



September 7, 2017

To: Executive Committee
From: Darrell Johnson, Chief Executive Officer
Subject: Next 10: Market Conditions Forecast and Risk Analysis

Overview

A Market Conditions Forecast and Risk Analysis has been prepared to inform the Orange County Transportation Authority's Next 10 Plan. The Next 10 Plan provides the framework to accelerate the delivery of Measure M2 freeway, streets and roads, transit, and environmental projects through the year 2026. In response to lower actual sales tax revenue, new forecasting methodology, and increased competition for available resources due to capital work underway in the Southern California Region, a Market Conditions Forecast and Risk Analysis was conducted. The report and findings are presented to the Board of Directors for review.

Recommendations

- A. Receive and file the Next 10 Market Conditions Forecast and Risk Analysis.
- B. Continue to monitor the changing environment and its effects on the advancement of the Next 10 Delivery Plan.
- C. Continue to prioritize Measure M2 projects for external funding consistent with the Orange County Transportation Authority's adopted programming policies.

Background

On November 7, 2006, Orange County voters approved the renewal of Measure M, the one-half cent sales tax for transportation improvements. Work on expedited delivery of Measure M2 (M2) began in 2007, with emphasis on organizational, procedural, and technical efforts to prepare for early realization of M2 benefits beginning in 2011. Subsequent to early startup efforts,

the 2008 Great Recession resulted in a significant reduction in the M2 sales tax revenue forecast. In response, the Orange County Transportation Authority (OCTA) developed the M2020 Plan that established program delivery priorities through 2020. In response to continued lower actual sales tax revenue, a new forecasting methodology was adopted in March 2016 and prompted the need to develop a revised delivery plan focusing on the next ten years. On November 14, 2016, the Board of Directors (Board) approved the M2020 Plans successor, the Next 10 Plan (Next 10), which provides a framework to accelerate the delivery of M2 freeway, streets and roads, transit, and environmental projects through the year 2026.

To ensure success of the Next 10, a market conditions forecast and risk analysis was conducted to review OCTA's ability to deliver the breadth of programs and projects. The review was sought to forecast and analyze market conditions for public infrastructure development in the state, surrounding counties, and specifically Orange County, over the next five to ten years, to help develop strategies to anticipate and manage competitive cost pressures and the availability of materials, equipment, labor, and qualified professional staff and services that would affect delivery of the Next 10 in the next decade.

Discussion

Consulting services were sought to conduct OCTA's Market Conditions Forecast and Risk Analysis. Following OCTA's procurement policies, the contract was awarded to the Orange County Business Council. The consultant reviewed the prior market conditions forecast and risk analysis, completed in 2008, as a basis for this analysis. In addition, the consultant conducted a risk analysis to identify risk factors that could affect OCTA's construction costs. A copy of the consultant's report is attached for Board review (Attachment A), which includes findings and recommendations resulting from the analysis.

Seven risk factors were identified, analyzed, and discussed:

1. Sustained low unemployment
2. Increases in residential construction
3. Consolidation in the public works construction industry
4. Increases in interest rates
5. Neighboring county transportation construction programs
6. Construction wage pressure
7. Future recession

Of these, the consultant's analysis identified four near-term cost risks that are expected to be particularly influencing: neighboring county transportation construction programs, construction wage pressures, sustained low statewide unemployment, and residential construction demand and the effect on the public works construction market.

A summary of the consultant's near-term costs risks are included below.

Neighboring County Transportation Construction Programs

With local transportation measures in place in neighboring counties, the Southern California region is in the midst of a large transportation construction program. The analysis showed substantial transportation construction spending from neighboring counties, with Los Angeles County programming approximately four to six times as much construction as Orange County in the five and ten-year time periods. Riverside and San Bernardino counties programs are also substantial and are pursuing construction programs that are larger than Orange County's Next 10 Program.

This is expected to create cost pressures as contractors will have more opportunities to bid on projects and will be less likely to reduce bid prices and potentially fewer bids. This was noted by the consultant as one of the primary cost risks for OCTA in the near term.

Construction Wage Pressure

The review identified that construction wage growth in Los Angeles, Orange, Riverside, and San Bernardino has accelerated since 2014. This likely reflects labor demand pressures in these sectors and indicates stronger wage growth than the national economy.

Historical data suggests that construction employment can expand or contract substantially with economic cycles, but periods of high construction employment have coincided with periods of high public sector infrastructure costs when measured by the California Department of Transportation Construction Cost Index (CCI). The analysis concludes, if private sector economy continues to grow, coupled with large public sector construction programs in Southern California, pressure on construction wages and public sector construction costs will likely increase.

Sustained Low Unemployment

The unemployment levels in California are approaching levels that in the past have been considered full employment. While wage growth has, until recently, been slow, the possibility of sustained and prolonged low unemployment raises the potential for continued construction cost pressures.

Wages have not shown much upward pressure during the recovery from the Great Recession, generally increasing from 2 percent to 2.5 percent per year during the recovery, suggesting that the economy may still have some slack. If so, the unemployment rate might remain at or near current levels for the next few years. The consultant concludes, overall, sustained near-full employment will likely exert more cost pressure than their model predicts, and could place OCTA in a structurally high-cost and increasing-cost environment for capital projects.

Increases in Residential Construction

A key change from the past is how building permits correlated with the CCI in the approximate dozen or so years before 2012. However, building permitting activity has not recovered as the state's economy has rebounded from the Great Recession. Statewide, building permitting activity is at relatively low levels, considering the low unemployment rate. The California Legislative Analyst Office (LAO) has demonstrated that construction in Los Angeles County, in particular, has lagged what is necessary to accommodate population growth. A 2015 LAO analysis found that between 1980 and 2010, California's major metropolitan areas added approximately 120,000 new housing units each year, while the LAO estimated that 210,000 new units per year would have been needed to meet demand.

Several bills have been introduced in the state legislature to address housing needs. Some of the policy proposals may substantially streamline the approval process for new housing. If such proposals dramatically increase new housing construction, which the consultant's analysis finds possible but not likely, that will increase demand for construction labor and materials.

In light of the near-term risk factors, the consultant's analysis suggests the following four recommendations to mitigate cost risks:

- 1) Developing early warning indicators that track data that can provide information about risk factors. This would include, but not be limited to, data on building permits, construction employment and wages, executive opinion about the local economy, and construction commodity costs.

- 2) Explore apprenticeship programs that can increase the pipeline of skilled construction labor.
- 3) Explore ways to continue to be a preferred client for public works construction companies to maintain bid competition.
- 4) Explore further accelerating the Next 10 Program, to the extent possible, as the near-term risks mostly suggest increased rather than decreased public works construction costs.

A summary of the consultant's identified risk factors, impact on costs, likelihood, comments, and possible OCTA mitigation is found in Attachment B.

Next Steps

Overall, the consultant's analysis identifies a strong potential that during the Next 10 delivery years, OCTA will experience an increasing-cost environment. This, coupled with a reduction in revenue, presents the potential for significant challenges in the delivery of M2 and the Next 10 as envisioned. The consultant's recommendations include a consistent message that OCTA should accelerate projects to the extent possible.

Next 10, along with successor plans (Early Action Plan and M2020 Plan), was developed to accelerate projects where possible which has proven successful. Delivering early has allowed OCTA to capture significant external funding and deliver projects in a lower cost environment. During the Next 10 time period, more than \$6 billion in transportation improvements promised to the voters in M2 are slated to be completed or underway by 2026. While final sales tax receipts for fiscal year 2016-17 have not been received, the forecasting agencies' economic outlook provided to date indicate further decline in sales tax collections. Staff is currently reviewing the Next 10 and preparing an update. The update will review and revise project costs with the latest information, take into account the revised revenue projections, and incorporate information provided in this Market Conditions Forecast and Risk Analysis. The Next 10 update is scheduled to go to the Board in the fall 2017.

Summary

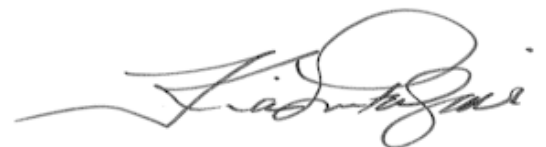
Overall, the final report of the Market Conditions Forecast and Risk Analysis that assessed OCTA's readiness to deliver the Next 10 indicates a potential increasing-cost environment. Staff will incorporate the recommendations from this analysis into the Next 10 update, scheduled to go to the Board in the October/November timeframe.

Attachments

- A. Orange County Business Council, OCTA Next 10: Market Conditions Forecast and Risk Analysis, August 2017
- B. Risk Factors, Effect on Public Works Costs, and Some Possible OCTA Mitigations

Prepared by:

Tamara Warren
Manager, Program Management Office
(714) 560-5590

Approved by:

Kia Mortazavi
Executive Director, Planning
(714) 560-5741