City of Rialto

Legislation Text

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For City Council Meeting [April 9, 2019]

TO: Honorable Mayor and City Council

APPROVAL: Sean Grayson, Interim City Administrator

FROM: Jessica Brown, Finance Director
Robb Steel, Assistant CA/Development Services Director

Request City Council to Receive, File, and Provide Direction on the Report from the Pension Ad Hoc Committee. **POWERPOINT**
(ACTION)

BACKGROUND:

As part of the adoption of the 2018-19 budget, on August 14, 2018, the City Council directed the formation of a Pension Ad Hoc Committee (Committee) to develop an implementation strategy to address the City's unfunded pension and other post-employment benefit (OPEB) liabilities, and to review and recommend potential revisions to the City's General Fund Reserve Policy. The Committee consisted of Mayor Robertson, Councilman Trujillo, City Treasurer Carrillo, the Interim City Administrator, City Attorney Fred Galante, and other management personnel.

As in many other cities in California, the growing obligations related to employee retirements represent a significant financial burden of the City. According to one state report, Rialto had the highest pension burden (pension payments as a % of payroll) of any city in San Bernardino County and the 14th highest in the State. According to the pension and OPEB plan report prepared by Bartel & Associates, the City's annual payments to CalPERS will grow from $12.0 million in 2017-18 to a high of $25.6 million in 2029-30, an increase of $13.6 million. This averages out to a $1.1 million increase each year for the next 12 years, consuming an estimated 25% of the City's projected revenue growth.

Employer contribution rates will increase from 35% of payroll to 50% of payroll for miscellaneous employees and from 50% to 80% of payroll for safety employees. Pension payments alone will grow from 16% of general fund revenues to 22% of projected general fund revenues, crowding out essential services and capital improvements. The City's last reported unfunded pension liability is $122 million, and the OPEB liability adds another $40 million in unfunded obligations for total debt of $162 million. The City's pension obligations are currently 69.5% funded and its retiree medical care obligations are 37% funded.

The $122 million unfunded pension liability represents a long-term financial obligation owed by the City to CalPERS. The discount rate (the expected investment rate of return on assets and the rate applied to future liabilities to arrive at a net present value of the pension program) is currently 7.25% and will drop to 7.00% in 2019-20. In order for the City's pension plan to pay full benefits to the City's retirees (current and future), the City would need to immediately pay this $122 million to CalPERS so that the expected investment earnings equate with the obligation to pay benefits. At a 7.00% discount rate over 30 years, CalPERS will owe more than $260 million to retirees funded from employee and employer contributions, along with investment earnings. Since the City cannot feasibly advance $122 million immediately, the City must compensate CalPERS for the investment shortfalls.

Opinions vary regarding the desired minimum level for unfunded pension obligations; however, a commonly accepted standard targets a minimum funding level of 80%, which leaves 20% of the overall pension liability for future resolution via UAL payments. To reach the 80% funding standard today, the City must devote an additional $41.8 million to reduce the current pension liability. The City's long-term goal should be 100% funding, meaning that assets equal liabilities.

Subsequent to the formation of the Committee in August, seven meetings occurred to discuss numerous issues and alternatives in connection with the City's unfunded pension liability. This agenda item presents the findings and recommendations of the Committee to the City Council.

ANALYSIS/DISCUSSION:
Strategies for addressing the City's unfunded pension liability fall into two broad categories: (1) those that require the City to create funding to pay down or offset the pension liability (Internal Funding Strategies) and (2) those that borrow to pay down the unfunded liability (Borrowing Strategies). The following sections discuss the options within these two broad categories.

Internal Funding Strategies
In terms of generating internal funds for addressing the City's unfunded liability, the City can either (A) reduce existing expenditures and use the savings for pension liability reduction, or (B) use new or increased revenue to reduce or offset the unfunded pension liability.

A. Reduced Expenditure Solutions
In the opinion of the Committee, reducing General Fund expenditures is not a viable solution at this time. The City of Rialto currently faces a structural General Fund deficit along with upward pressure on costs just to maintain existing levels of service, let alone accommodate the demands created by community growth. Cutting expenditures and using the money to reduce the unfunded liability would necessitate a reduction in the ability of the City to maintain these programs and services at existing levels.

Moving forward, the primary area to examine for expenditure reduction purposes is that of payroll costs. Currently, salary and benefits comprise approximately 2/3rd of the General Fund budget. CalPERS assumes a 2.875% annual growth rate for salaries in its modeling for future liabilities -- any increase in "PERSable" compensation above this rate will cause the unfunded liability to increase.

B. Revenue Based Solutions
The City currently has a number of potential options to pursue additional revenue that could then be devoted to addressing the unfunded pension liability. These options include:

(i) PERS Property Tax Override. The City Attorney opined earlier this year that the PERS tax is a valid ad valorem tax in excess of the one-percent tax limit under Article XIIIA of California Constitution. Since 2003, as part of the initial Utility Tax adoption, the City Council has set the tax rate to 0.0%. Since the City can use the revenues from the PERS Tax only to pay for retirement benefits that existed on or before July 1, 1978, the City must perform an actuarial study to determine the total annual amount available. A rough estimate places this amount at approximately $1 million per year. The City can levy this tax without a vote of the citizens.

(ii) Fire Protection District/Fire Suppression Levy. Creation of a special district dedicated to providing fire services would allow the City to shift costs from the City's General Fund thereby releasing current revenues for pension liability reduction. The City funds the Fire Protection District through taxes paid by all residents of the City, or limited to property owners only. As a special tax, it will require a 2/3rd vote for adoption. The City has the flexibility to set the rate all the way up to fully covering the operations of the Fire Department ($21± million). The financial resources raised through this approach can either replace or supplement existing revenues. To the extent the City uses the levy under the Fire Protection District to supplement existing revenues, these funds would be available to reduce the unfunded pension liability.

If, instead of a special tax, the City opted to implement a fire suppression assessment, a 50% vote of the property owners would be required to levy the assessment. Unlike with the fire protection district special tax, the money can only be used for fire suppression costs (emergency medical costs would not be covered). The levy could cover a portion of the fire department's pension liability.

(iii) Measure U. Rialto voters adopted this measure in 2014 and established a business license tax on fuel storage capacity. An escrow agent holds approximately $31 million pending the outcome of litigation between the City and the owners of the fuel storage tanks. Should the City prevail in this litigation (or settle), the City could devote the escrowed money (as well as the ongoing revenue) received to unfunded liability reduction.

(iv) Sale/Lease of City Assets. The City owns a number of assets that could be sold or leased. The City has not completed a comprehensive financial assessment of these assets for a number of years and it is therefore difficult to estimate the potential dollar value from disposition. One such asset, however, is the treated wastewater the City currently discharges into the Santa Ana River. The 6,800 acre feet currently discharged is worth $3-5 million per year. Resolution of water issues tends to be lengthy and this is a longer-term solution. The revenue realized from wastewater sales would probably flow through the Rialto Utility Authority and the General Fund would realize the revenue via increased lease payments.

(v) Other Taxes. Increasing taxes requires a vote. Alternative taxes available include the Transient Occupancy Tax, Sales Tax, and Community Facilities Districts. Additional tax revenue collected could be used to address the unfunded liability. In June of 2018, the residents of the City passed Measure M to make the Utility Users Tax permanent. Before serious exploration of any of these options, it is recommended that the City poll the residents to determine the feasibility of additional taxation.

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(vi) RUA Lease Payments. Currently the RUA lease payment to the City is $2 million per year. The City could capture increased lease payments for pension liability reduction purposes; however, the RUA would pass this cost along to the RUA ratepayers after satisfaction of the Proposition 218 protest vote process. The City's current water and sewer rates already range toward the upper end of the spectrum of competing cities.

Borrowing Strategies

The alternative to internally generating resources is to borrow money and use that borrowed money to reduce the pension obligation. The new debt must carry a lower interest cost than the retired debt for this strategy to work.

(i) Pension Obligation Bonds. The City could issue taxable pension obligation bonds (POB's) to, in effect, refinance its liabilities. When the City issues POB's, the City uses the proceeds to pay down its CalPERS unfunded pension liability. The City then makes periodic debt service payments to retire the bonds over a period of 20 to 30 years. The POB's will presumably carry an interest rate less than the rate applied to the unfunded liability. This interest rate differential results in budgetary savings to the City. The City could use these savings to meet current budgetary needs such as adding additional law enforcement officers or accelerating reduction of the unfunded liability.

The City can size and structure the POB's in a number of different ways and under one suggested alternative, the City would save a total of $21 million over a 30-year period by issuing bonds and using the proceeds to pay down the unfunded liability. Most of the cash flow savings, however, will occur after 20 years. When comparing bond debt service with scheduled CalPERS payments, the annual savings do not exceed $300,000 for the first ten years. In addition, the decision to pay money to CalPERS is irrevocable. Once the City sends the money to CalPERS, the City cannot recover it for other purposes. If the CalPERS discount rate drops further, the unfunded liability will re-accumulate and the City will still be required to make debt service payments on the outstanding pension obligation bonds. Similarly, if the CalPERS unfunded liability decreases for any reason, the City remains obligated to make payments on the POB's, regardless of what the CalPERS obligation becomes. If in the future, some statewide bailout or restructuring of pension obligations occurs, Rialto remains obligated to make debt service payments on the bonds.

POB's increase the City's financial risk and the Government Finance Officer Association (GFOA) advises against this approach for resolving pension liabilities. The GFOA expressed concerns that (1) the invested proceeds will not outperform the cost of the debt, thereby increasing liabilities, (2) the POB's may carry complex debt structures increasing credit and interest rate risk, (3) the POB's use up the debt capacity of the organization and may be difficult to refinance due to the taxable structure, (4) the POB's may extend repayment periods thereby increasing long-term costs, and (5) rating agencies may negatively view the debt unless part of a more comprehensive debt management strategy.

(ii) Internal Note. Another borrowing strategy discussed by the Committee involved an internal borrowing of the City's investment portfolio (the City of Chino approach). Under this strategy, the City uses various cash from its investment portfolio and structures a 20 year note payable and essentially refinances its outstanding obligation at a rate of 2% per

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annum. The note payable is recorded in the General Fund and the note receivable is recorded in the Employee Benefits Internal Service Fund (ISF). Repayment of the note is secured by the statutorily required contributions that would otherwise be paid to CalPERS. The City Treasurer has expressed opposition to this plan as originally presented. The City Treasurer has also contacted the California State Treasurer's Office and received a negative opinion of this option. The City Auditor has reviewed this concept as presented in the City of Chino's 2017-18 audited financial statements and finds the concept of internal borrowing to potentially be an acceptable option following an in-depth analysis of each funding source to identify current obligations, budgets, fund balance assignments, commitments, and restrictions that were previously adopted; and any restrictions on use of funds. This type of interfund borrowing is legally acceptable for legitimate purposes.

Retiree Healthcare (OPEB)

The City's retiree healthcare (otherwise known as OPEB) had a total liability of $56.7 million as of June 30, 2018, and of this liability, approximately $40 million was unfunded.. The OPEB obligation is similar to the CalPERS pension unfunded liability with four important differences. First, the City currently has a Section 115 Trust for OPEB purposes. This Trust had a $16.7 million balance as of June 30, 2018, and will decrease by approximately $2.0 million in 2018-19 due to the City withdrawing funds for the current year obligation with no programmed contributions. Second, the City has flexibility over how much of the unfunded liability is paid each year, unlike with the CalPERS unfunded liability in which the payment is mandated. Third, OPEB obligations likely do not have the same level of vesting protection of pensions. Finally, the City can stop offering this benefit for new-hires. The annual expense for current and retired employees is approximately $4 million.

Despite the differences between the City's OPEB and its pension obligation, the obligation for retiree healthcare needs to be paid over time. As a result, the recommendations in the following section, while targeting the pension obligation, are also applicable to the OPEB liability.

Section 115 Trust

This Report outlines a number of potential options for generating funds that the City could use to reduce or offset the City's pension liability. If the City sends the funds generated from any of these options to CalPERS, it directly reduces the unfunded liability, saving the City 7% per year on the amount of the liability reduction.

The City has one other option for all options except for the POB's (which require that the City remit the funds to CalPERS). The City can place the money into a Section 115 Trust account. A Section 115 Trust is a tax-exempt investment tool used to prefund retiree medical and retirement plan benefits. Because the City designates the Trust for these purposes, it is exempt from the state mandated investment restrictions placed upon the City's general portfolio. As such, the City has greater flexibility in the types of instruments that can be purchased as investments and this added flexibility may lead to greater investment returns than could otherwise be achieved in the City's general investment pool (with the City accepting direct responsibility for the volatility in returns that now resides with CalPERS). In order to remain tax-exempt, the City must designate the assets held in the Section 115 Trust as irrevocable, meaning they must be used only to fund the City's retirement plan obligations. For this reason, the City may withdraw monies from a trust either to reimburse the City for current and/or the previous year's pension payments, or to pay CalPERS directly. Under the terms of a Section 115 Trust, a third-party trustee holds the investments and thereby protects the investment from creditors in a bankruptcy proceeding.

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The City of Rialto currently has a Section 115 Trust established for its OPEB obligations. The annualized returns in the OPEB Trust since its inception in 2009 are 9.4%; however, past returns are not indicative of future results.

The Section 115 Trust provides the City with greater financial flexibility than remitting funds to CalPERS because the City can access the funds to reimburse its annual payments to CalPERS in the event of financial distress. However, CalPERS does not recognize the assets held in the Trust therefore the City's annual UAL payments will not change, and the City would most likely use Trust resources to mitigate its annual payments. The City must also accept investment risk for Trust assets by choosing the portfolio that achieves the greatest return at acceptable risk. If the City underperforms the CalPERS portfolio, then the Trust structure produces increased liabilities. The City may accept this risk in exchange for the greater flexibility.

Committee Recommendations:

The Committee recommended that the City establish a short-term goal to reach a funded ratio of 80% (assets held in trust equal 80% of the pension liability). The Committee reached the conclusion that no single solution is practical to provide the approximately $42 million necessary to achieve this goal. Consequently, the blueprint for addressing the City's unfunded pension liability involves a multi-faceted approach relying upon the Internal Funding Strategy. The Committee did not recommend a Borrowing Strategy, although it did recommend further investigation of the Internal Note structure.

The Committee's recommendations at this time are:

1. **Establish a Section 115 Trust account for pensions.** Placing the money in the Section 115 Trust does not reduce the City's pension liability but allows the City to have some flexibility in how and when the money is used; however, the City assumes responsibility for investing these funds and accepting the volatility in market returns.

   This recommendation is in line with the Budget Advisory Committee's recommendation as detailed in the July 24, 2018, Expenditure Efficiency Recommendation report, to establish a Section 115 Trust to offset its pension liability.

2. **Explore funding options and policies for the OPEB and Pension 115 Trusts during the 2019-20 budget cycle.** Currently the Finance Department is in the process of reconciling and analyzing the City's available fund balances. Once completed, the Committee will further review and consider possible funding options and policies for the OPEB and Pension 115 Trusts including further analysis of the Internal Note structure.

   The Budget Advisory Committee's Expenditure Efficiency Recommendations report dated July 24, 2018, recommended the establishment of a Section 115 Trust to offset its pension liability and included various possible funding options. These funding options included: the allocation of a portion (1/3) of all future discretionary non-operating revenue (e.g. land sales or rents) to supplement funding; the allocation of 5% of annual payroll from the operating budget; and/or the allocation of all of the Measure U revenues accumulated in the escrow account upon disposition of the case in favor of the City (estimated at the time to be approximately $30 million). These options will be further considered during the 2019-20 budget cycle.

3. **Pursue the Formation of a Fire Protection District.** Formation and implementation of a fire protection district will require a LAFCO process and an election requiring a 2/3rd vote as a special tax. The City must hold this election on a regularly scheduled election date that would be approximately two years away. Therefore, this is not an immediate or certain solution; however, the City should begin the selection process for a firm to conduct a feasibility analysis.

   This recommendation is in line with the Budget Advisory Committee's recommendation as detailed in the Revenue Enhancement Recommendations report, dated July 24, 2018, to further research the formation of a Fire Protection District and initiate a feasibility study.

4. **Salary and benefit cost containment.** Salary and benefit costs represent 2/3 of the General Fund budget. The Committee recommends containing future salary and benefit costs through labor negotiations.

   This recommendation is in line with the Budget Advisory Committee's recommendation as detailed in the Expenditure Efficiency Recommendations report, dated July 24, 2018, to work with the various City unions toward aligning cafeteria benefits to market standards, developing tiers of paid time off for new hires, properly plan staffing levels to control overtime costs, and developing alternatives to specialty pay.

5. **General Fund reserve policy analysis.** As indicated above, the Finance Department is in the process of reconciling and analyzing the City's General Fund available fund balance as well as expenditure obligations. Once completed, the Committee will further review and make recommendations regarding the City's General Fund reserve policy.

ENVIRONMENTAL IMPACT:
The Committee is an administrative action of the legislative body and is not defined as a project. The proposed action is therefore exempt from California Environmental Quality Act (CEQA). CEQA does not apply to projects for which "it can be seen with certainty that there is no possibility that the activity in question may have a significant impact upon the environment" (Section 15061(b)(3) of the CEQA Guidelines).

GENERAL PLAN CONSISTENCY:
This action is consistent with Guiding Principle 3A in the General Plan: Our City government will lead by example, and will operate in an open, transparent, and responsive manner that meets the needs of the citizens and is a good place to do business.

LEGAL REVIEW:
The City Attorney has reviewed and approved this staff report.

FINANCIAL IMPACT:
Operating Budget Impact
If the Committee recommendations are accepted, staff will prepare an agenda item for Council approval. Specific operating budget impacts will be outlined at that time.

Capital Improvement Budget Impact
This action causes no impact to the capital improvement budget.

Licensing
There is no licensing requirement directly associated with this request. Any vendors the City may engage as part of this assignment would purchase a business license.

RECOMMENDATION:
Staff recommends that the City Council Receive, File, and Provide Direction on the Report from the Committee.