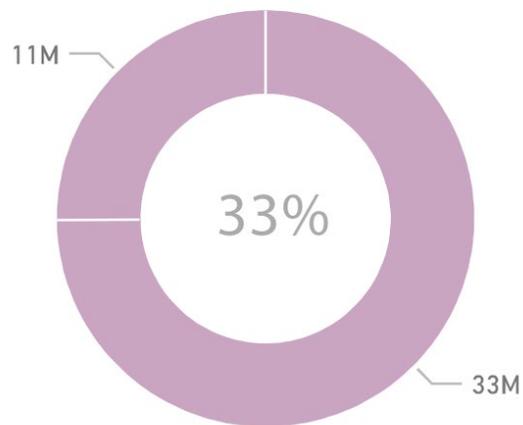
Sales Tax Update

Sales tax continues to lag budgeted amounts by approximately three-percent. While three-percent is not an alarming value, the trend has continued at roughly the same rate all year signaling a trend beyond seasonality. Forecasting of revenues for biennial budgeting compounds year-over-year increases in sales tax, so a negative trend in the first year of the budgetary period will likely compound in the second year. The biennial result of the underperforming sales tax does not differ significantly from past quarterly reports, but the message is tempered with less optimism as the trend has continued over a longer period of time. It should also be noted that unless there are signs of a rebound in 2020 during 2021-2022 budget development the effects of this trend will negatively impact the 2021-2022 sales tax forecast.

Additionally, during the third quarter the Department of Revenue issued a significant sales and use tax refund to a Bothell taxpayer. As a result, Bothell was forced to return approximately \$300,000 in sales and use tax to the State. This was a one-time event.

The chart to the right is a graphical representation of period-to-date sales tax collections relative to the amounts in the biennial budget.

Sales Tax, Percent of Budget Collected



Utility Tax Update

Utility taxes appears to be continuing the trend reported in the second quarter of poor revenue performance. While utility tax volatility is typically associated with weather, the poor performance in this case appears to be attributable to consumer behavior. The move away from traditional landline telephones and very low cost cellular phone charges (not including data charges) is negatively impacting telephone utility taxes. Additionally, cable television utility tax collections appear to be sliding a bit too.

It is difficult to predict the new normal for these utility taxes, but the expectation is that collections will continue to decline at a modest pace as consumer preferences evolve.

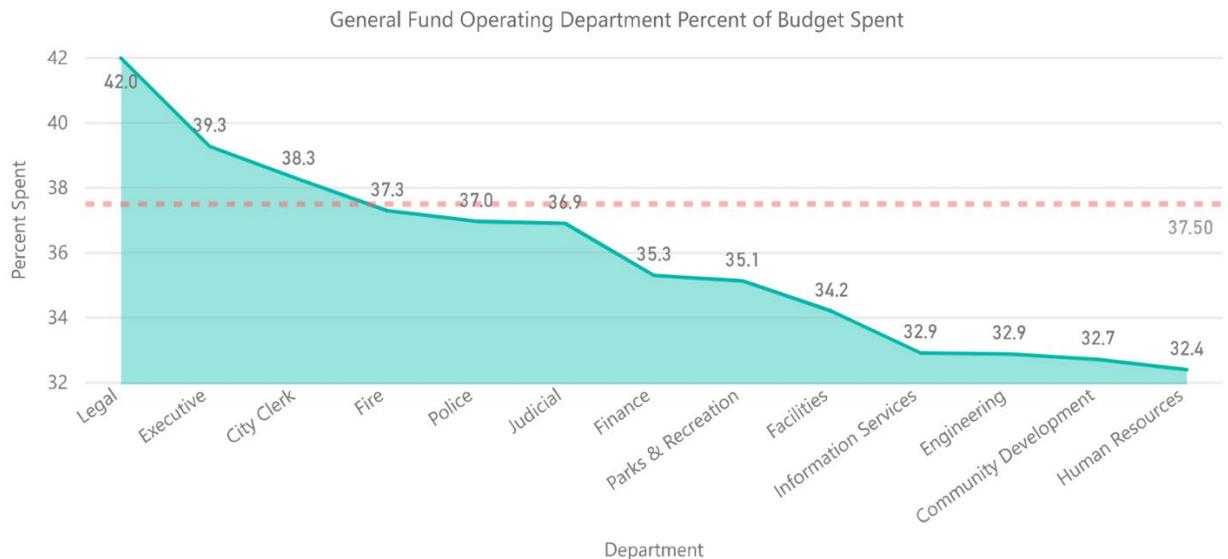
GEMT and Transport Revenue Update

The General Fund received nearly \$600,000 in additional Ground Emergency Medical Transport (GEMT) revenues in the third quarter. As a reminder, this revenue is new to the City and is unbudgeted. The receipt of this unbudgeted revenue is softening the impact of the aforementioned sales tax and utility tax underperformance. Budgeted transport revenue received from sources other than the State also performed well in the third quarter and are on track to beat budgeted amounts for the biennium.

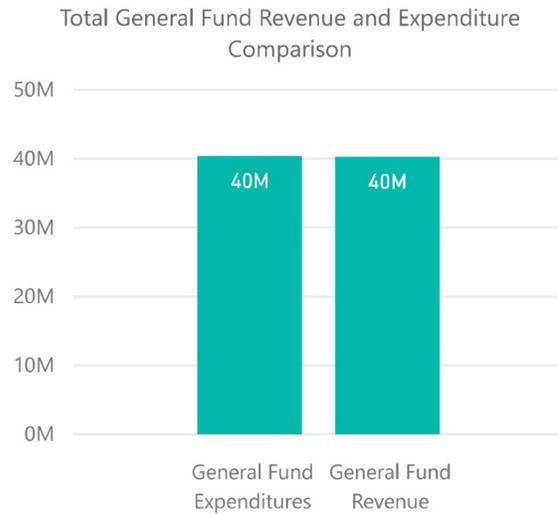
General Fund Expenditures

General Fund departments as a whole, continued to exercise good budget discipline during the third quarter of the year. Department spending, in most cases, is near or below budgeted amounts biennium-to-date and are largely unremarkable.

The following chart is a graphical representation of departments' percentage of spending of their biennial budgets to date. The dotted red line represents the relative position in the biennium, 37.5%. A department with a flat spending curve (one that spends the exact same amount each quarter of the biennium) would be on target to spend 100% of their budget appropriation at the end of the biennium if the department was at 37.5% as of the date of this report.



As has been the trend thus far in the year, the combined result of the lower than budgeted General Fund revenue plus the lower than budgeted expenditures is a General Fund operating deficit (the difference between revenue and expenditures) including the new and unbudgeted GEMT revenue. Despite a growing deficit, 2019 financial results are likely to be better than budgeted.



Other Funds

Real estate excise tax (REET) collections slowed significantly during the third quarter. As a result REET revenues lost some of the earlier gains, but ended the quarter with collections approximately \$200,000 in excess of period-to-date budgeted amounts.

As was reported in prior periods, utility revenues and expenditures are consistent with budgeted amounts and are unremarkable.

Other Matters

Economic Update. This is the third quarterly report to include the mention of a looming recession. Generally speaking economic results do not indicate that we are in a recession. Economic indicators, however, indicate uncertainty in the near term and show signs of a possible recession. Also, there is tremendous uncertainty in certain economic sectors and in the global economy. This uncertainty historically impacts consumer confidence, which may impact sales tax collections and other transaction taxes, such as REET. While current data does not indicate a recession, it is becoming increasingly difficult to ignore the chatter that a recession is on the horizon.

Long Term Financial Sustainability. The continuation of the sales and utility tax trends, as well as the possibility of a recession in the near term, necessitate a mention of the long term financial sustainability issues facing the City. While each Washington city has a unique set of financial circumstances, most, if not all, face the issues resulting from expenditure growth that outpaces revenue growth (commonly referred to as a structural deficit). While a number of factors contribute to impact Bothell's structural

deficit, two factors stand out due to their uniqueness: the nature of past economic development efforts and the City's response to the Great Recession.

Past economic development efforts appear to have emphasized community character rather than developing sales tax revenue, the result is relatively low sales tax revenue per capita to fund city services.

Also, during the Great Recession a decision was made to forego the allowable property tax increase and maintain levels of service by funding a portion of operations with fund balance. Due to the nature of our property tax system, the decision to forego annual property tax increases will negatively impact the value of the City's regular property tax levy as long as the current tax system is in place. Also, maintaining levels of services throughout the Great Recession without identifying new revenue sources effectively deferred the necessary process of aligning operations with resources, or right-sizing the City's levels of service to its financial means.

The City is at an important financial juncture; addressing the structural deficit and realigning levels of service with financial resources is necessary to maintain the financial health of the City. Staff is preparing to advance innovative solutions and choices to address the structural deficit during 2021-2022 budget development.

Other Matters – Subsequent Events

Credit Rating Upgrade. The credit rating agency Moody's performs an annual process to evaluate whether the City's current credit rating that is assigned to all of the City's outstanding general obligation debt is still appropriate. The process concludes with Moody's publishing an opinion as to whether the current credit rating is sustained, upgraded, or downgraded. In early 2019 Moody's performed this process and sustained the then current rating of Aa2.

In anticipation of issuing the voter approved bonds to rebuild Fire Stations 42 and 45, the City initiated a process to establish a new credit opinion, this process is much more in depth compared to the annual maintenance process. Throughout the lengthy process staff focused on demonstrating the City's credit strengths.

On October 11th, at the conclusion of the process, Moody's upgraded their credit opinion of the City to Aa1. The opinion upgrade applies not only for the upcoming bond sale, but to all of the City's existing general obligation debt. The rate of interest that investors are willing to accept from an agency's debt is directly correlated with the agency's credit rating, so this upgrade will result in lower interest cost to the City for future debt issuances, including the bonds to rebuild Fire Stations 42 and 45.

Fire Station Bond Sale. The City sold \$25.5 million of voter approved bonds in the fourth quarter. The proceeds of the bond sale will be used to fund the reconstruction of Fire Stations 42 and 45. Voters approved a total bond issuance of \$35.5 million; it is expected that the second bond sale for \$10 million will occur in two-to-three years based on the cash needs of the project.

The recent bond sale was extremely competitive; eight underwriters submitted bids to buy the bonds. The successful bidder, Morgan Stanley proposed the lowest true interest cost at approximately 2.4 percent annual percentage rate. The rate of interest is lower than the estimate used in the development of the ballot measure taken to voters and will result in savings on the total cost of the fire station projects. The low rate is attributable to changes in the bond market that are favorable for issuers and the City's credit rating upgrade.

In conclusion, the third quarter financial results are generally consistent with the budget due to thoughtful financial stewardship demonstrated by the City Council and staff. While uncertainty is present in the economy, staff is monitoring the situation and is preparing the organization to address whatever comes its way.

Please contact me with any questions.

Best regards,

Chris Bothwell
Finance Director