

**Metro**Los Angeles County
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metro.net**FINANCE AND BUDGET COMMITTEE
JANUARY 17, 2007****SUBJECT: STRUCTURAL DEFICIT****ACTION: RECEIVE AND FILE REPORT ON STRUCTURAL DEFICIT****RECOMMENDATION**

Discuss the attached report pertaining to the transit operating and capital structural deficit.

ISSUE

The FY07 Ten-Year forecast, presented to the Board at the October meeting, shows that under the current assumptions, Metro faces a structural deficit of \$1.8 billion over the next ten years. The structural deficit is defined as: "... the result when available revenues designated for transit operating and capital are less than the forecasted expenditures." As part of the CEO's FY07 performance goals, the Board directed that the CEO provide a plan to resolve the transit operating and capital structural deficit within three years.

DISCUSSION

The attached white paper outlines the current financial status of Metro, and reasons for the structural deficit and also identifies strategies for resolving the deficit. These are not recommendations. To solve the deficit, the Board may wish to adopt a plan that combines several strategies.

ALTERNATIVES CONSIDERED

There are myriad combinations of fare adjustments, service adjustments and/or operating efficiencies to eliminate the structural deficit in part or over time. These will be discussed with the Board prior to final adoption of a deficit reduction strategy.

FINANCIAL IMPACT

The structural deficit is forecasted to be \$1.8 billion over the next ten years using the assumptions approved in the FY07 budget.

NEXT STEPS

Conduct a special Board workshop on Deficit Reduction in February 2007 incorporating the input provided by the Board at the January Finance and Budget Committee meeting.

Attachment

Prepared by: Office of Management and Budget



Roger Snoble
Chief Executive Officer

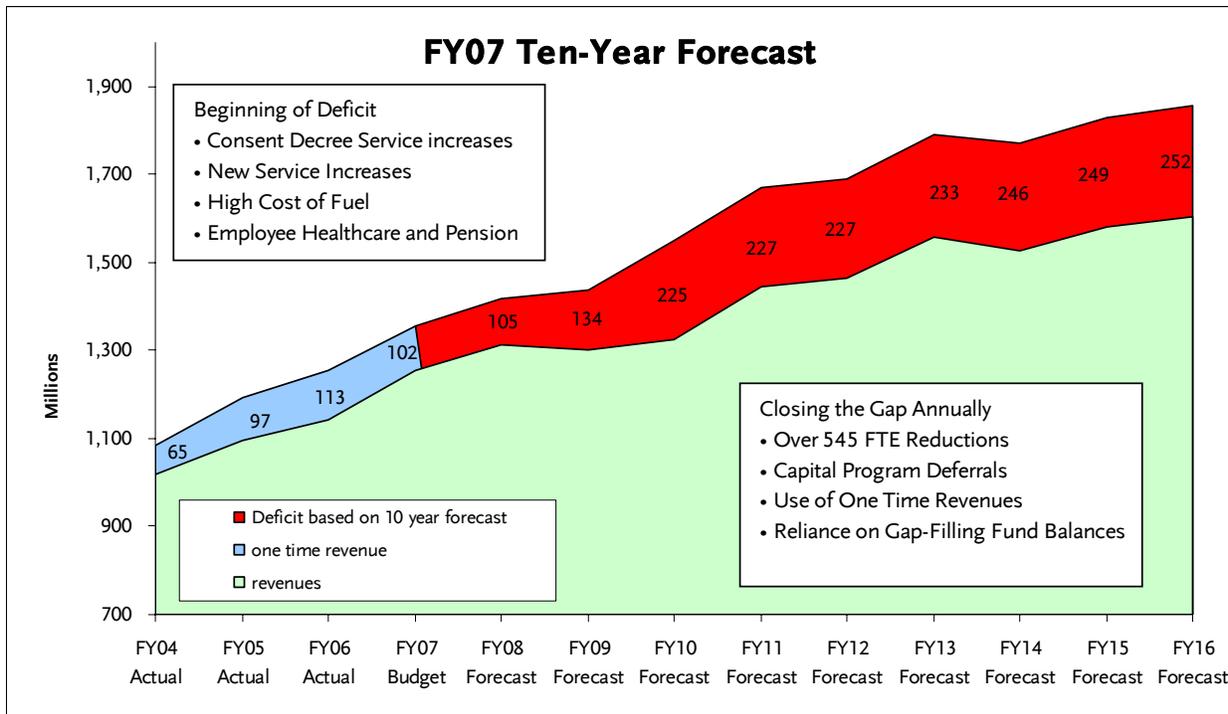
METRO TRANSIT OPERATING AND CAPITAL STRUCTURAL DEFICIT

INTRODUCTION

Simply put – the cost of providing current Metro transit service is greater than the money available to pay for it.

Metro’s annual budget in FY07 was nearly \$3 billion. The budget is comprised of three core business units: Bus and Rail Operations and Capital programs, Countywide Planning and Development and Major Construction Programs. A structural deficit is defined as the result when available revenues designated for transit operating and capital are less than the forecasted expenditures. The FY07 Ten-Year Forecast presented to the Metro Board in October 2006 showed that forecasted operating expenses for Metro bus and rail operations and future capital programs exceed designated revenues by \$1.8 billion over ten years. The forecast showed that in FY08, the cost of providing Metro transit service is greater than the funding available to pay for it by at least \$104.6 million.

Exhibit 1 FY07 Ten-Year Forecast



The Countywide Planning and Major Construction budgets are approximately 60% of the total Metro budget. The expenditures for Countywide Planning and Major Construction are constrained to the forecasted available funding; therefore, there is no deficit in those Metro activities.

If no action is taken to either reduce costs or increase revenues in the FY08 budget, Metro will not be able to meet its payroll obligations as early as August 2008.

BACKGROUND

Metro has been reporting a structural deficit to the Board since 1993. In Board reports, the Financial Impact Section was labeled “Impact on Budget Deficit.” In December 1996, the CEO presented a Board report discussing the “Systemic Deficit.” The Systemic Deficit report stated that:

Traditional bus revenues, fares, and formula subsidies have declined while bus operating levels, service, and cost, have been maintained. Long Range Plans prior to 1996 assumed that the gap would be closed through service adjustments, efficiencies and increases.

The report defined the Systemic Deficit as the “...inability of Bus Operations to live within its means.”

On June 4, 1997, the Board adopted a “Recovery Plan” at a special meeting that included five principles for financial management including the following: “...Identifying and implementing needed agency-wide efficiencies that would help manage and eliminate the structural deficit in the MTA annual budget...”

In November 1997, a Board report was prepared at the Board’s request, to review historical information regarding MTA operations shortfalls and the actions taken to minimize or mitigate the shortfall from FY03 through FY97.

In February 1998, the Board adopted the hiring of a consultant to assist management to “eliminate the recurring deficit by making fundamental changes in operating areas where the MTA has structural inefficiencies.” This resulted in a three-month effort of work-out teams to reduce Metro operating costs.

Since FY02, Metro has presented deficit reduction strategies to the Board at the time of the annual fiscal year budget adoption. These strategies have included general and administrative cost cutting, reductions in force, deferment of bus and rail capital projects and use of one-time revenues.

Most recently, a presentation on the Structural Deficit was made to the Metro Board in April 2006 prior to adoption of the FY07 budget.

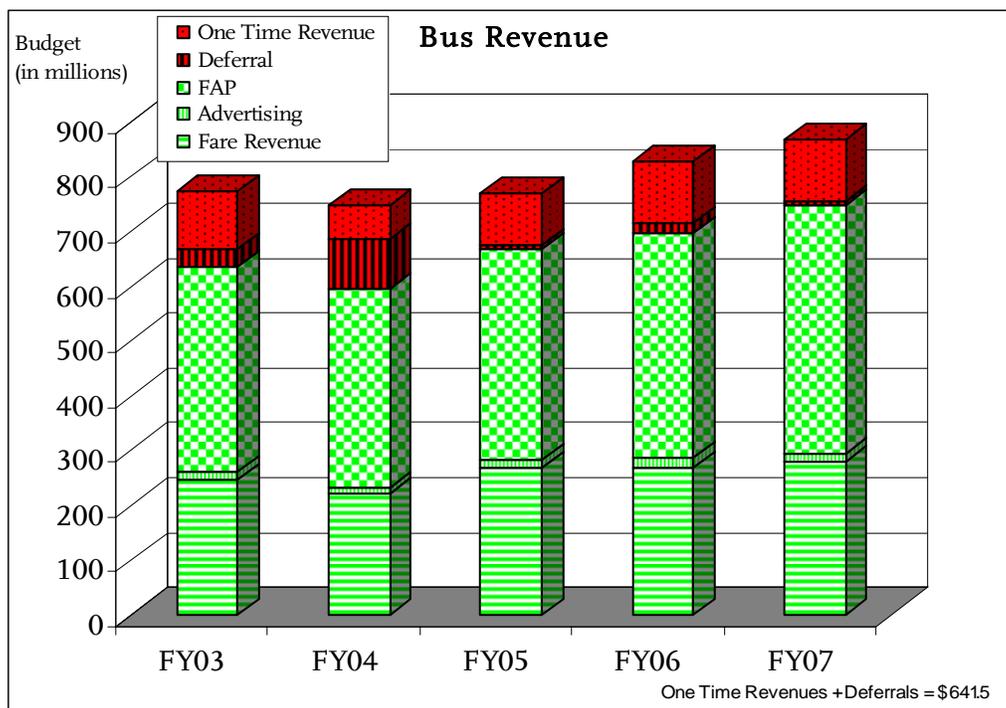
Actions must be taken for FY08 because we have virtually exhausted all reserves, deferred capital maintenance to a dangerously low level, and reduced administrative activities so much that it threatens our ability to maintain sound internal controls.

Although Metro’s revenues have increased over the last five years, numerous factors have caused the structural deficit to worsen. The Consent Decree required Metro to add 1.4 million additional revenue service hours without increasing ridership. Metro purchased 2,143 new CNG buses to accommodate the service increases and replace the aging fleet. Service was also increased on the Metro Blue Line to accommodate increasing ridership. Segments 2 and 3 of the Red Line and the Gold Line were opened, increasing rail operating costs. The Orange Line was opened and the Metro Rapid program was implemented both of

which increased bus operating costs. Additionally, the price of fuel has escalated 117% in the last five years with employee healthcare and pension costs keeping pace at an increase of 90%.

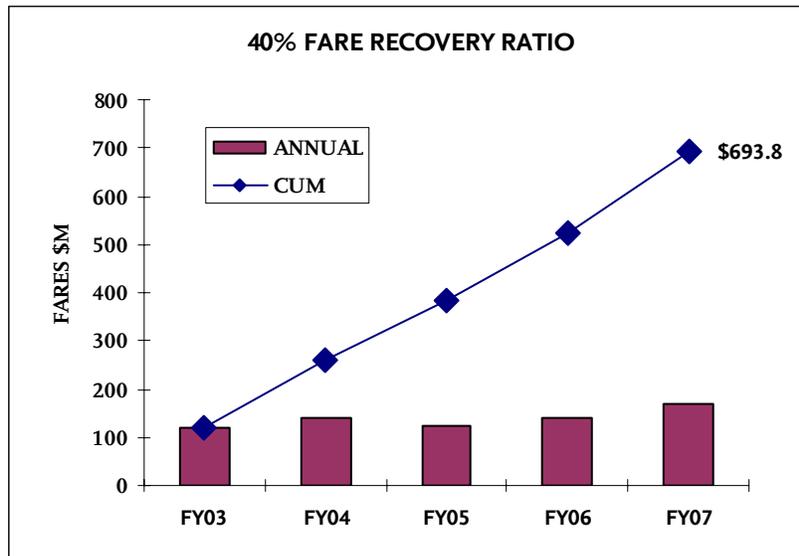
Since 1993, Metro has balanced the annual budget deficit through cost reductions, deferred capital maintenance, the implementation of two fare changes (one in 1995 and one in 2004) and through the use of one-time revenues or reserve balances. The FY07 Ten-Year Forecast indicates that Metro’s General Fund uncommitted fund balance will be approximately \$60 million by the end of FY07. Five years ago this fund reported an uncommitted fund balance of \$143 million. During this period, over \$641 million in project deferrals and one-time revenues were used to balance the transit operating budget.

Exhibit 2 – Bus Revenue



Should Metro have achieved a 40% fare recovery ratio during the same years shown in Exhibit 2, Exhibit 3 shows that corresponding fare revenues of \$694 million would have provided adequate funding for the expenses shown above.

Exhibit 3 – 40% Fare Recovery Ratio



SOLVING THE DEFICIT

There are essentially two basic ways to eliminate the structural deficit: Reduce expenses or increase revenues.

Reducing expenses could include the following actions:

- Defer bus purchases and/or other transit capital projects
- Reduce indirect costs
- Reduce service delivery

Increasing revenues could include the following actions:

- Increase county sales tax by ¼ cent
- Change the Formula Allocation Procedure (FAP)
- Use available uncommitted fund balances
- Improve the fare recovery ratio

Reduce Expenses

The first solution is to reduce operating expenses to match the available revenues. This would require sustained expense reductions of approximately \$104.6 million in FY08, \$30 million in FY09 and \$90 million in FY10 totaling \$224 million of sustained reductions in three years.

The agency appropriates approximately \$200 million annually on its transit capital program (including bus procurements). Because capital reductions represent only one-year savings, elimination of the entire capital program would not achieve the goal of sustained reductions totaling \$224 million per year by FY10. This would also have the resulting negative impact of deteriorating capital infrastructure similar to the environment prior to implementation of the Consent Decree.

Expenses in the budget relating to the support of bus service (commonly referred to as indirect expenses or administrative expenses), are forecasted to be \$89 million in FY08 (8% of the total transit operating budget). Eliminating all support service would not solve even the first year of the deficit and would result in cessation of transit operations. For example, all accounting services (including payroll), human resource services (including recruitment and benefits administration), computer and telephone support, procurement and Board of Directors support are part of these expenses. Metro has consistently reduced these expenses over the past five years during the budget process. Further reductions will place the agency at risk to effectively monitor and manage all operations.

Thus to completely solve the deficit through expense reductions service delivery must be reduced. If the entire structural deficit were to be solved by reducing bus service, approximately 2.4 million hours of bus service would need to be eliminated (a total of 72 routes). This represents approximately a 30% reduction from current service levels. The process for determining service reductions includes a detailed review of each route to assess the manner in which the route performs per the Board adopted performance criteria. The routes that do not meet the Board threshold for productivity would be considered for reduction. It is unlikely that a service reduction of this magnitude could be accomplished through attrition and would, therefore, negatively impact existing bus operators, mechanics, service attendants, supervisors, and managers. Moreover, any service reductions must not violate the New Service Plan, the implementation of which is still subject to federal court jurisdiction.

Exhibit 4 shows the impact of using only service reductions to solve the structural deficit.

Exhibit 4 – Using Only Service Reductions to Solve Structural Deficit

| | Revenue Service Hour Reduction Target (\$) | Number of Lines to Cancel | Hours Saved | Annual Patronage Impacted |
|---------------|--|---------------------------|------------------|---------------------------|
| FY08 | 1.1 mil | 57 | 1,154,956 | 35,483,859 |
| FY09 | .3 mil | 4 | 298,778 | 13,324,651 |
| FY10 | .9 mil | 10 | 912,606 | 43,807,651 |
| FY11 | .03 mil | 1 | 59,543 | 2,891,213 |
| Totals | 2.33 mil | 72 | 2,425,882 | 95,507,373 |

*Revenue hours reduction targets based on deficit projections provided by OMB January 9, 2007

Exhibit 5 shows the history of revenue service hours and the impact of resolving the structural deficit using only service hour reductions and Exhibit 6 shows the impact on ridership.

Exhibit 5 – Impact of Service Hour Reductions

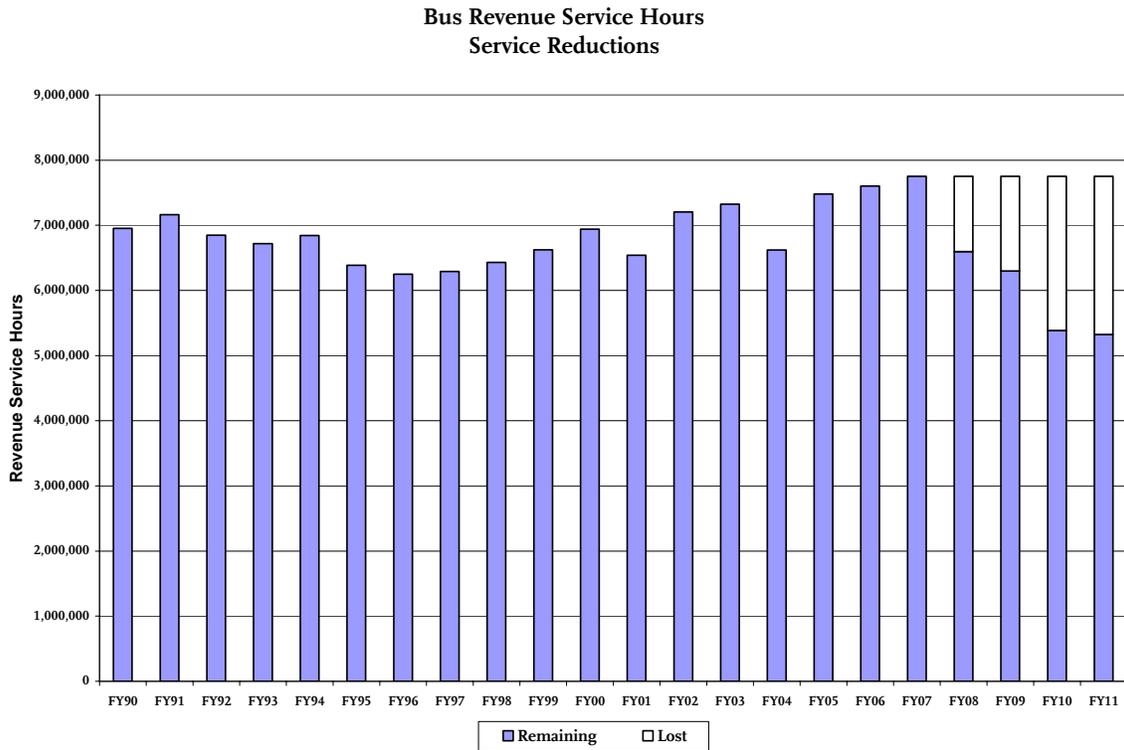
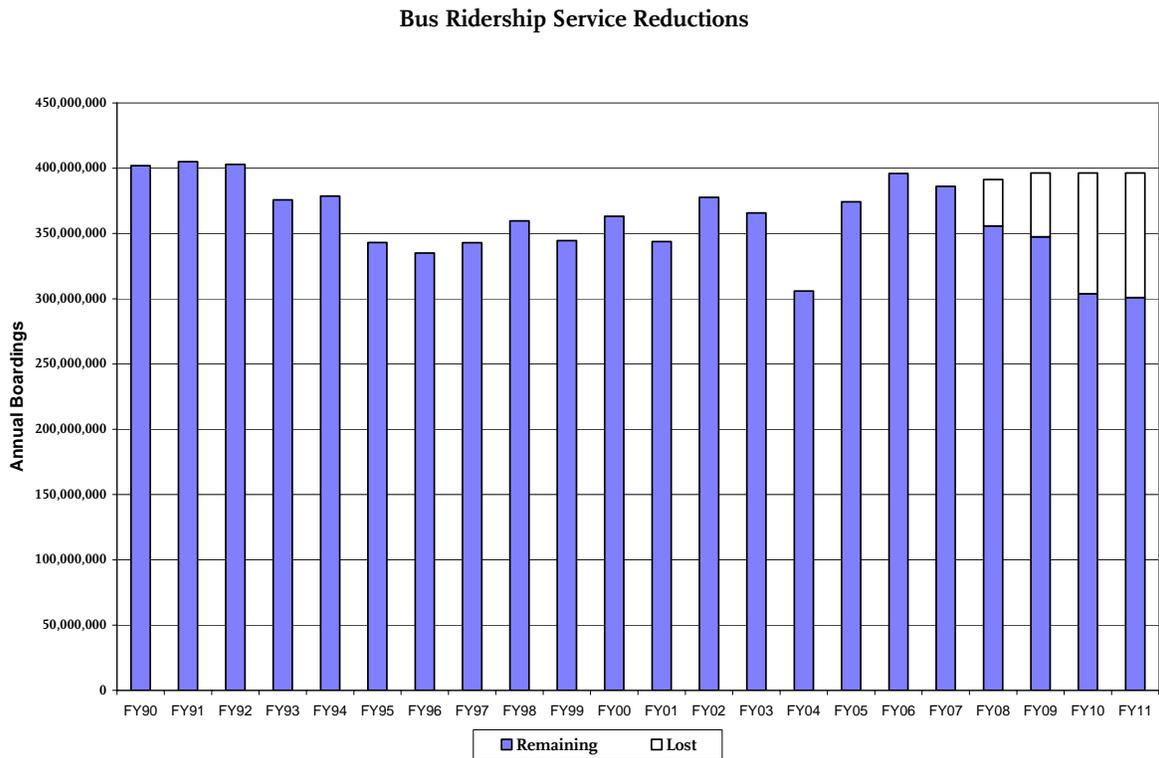


Exhibit 6 – Impact of Service Reductions on Bus Ridership



The FY07 budget for rail operating and capital is approximately \$251 million. This budget is funded with \$50 million of fare revenue, \$96 million of Proposition A 35% Rail Funds, \$47 million of Federal Fixed Guideways and \$14 million of miscellaneous grant funds. These funds can only be used for rail services or would not exist if the rail program were eliminated. The remaining funding on the rail program is \$33 million State Transit Assistance Population Share (historically used only for Rail) and \$11 million of Proposition C 40% Discretionary and could be programmed by the Board to solve the structural deficit. This solution does not provide enough available eligible funding, therefore, eliminating the rail program would not be a viable solution to resolve the structural deficit.

Increase Revenues

One solution for solving the structural deficit would be to ask the voters to approve a new $\frac{1}{4}$ cent county-wide sales tax. Modeled after Proposition A, the new tax would provide \$350 million for regional transit purposes of which \$122 million (35%) would be for our rail transit operating and capital and \$140 million (40%) for bus. In order to implement this solution the Legislature would need to grant us additional sales tax authority. The proposal would then need to be approved by a two-thirds majority of County voters. Assuming ultimate voter approval, it would be at least two years before we begin to receive these additional revenues. Therefore, this is not an immediate solution to the structural deficit.

Another way to increase revenues would be to modify the regional Formula Allocation Procedure (FAP) to one more equitable to Metro. Since the pool of funds distributed through the FAP is limited, a change to the formula that provides an increase of revenues for Metro would mean a decrease of revenues for the other municipal bus operators. Metro would have to receive all of the FAP funding in order to resolve the deficit. Any FAP change requires a $\frac{3}{4}$ majority vote of the Board.

In 2001, the Board voted to augment Metro and the Municipal Operators formula funds with approximately \$60 million per year (increasing by 3% per year) of regional Proposition C 40% funds (also known as MOSIP). In 2006, the Board voted to continue the MOSIP program throughout the ten-year forecast and Long Range Transportation Plan. Therefore, the assumption of revenues available in the Ten-Year forecast relies on the continuation of the MOSIP program for both Metro and the Municipal Operators, and any additional use of Proposition C 40% funds to balance the annual budget would be additive to this amount.

Another way to increase revenues on an annual basis would be to consume the remaining uncommitted fund balances. The two sources of one-time revenues that have historically been used to augment bus operations are General Fund revenues and Proposition C 40% discretionary fund balances. These fund balances could be used for transit capital improvements if they had not already been used on annual bus operating costs. As a result of this practice the fund balances are declining and should they be used to backfill the deficit in FY08, minimal fund balances will remain.

Additionally, the available fund balances are projected in the Ten-Year Forecast to grow less than the amount required to completely solve the deficit on an annual basis. Furthermore, if regional fund balances (Proposition C 40% funds) are used to solve a portion of the deficit, the Board should expect to delay some planned major regional transit and highway capital

projects and/or Call for Projects, as well as delete some projects entirely (including new projects contemplated as a result of recent state bond approvals).

The Board may also wish to change fares as a means of increasing revenues for transit operations. Solving the structural deficit through fare changes alone, would require substantial increases in FY08 and FY10 with a moderate increase in FY09. As an example of the impact of this solution, today's base fare price would change from \$1.25 to \$3.20.

A key transit performance indicator is the fare recovery ratio,-- total fare revenue divided by total operating costs. Increasing the fare recovery ratio could be achieved by decreasing costs, increasing fare revenues or a combination of these two. To consistently operate a balanced budget at the baseline level of capital investment, Metro's fare recovery ratio needs to be at least 38%.

According to the 2004 National Transit Database, Metro's fare recovery ratio was approximately 25%, a figure that is scheduled to decline over the ten years of the forecast. As a means of comparison, New York City Transit Authority reports a fare recovery ratio of 60%; Washington Metro reports 46%; SEPTA (Philadelphia) reports 43%; New Jersey Transit reports 43%; and Chicago Transit Authority reports 38%.

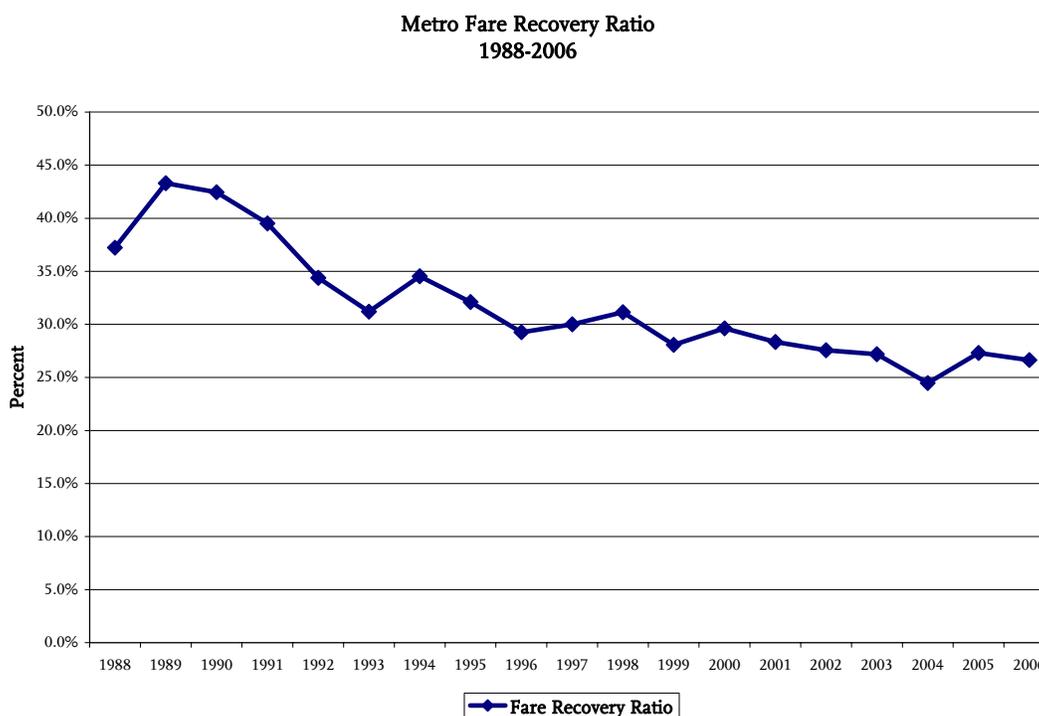
Exhibit 7 – Comparison of Fare Recovery Ratios

| Transit Agency | Modes | Fare Recovery Ratio | Ave fare/boarding |
|--------------------------------|--------------|----------------------------|--------------------------|
| APTA Peer Group | | | |
| AC Transit | Bus | 19.7% | \$0.691 |
| Chicago Transit | Bus & Rail | 45.2% | \$0.849 |
| New York City Transit | Bus & Rail | 59.2% | \$0.958 |
| OCTA | Bus | 23.3% | \$0.590 |
| SEPTA (Philadelphia) | Bus & Rail | 40.0% | \$0.974 |
| | | | |
| Metro (1) | Bus & Rail | 24.7% | \$0.590 |
| Other Large Systems | | | |
| MBTA (Boston) | Bus & Rail | 28.9% | \$0.765 |
| WMATA (Wash, DC) | Bus & Rail | 40.8% | \$1.056 |
| BART | Rail | 49.1% | \$2.254 |
| New Jersey Transit | Bus & Rail | 38.3% | \$2.360 |
| San Francisco | Bus & Rail | 25.5% | \$0.530 |

Based on 2004 National Transit Database, most recent available as of November 2006.

Exhibit 8 shows that Metro's fare recovery ratio has generally declined since 1988.

Exhibit 8 – History of Metro Fare Recovery Ratio



COMBINING SOLUTIONS

There are myriad combinations of fare adjustments, service adjustments and/or operating efficiencies which would eliminate the structural deficit in part or over time.

A combined solution for Metro should incorporate reduced expenses with fare changes to achieve a 38% fare recovery ratio within three years. The Ten-Year Forecast assumes a reduced level of service hours (447,000 hours) from the FY07 baseline as a result of efficiencies implemented with Metro Connections with a corresponding 4% increase in seat capacity as a result of procuring high-capacity buses. A further reduction of service hours is not desirable but may be necessary to achieve an affordable balance between revenues and expenses. Any proposed service reductions must not violate the New Service Plan, implementation of which is still subject to federal court jurisdiction.

The goal of the deficit reduction strategy is to make it possible for Metro to live within its means (use only the available revenues without dipping into fund balances or one-time revenues to achieve a balanced budget). As mentioned previously, the available revenues in the Ten-Year Forecast assume continuation of the MOSIP program. Further adjustments to the fare recovery ratio would be required if the MOSIP funding were not included in the annual budget.

The Board may wish to consider allocating additional regional funds to Metro to reduce potential fare change and service impacts annually. These regional funds may be in the form of CMAQ funds for the annual \$84+ million bus procurement or Proposition C40% fund balance. However, it should be noted that the annual Proposition C40% fund balance

is inadequate to solve the deficit in total in any year. As noted previously, this would also delay or eliminate currently planned regional highway and/or rail or other regional projects.

Both fare changes and service reductions negatively impact ridership. These deflections must be considered in the revenue modeling when developing different scenarios.

NEXT STEPS

Conduct a special Board workshop on Deficit Reduction in February 2007 incorporating the input provided by the Board at the January Finance and Budget Committee meeting.