CITY OF MORRO BAY
CITY COUNCIL
NOTICE OF SPECIAL MEETING

The City of Morro Bay provides essential public services and infrastructure to maintain a safe, clean and healthy place for residents and visitors to live, work and play.

SPECIAL MEETING AGENDA
Tuesday, May 22, 2018 @ 4:00 PM
Veterans Memorial Hall
209 Surf St., Morro Bay, CA

ESTABLISH QUORUM AND CALL TO ORDER

PUBLIC COMMENT FOR ITEMS ON THE AGENDA

SPECIAL MEETING AGENDA ITEM:

I. BUDGET STUDY SESSION #3: PROPOSED BUDGET FOLLOW-UP, TEN-YEAR FORECAST UPDATE AND OPTIONS TO ADDRESS UNFUNDED LIABILITIES

RECOMMENDATION: Council receive staff presentation and provide direction, as necessary.

ADJOURN

DATED: May 18, 2018

Marlys McPherson

Marlys McPherson, Mayor Pro Tem

THIS AGENDA IS SUBJECT TO AMENDMENT UP TO 24 HOURS PRIOR TO THE DATE AND TIME SET FOR THE MEETING. PLEASE REFER TO THE AGENDA POSTED AT CITY HALL FOR ANY REVISIONS OR CALL THE CLERK'S OFFICE AT 772-6205 FOR FURTHER INFORMATION.

IN COMPLIANCE WITH THE AMERICANS WITH DISABILITIES ACT, IF YOU NEED SPECIAL ASSISTANCE TO PARTICIPATE IN A CITY MEETING, PLEASE CONTACT THE CITY CLERK'S OFFICE AT LEAST 24 HOURS PRIOR TO THE MEETING TO INSURE REASONABLE ARRANGEMENTS CAN BE MADE TO PROVIDE ACCESSIBILITY TO THE MEETING.

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AGENDA NO: I

MEETING DATE: May 22, 2018

Staff Report

TO: Honorable Mayor and City Council **DATE: May 16, 2018**

FROM: Jennifer Callaway, Finance Director

SUBJECT: Budget Study Session #3: Proposed Budget Follow-up, Ten Year Forecast Update and Options to Address Unfunded Liabilities

RECOMMENDATION

Council receive staff presentation and provide direction, as necessary.

BACKGROUND

Following Budget Study Session #2 on May 9, 2018, the following items remain open for Council to comment on/provide direction to staff:

Council Bequests: A funding request has been received from Senior Nutrition and is attached for Council consideration and direction. The request submitted is for $10,000. Based on previous Council discussion, $5,000 remains to be allocated out of the Council bequest line item. (Attachment 1)

City Attorney Contract: The City Attorney is requesting a rate increase of $10.00 per hour for all billing codes as proposed below:

First 50 hours of general services[1]	$175.00/hour
Hours over 50 for general services	$195.00/hour
Special services[2]	$215.00/hour
Insurance defense	$160.00/hour
Private party reimbursement	$260.00/hour
Paralegals/Law Clerks	$130.00/hour
Document Clerks	$ 70.00/hour

[1] General services are everything other than special services, insurance defense, private party reimbursement and public financing

The total projected budget for FY 2018/19 incorporating the $10.00 per hour increase is $411,261.50. Staff previously proposed a budget of $409,376. Staff previously discussed with Council on May 9, 2018 that legal services would be added to the WRF capital project. Staff determined that $25,000 would be an appropriate budget for these services. Therefore, with the inclusion of $25,000 for

Prepared By: JC	**Dept Review:** ______
City Manager Review: ________	**City Attorney Review:** ______

anticipate WRF related legal services there will be sufficient budget incorporated into the proposed FY 2018/19 budget for the proposed rate increase.

Parks Strategic Plan: During the May 9, 2018 budget study session staff mentioned the possibility of funding a Parks Strategic Plan. Staff asks for Council clarification if that should be included in the revised proposed budget.

Surf Street Stairs Capital Project: During the May 9, 2018 budget study session the Council directed staff to include and fund the reconstruction of the Surf Streets stairs. On May 15, 2018 the Citizen's Finance Advisory Committee (CFAC) had an opportunity to review the proposed budget in its entirety and comment on the budget. During that discussion CFAC recommended to Council that the Surf Street Stairs replacement project not be funded. CFAC felt that there is not enough data available about stair usage to support the project and recommended that the $300,000 proposed budget for the replacement be reallocated to other ADA needs within the City that were identified in the ADA transition plan.

Unfunded Liabilities

New accounting standards have dramatically impacted local government financial statements by requiring the net pension/OPEB liability (OPEB effective date is FY 2017/18) be reported as a liability on the City's statement of Net Position; thereby reducing the City's financial net position (assets in excess of liabilities). Prior to the change in accounting standards in the long-term liability amounts referred to as unfunded accrued actuarial liability were not included on the City's balance sheet. Annual payments for pension and OPEB costs were paid on a "pay-as-you-go" basis, therefore no additional accrued actuarial expenses were added to City pension or health care costs and there was not an additional liability reported on the balance sheet. The addition of these unfunded long-term liabilities to the entity-wide financial statements has brought these liabilities to the forefront of attention among public officials and citizens nationwide.

In development of the Proposed FY 2018/19 Budget, staff identified four goals/strategies to guide the budget process:

- Develop a recommended balanced budget without impacting core services
- Be mindful of internal service funds and support of infrastructure, facility and equipment needs
- Identify opportunities to enhance service delivery through technology and open government
- Limited growth being mindful of future budget challenges and forecasted shortfalls.

The last goal/strategy, "limited growth being mindful of future budget challenges and forecasted shortfalls" comes directly from the future implication of the California Public Employees Retirement System (CalPERS) discount rate reduction and growing cost that is being passed onto member agencies. Staff contacted the City's assigned CalPERS actuary to discuss various pay off options. The assumption of pay off options includes a variety of factors and amortization bases. These options presented below are "level percent" estimates (actuaries recommended method), however with further Council direction on which option staff should pursue, refined cost savings estimates can be provided.

DISCUSSION

Ten-Year Forecast

The General Fund Ten-Year Forecast, provided as Attachment 2, indicates a balanced budget in FY

2018/19 as proposed with the future years indicating budget shortfalls up to $3.5 million by FY 2027/28. The forecast assumes a stable economy through most years, with a regression in FY 2025/26. It does not assume a long-term recession. The budget shortfalls identified in the forecast are primarily due to the PERS rate increases. The updated General Fund ten-year forecast reflects the staffing model proposed in the FY 2018/19 budget. The forecast assumes top-step for employees beginning in FY 2019/20. No COLA increases are included in the forecast at this point, however, if triggers are met in FY 2019/2020 those COLAs would be extended to the bargaining groups who have negotiated for them. Staff has estimated PERS increases based on most recently available information, however staff cautions that these are estimates only and subject to change given the results of the City's next actuarial evaluation as well as future CalPERS policy changes. In updating the ten-year forecast, staff assumed the following:

	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	AVG
Revenues										
Property Tax	0.42%	3.52%	3.93%	3.93%	3.13%	3.14%	1.00%	2.98%	3.00%	2.78%
Sales Tax	3.94%	4.91%	4.84%	3.07%	3.08%	3.09%	0.00%	3.12%	2.92%	3.22%
TOT	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%
Business License	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
Expenditures										
Salary	0%	0%	0%	0%	0%	0%	0%	0%	0%	0.00%
Pension	10%	8%	7%	4%	5%	5%	5%	5%	5%	6.00%
Health	2.00%	1.00%	1.00%	1.00%	3.00%	3.00%	3.00%	3.00%	3.00%	2.22%
Medicare	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
WC	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Unemployment Insurance	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Transfers										
Vehicle	$ 178,084	$ 198,345	$ 201,296	$ 267,226	$ 270,675	$ 210,689	$ 214,009	$ 217,430	$ 220,952	
Technology	$ 364,674	$ 377,461	$ 390,798	$ 403,621	$ 416,325	$ 428,297	$ 419,266	$ 419,266	$ 419,266	
Facilities	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	
Capital	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	
Fire Equip	$ 71,344	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 75,000	$ 75,000	$ 75,000	$ 50,000	
Other (Risk & Comp Leave)	$ 61,800	$ 63,654	$ 65,564	$ 67,531	$ 69,556	$ 71,643	$ 73,792	$ 76,006	$ 78,286	

While there may be some capacity to reduce expenditures by reducing transfers, staff believes it is vital to continue to contribute to vehicle and facility replacement/maintenance funds as well as the capital improvement funds. As such, and as part of the efforts of the employee budget advisory team, staff will be bringing forward several options for the City Council to consider in FY 2018/19 to enhance future years revenues. These revenue enhancements include:

- RV Camping at the Rock
- Paid Parking Options
- Cannabis Tax
- Fee Increases
- Sale of property/credits (one-time money)

While remaining cognizant of the need to increase revenues, staff remains realistic that increasing revenues alone will likely not solve the projected shortfalls and the overall impact of the CalPERS rate changes. Expenditure reductions be analyzed and considered throughout this next fiscal year. Staff remains committed to evaluating how we provide services, examining the City's structure and identifying ways to reduce on-going expenditures. Staff looks forward to establishing a robust community outreach program to gain input on future year budget decisions, along with continued outreach to City staff.

CalPERS – Unfunded Liabilities

City Plans

City of Morro Bay permanent employees participate in CalPERS. Sworn employees (both fire and police) are covered under the Fire and Police Safety plans respectively, while all other employees are covered in the separate Miscellaneous plan. A pooled plan was required by California law for those agencies who had fewer than 100 active members, which was applicable to the City's plans. These assets and liabilities are pooled with all other smaller agency plans in the State with fewer than 100 active members to provide a large, risk sharing pool. This risk sharing dramatically reduces or eliminates large fluctuations in an employer's pension contribution rate caused by unexpected demographic events.

Depending on an employee's position and hire date, a City employee is included in one of the nine possible plans as follows:

Plan	Miscellaneous	Safety Fire	Safety Police
Classic Members	2.7% at Age 55	3% at Age 50	3% at Age 50
Tier 2	2% at 60 (Effective FY 2012/13)	3% at Age 55	3% at Age 50
PEPRA Plan	2% at Age 62 (Effective Jan 1, 2013)	2.7% at Age 57 (Effective Jan 1, 2013)	2.7% at Age 57 (Effective Jan 1, 2013)

Funding for the City's CalPERS retirement plans is supported by both employer and employee contributions. Using current fiscal year rates these contributions are detailed below:

Plan	Employee Misc. Rate	Employee Safety Fire Rate	Employee Safety Police Rate
Classic Members	8.00%	9.00%	9.00%
Tier 2 Members	7.00%	9.00%	9.00%
PEPRA Members	6.25%	11.50%	11.50%

Plan	Employer Misc. Rate	Employer Safety Fire Rate	Employer Safety Police Rate
Classic Members	43.256%	73.966%	61.792%
Tier 2 Members	7.822%	18.049%	17.737%
PEPRA Members	6.921%	12.250%	12.262%

The annual employer contributions are determined by actuarial valuation reports prepared by CalPERS for each of the City's plans. Due to the amount of data involved, the employer rates for FY 2018/19 are set forth in the June 30, 2016 actuarial valuation report.

Beginning January 2018, public agencies that have collectively bargained in good faith and have completed impasse procedures (including mediation and fact finding) will have the ability to unilaterally require classic members to pay up to 50% of the total normal cost of their pensions benefits. However, the employee contribution rate may only be increased up to an 8% contribution rate for miscellaneous members and 12% contribution rate for safety members.

CalPERS Funding Review

The CalPERS retirement system is funded by three main categories: (1) CalPERS Investment Earnings; (2) Employer contribution rates; (3) Employee contributions to CalPERS.

CalPERS reports that over the past twenty years every average dollar spent on public employee pension has been sourced from the following as of June 30, 2015

- 65 cents – CalPERS investment earnings
- 22 cents – Employer contributions to CalPERS
- 13 cents – Employee contributions to CalPERS

On March 8, 2017, CalPERS announced the following average returns on its investment portfolio:

- 7.8% over the past five years
- 4.6% over the past ten years
- 6.9% over the past twenty years

Per CalPERS, the average retiree pension is $30,500 per year. The benefit paid to a retiree varies depending upon the number of years they have worked for a CalPERS participating government agency, the employee's salary, and the government agency's retirement formula. The City is one of over 3,000 government employers who participate in the CalPERS retirement system.

CalPERS Pension Fund Stability Initiatives

Over the past few years CalPERS has taken steps to stabilize and improve the system's fiscal strength and lower future risk to the pension trust's sustainability. The expected rate of return on the pension fund's investments referred to as the "discount rate" was reduced from 7.75% to 7.5% effective FY 2014/15. In December 2016, CalPERS voted again to lower its discount rate in steps beginning in FY 2018/19 from 7.5% to 7.0%. Lowering the discount rate impacts local governments because lower expected returns over time will require increased contribution rates to provide sufficient assets to pay benefits.

In November 2012, California voters passed the Public Employees' Pension Reform Act (PEPRA) providing that new employees hired after January 1, 2013 are required to contribute more to their pensions and must also work longer before they can retire and begin to receive the benefits promised by their employers. CalPERS announced that in the four years since PEPRA reforms were put in place that employers like the California State government have experienced cost savings of 1.2% of payroll for miscellaneous employees and 5.1% of payroll for safety employees.

Unfunded Liability Status

As reported previously, the City's current actuarial valuation reports (June 30, 2017) calculated unfunded liabilities referred to as the Unfunded Accrued Liability as shown below:

Plan	Unfunded Accrued Liability
Miscellaneous Pension Plan	$12,881,900
Safety Fire Pension Plan	$4,411,786
Safety Police Pension Plan	$6,335,453
Total Unfunded Accrued Liability	**$23,629,139**

Funded Status

The following table presents the funded status of the City's pension plans. This percentage represents the value of the assets in the City's trust at the end of the fiscal year compared against the projected benefit obligation.

Plan (Classic Plans Only)	Funded Percentage
Miscellaneous Pension Plan	70.30%
Safety Fire Pension Plan	68.6%
Safety Police Pension Plan	69.4%

In comparing the City's funded status for its plans, the average funding status for local government pension plans across the nation is approximately 72%. Best practices for pension plans advocate funded status goals of over 80% be maintained.

Origins of the Pension Unfunded Liabilities

Experts in the field, have highlighted in public presentations that because investment returns have provided 65% of the retirement funds paid out to retirees the primary reason for the development of the unfunded liabilities for local government pension plans has been due to lower than expected investment returns and not primarily due to enhanced benefits that may have been agreed to in past years through the collective bargaining process. According to information released by CalPERS, the City's pension unfunded liabilities developed because of two major market downturns since 1995. The first being the downturn in the early 2000's related to the "dot com" stock market bubble and the second major loss related to the global economic "Great Recession" of 2008. Another large impact was a series of "assumption changes" made by CalPERS actuaries that added millions of dollars to the City's accrued pension liabilities. These assumption changes, such as increasing the expected life span of retirees, among other factors increased the expected payments made to retirees out of the trust.

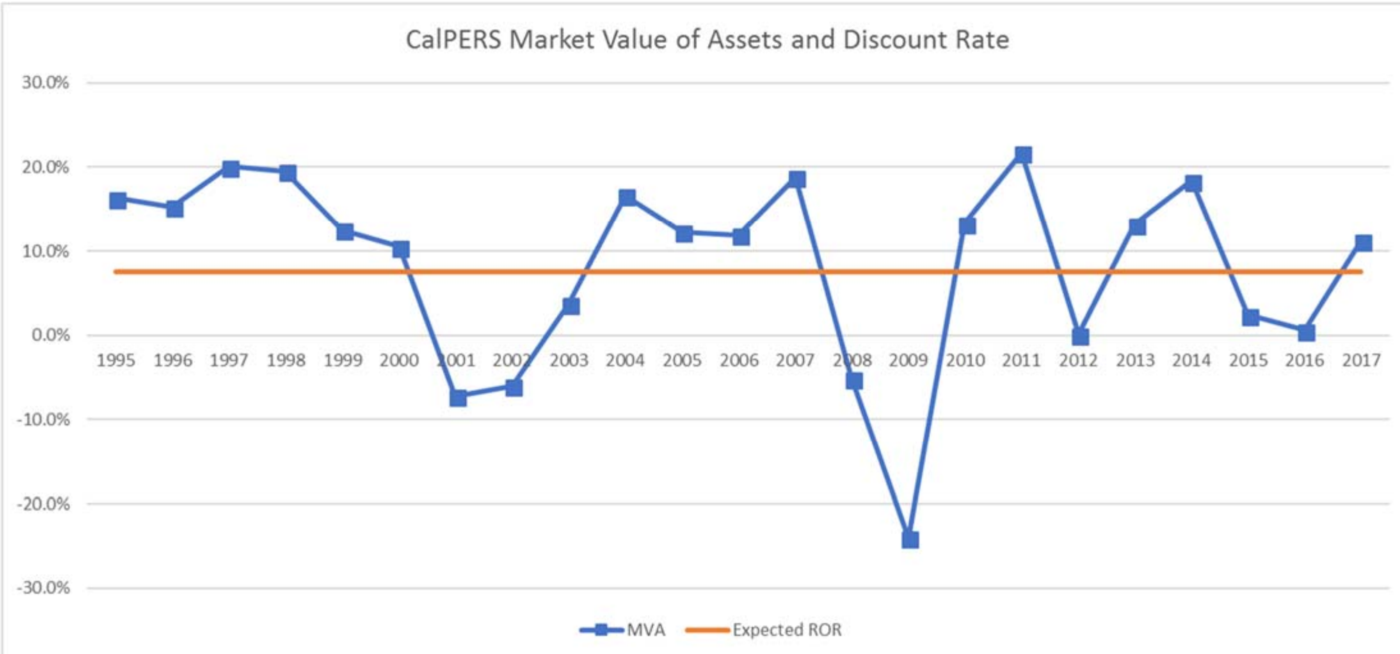
City's Proactive Steps Taken to Date

The City prudentially addressed a major new unfunded liability pertaining to a "side fund" liability created by CalPERS when state law required the City's plans be placed in a state pool. Upon doing this, the City incurred a side fund liability determined by CalPERS for the City's proportionate share of pooled unfunded liabilities. The City paid off the safety police side fund in FY 2017/18 and prepaid the safety fire side fund in FY 2017/18 as well.

Investment Return History

One of the most critical assumptions in attaining full funding goals for the CalPERS pension plan is the rate of return on investments in the trusts. CalPERS' current annual rate of return (ROR) assumption is 7.5%. Assuming this rate of return is attained, then funding of the pension obligations would be derived 65% from investment gains and 35% from contributions. If the 7.5% rate of return is not realized, then contributions from employers and employees will have to increase. Unfortunately, this ROR has not regularly been achieved by CalPERS (11.2% in 2017, 0.6% in 2016 and 2.4% in 2015) and the outlook from the investment community and actuaries for a 7.5% annual rate of return for the near future is increasingly pessimistic. In fact, the average actual rates of CalPERS returns in the table below have fallen below expectations in several time periods.

The CalPERS investment returns over a twenty-year time period are presented below compared against the assumed 7.5% discount rate which is presented by the solid blue line on the graph.



Future Pension Employer Cost Forecast

As previously stated, in December 2016 the CalPERS Board announced a plan to lower its discount rate from its current rate of 7.5%. Effective with FY 2018/19 the phase-in of the discount rate change approved by the Board is as follows:

Valuation Date	Fiscal Year for Required Contribution	Discount Rate
June 30, 2016	FY 2018/19	7.375%
June 30, 2017	FY 2019/20	7.25%
June 30, 2018	FY 2020/21	7.00%

The immediate effect of this change is the actuarial valuation report being prepared for June 30, 2016 by CalPERS which sets the employer contribution rate for FY 2018/19 at lower discount rate of 7.375%. This action will lead to increased actuarial accrued liabilities because with lower expected returns there are lower projected assets to meet the expected pension obligations.

Speculations are being raised about future actions the CalPERS board may take including potentially reducing its discount rate below the 7% rate target approved by the board in December 2016. More recently CalPERS has indicated that they are not currently planning to reduce the discount rate below the 7% target already approved. The CalPERS Board has adopted a Risk Mitigation policy that will be effective in 2020 once the effect of the change of the discount rate to local governments has been phased in by CalPERS. This policy will take advantage of years when returns exceed 2% above the forecasted returns for the CalPERS investments. In those years, CalPERS will make gradual cuts of 0.05% to 0.25% lowering the discount rate over an expected 20-year phase in to a new target of 6.0%. This strategy would allow CalPERS expected returns to align better with CalPERS actual returns for the next thirty years (according to Wilshire Advisors – 6.2% over the next decade and 7.8% in following two decades). The Risk Mitigation Strategy also takes advantage of return years above forecasts by shifting investments into less risky (less volatile) investment instruments/categories over the same timeframe.

Possible Strategies to Meet the Future Unfunded Pension Challenges

Concluding that the unfunded liabilities arise chiefly out of investment returns that fail to meet CalPERS expectations or result from CalPERS changes in assumptions, it would appear that local government have limited opportunities to influence the balance of the unfunded liabilities as calculated by CalPERS. However, there are opportunities/choices available that the City can explore to address this issue including the following:

Option 1: Status Quo

The status quo option essentially entails that the City continues to pay down gradually the unfunded liability with the existing rates that CalPERS is charging the City. Under this option, the pay off duration is estimated to be 29 years. The rates and payoff duration will fluctuate based on market conditions.

The City's current funding approach utilizes the status quo amortization scheduled referred to as the "Five-Year Ramp Up/Down-Direct Rate Smoothing" policy which provides the minimum City contribution required by CalPERS and includes a graduated payment increase to allow employers to absorb the change more smoothly. Unfortunately, this policy inevitably costs more in the long-run because the required annual payment does not cover the full interest accrual in the early years and any shortfall in payment of interest is added to the principal balance. Beginning in FY 2018/19 the City will prepay the unfunded amortization amount in one lump sum payment in July, saving approximately $50,000 in interest charged by CalPERS versus paying it monthly over the fiscal year.

Option 2: Fresh Start

The City's second option is to make a "fresh start." A fresh start is a CalPERS term for re-amortizing the current unfunded liability over a shorter period of time. There are two fresh start choices described below, one for a 20-year fresh start and the second for a 15-year fresh start. Staff notes that future actuarial valuations could create new "unfunded" liabilities that will not be addressed by the fresh start option.

Table 1 below summarizes the savings for a 20-year and 15-year fresh start options. These are provided as estimates only as the payments under a fresh start are expected to increase by a flat 3% each year and also vary depending on the plan that early payment is applied towards. The City could commit to a 20-year fresh start, amortizing the City's liability over a 20-year period. Under this scenario, the City's estimated FY 18/19 contribution would increase by approximately $259,251 and the City would save an estimated $1.8 million over the 20-year period (if applied towards the classic miscellaneous plan). Alternatively, the City could commit to a 15-year fresh start, amortizing the City's liability over a 15-year period. Under this scenario, the City's estimated FY 18/19 contribution would increase by approximately $479,324 and the City could save approximately $6.2 million over the 15-year period (if applied towards the miscellaneous plan).

Plan	20-Yr Amortization	15-Year Amortization
Misc	$ 1,847,250	$ 6,152,024
Police	$ 1,151,899	$ 3,132,800
Fire	$ 466,801	$ 1,862,475

Based on the City's financial projections at this time, an annual expenditure increase would likely need to be supported through utilization of the City's General Fund Emergency Reserve.

Fresh-start options for either the Police for Fire plan may be more attainable for the City. The average increase in payments over the amortization period are outlined in the chart below:

Average Increased Payment		
Plan	**20-Yr Amortization**	**15-Year Amortization**
Misc	$ 126,679	$ 262,935
Police	$ 53,796	$ 132,866
Fire	$ 49,626	$ 99,402

Option 3: Additional Lump Sum Contributions

Alternatively, the City could choose to make lump sum payments above the existing required contributions when resources are available to do so. This is described by CalPERS as Additional Discretionary Payments, and involves the City making additional payments either once annually or making additional discretionary payments above the amounts required by CalPERS on a monthly or a payroll cycle basis during the fiscal year. The advantage of the lump sum option is that the City can leave its payment obligation status quo but can opt to make annual payments when budget circumstances are favorable.

Option 4: Establish a General Fund Reserve to Fund a 20-Year Fresh Start with Additional Lump Sum Options

In discussions with CalPERS, staff confirmed that one option is to combine a fresh start with a lump-sum contribution. The lump sum payment would be recommended to be made from a newly established General Fund PERS Reserve. This option provides the benefit of savings that accumulate from a fresh start option because the amortization period will shorten from an average of 30 years to 20 years and the newly established General Fund PERS Reserve are expected to be available to help fund the higher initial annual payments required as a result of the 20-year fresh start. It should be noted the PERS unfunded liability is not a fixed principal balance and the liability changes from valuation period to valuation period. CalPERS completes a new 'base year' valuation of the liability every two years and the liability can change due to market gains and losses, changes in benefits, and changes in actuarial assumptions.

A General Fund PERS Reserve account can be established from currently available General Fund Emergency Reserves and/or year-end savings. Establishing such a PERS reserve would require Council action.

Establishing a dedicated Reserve would enable the City to:

- Match required payment fluctuations based on change in actuarial assumptions and experience gains or losses.
- Provide funding sources for higher payments required under a fresh start program. This option can provide significant savings, paying off the unfunded liability in 20 years instead of 30 years. However, based on the City's current financial projections, an annual expenditures increase associated with any fresh start option does not appear sustainable over the amortization periods of either 15- or 20-year options without dedicated reserve to fund the payment differences over time.

Option 5: IRS 115 Pension Trust
This option involves prefunding the pension unfunded obligations through an IRS approved independent retirement plan administrator such as those currently administer by Public Finance Manager (PFM), Keenan Associates, or Public Agency Retirement Services (PARS).

Option 6: Pension Obligation Bonds
Consider issuing taxable pension obligation bonds, the proceeds of which would be used to make additional discretionary payments to CalPERS reducing the unfunded liability but also increasing the level of City bonded debt.

Option 7: Employee Cost Sharing
With the passage of PEPRA, local governments are allowed to agree to cost share the employer required contributions with their employees.

Option 8: Line of Credit
This idea originates from a Southern California City forum on unfunded liabilities. Essentially, it involves using "one-time" balances as a funding source for additional discretionary payments for pension unfunded liability pay-downs. The City would match the withdrawal with a blank line of credit to borrow against should the need arise for the one-time funds. The current borrowing rate for the line of credit is likely to be less than the rate charged by CalPERS on the unfunded balance.

<u>Analysis of Unfunded Liability Funding Strategies</u>

<u>Status Quo:</u>
<u>Pros</u>

- Because of the somewhat arbitrary nature of CalPERS unfunded pension liability calculations, this option gives the "minimum" payment to the CalPERS pension trust.
- Preserves local control of cash assets for other discretionary City purposes beyond the amounts actuarially required to be paid to the Pension Trust.

<u>Cons</u>

- If rates of return continue at historic low levels, CalPERS will be adding to the unfunded lability an "asset loss" which is amortized up to 7% over approximately 20 years. Much like a home mortgage, the interest costs amortized over that period will be substantially higher than the original amount of the asset gain or loss. The current amortization scheduled supplied by the City's CalPERS actuaries indicates that he City would pay approximately $28 Million in total interest to bring the unfunded liability to zero.
- The unfunded liability is likely to grow to higher levels with corresponding increased amounts of required employer contributions needed to fully amortize them. This situation has the potential to adversely impact the City's future operating budgets.

<u>Shorter Amortization Schedule – "Fresh Start"</u>
<u>Pros</u>

- This option would shorten the current amortization from 30 years to 20 or 15 years. This option would require the City to commit to a higher annual employer pension payment level, much like a homeowner refinancing their home mortgage over a 15-yer period from a 30-year amortization period, whereby the loan would be paid off earlier, but the monthly payments would increase from amounts paid for a 20-year mortgage.
- Should the City apply for a "fresh start" to a 20 or 15-year amortization period, the City could expect annual payments to increase from $50,000 to $263,000 per year respectively.

- Based on current data, the City could experience total interest savings of approximately $467,000 on a 20-year fresh start for the Fire classification and $6.2 million if the City chose a 15-year amortization period on the miscellaneous classification.

Cons
- If the City were to establish an alternative amortization schedule, the annual average annual budgeted pension employer contribution is estimated to increase by $116,000 to $250,000 based upon the 2016 Actuarial Valuation reports. This action would likely require a corresponding reduction in City funds dedicated to support operating budget service levels to accommodate this increase in pension expense for each future fiscal year affected.
- The fresh start program is not flexible. Once the City commits to the new amortization, it cannot change to a longer period to reduce costs and balance its budget. There may be one possible way to lengthen it again, but it would require the City to declare itself in a fiscal emergency.

Lump Sum "One-Time" Voluntary Payments

Pros
- This option includes many different varieties of different payment options. The City could elect to make an additional annual or monthly payment, or intentionally pay a higher amount per covered payroll with the excess payment applied to the unfunded balance.
- The City's additional payments are discretionary as to time and amount of payment, providing flexibility if future circumstances allow for higher, lower or perhaps no payments for that particular fiscal year.
- Interest savings are dependent upon the amount of additional payment but based on the current staff estimates a "one-time" payment would yield the following interest savings over the amortization period estimates:
- Function very much like a homeowner making additional mortgage principal payments, this strategy provides flexibility and fi the City commits to a funding strategy with regular pay-downs, the unfunded liability could be retired ahead of the scheduled amortization period by a number of years.

Cons
- CalPERS has advised that additional discretionary payments can only be applied against outstanding unfunded liabilities. For instance, if the City were to elect to pay off the unfunded liability in its entirety and the returns over time exceeded CalPERS estimates, CalPERS would not return or credit the City's plan for the excess amounts paid into the trust.
- CalPERS has advised staff that once monies are paid into the pension trust, they are never returned back to the City. Future assets in excess of liabilities, should they occur, will not be refunded back to the City.
- Volatility of annual returns is a major concern for lump sum payments. Because of the aggressive nature of the CalPERS investment program, amounts paid into the pension trust are subject to large scale downturns in the stock market. For instance, had the City made a large lump sum payment to CalPERS prior to the stock market crash of 2008, the amount paid in would have incurred an approximate 30% "haircut" with only 70% of the amount paid in being available to apply against the unfunded liability.
- Future City Councils may not view the discretionary payments as a priority and the fiscal discipline to make these payments may decline as service level demands on the operating budget increase in future budgets.

Section 115 Trust (Pension Plan)

Pros

- This option would establish an Internal Revenue Service (IRS) sanctioned trust to accumulate assets to pre-fund the unfunded liabilities. The City would make periodic payments to the trust over time, building an asset portfolio that is irrevocably dedicated to funding pension obligations.
- The trust can be set up with alternative investment objectives from the aggressive approach used by CalPERS which could serve as a hedge against the volatility of placing all the City's available funds into the CalPERS pension trust.
- The City retains local control of the trust. If a future budget year has fiscal difficulties, the City could draw monies out of this trust (recommended as a "one-time" draw) to pay for other expenditure categories.
- Monies could be transferred out of this trust at any time with Council approval to fund additional discretionary payments to pay down CalPERS unfunded liability.

Cons

- Monies placed into the trust are irrevocable under IRS rules. The funds must be used only for employer pension contributions. They cannot be withdrawn and used for another governmental purpose in the future unless the unfunded liability was fully paid, and no liability existed for which the funds were placed into trust.
- At this time, staff believes the amounts placed in the trust would not be allowed to be factored into the Net Pension Liability under current Government Accounting Standard Board (GASB) guidance. Staff understands that GASB is reviewing its position and may allow it to be a direct offset against the calculated Net Pension Liability amount disclosed in the City's CAFR.

General Fund Reserve for Pension

Pros

- Funds in this reserve would be available for use as a funding source for any of the strategies approved by the City Council including additional discretionary payments.
- Funds held in the reserve generate interest earnings that could be used for the City's General Fund operating budget.

Cons

- Though held as a committed reserve, a future Council could re-direct these reserve funds to another governmental purpose by resolution.
- Funds held in reserve are not considered irrevocable and cannot be used as a direct offset to reduce net pension liability on the City's financial statements.

Pension Obligation Bonds (POB's)

Pros

- Pension Obligation Bonds are taxable bonds (meaning they carry a higher interest rate than tax-exempt bonds) issued by the local government. The proceeds could then be used to pay down the unfunded liability.
- In the best-case scenario, over the long term the interest cost of borrowing to the City would be lower than the total returns made in the pension trust.

Cons

- The proceeds of the bonds paid into the trust may fail to earn more than the taxable interest rate owed over the term of the bonds, causing the actual pension shortfall in terms of debt to increase.
- Pension Obligation Bonds are complex instruments that carry considerable risk.

- Issuing taxable debt to fund pension liabilities would increase the City's level of bonded debt burden, limiting potential uses of debt capacity for other purposes and possibly lowering the City's credit rating.
- In January 2015 the Government Finance Officers Association (GFOA) issued a Best Practices/Advisory recommending that state and local governments do no issue pension obligation bonds. GFOA commented, "the use of POB's rests on the assumption that the bond proceeds, when invested with pension assets in higher yielding asset classes, will be able to achieve a rate of return that s great than the interest rate owed over the term of the bonds. However, POB's involve considerable investment risk, making this goal very speculative. Failing to achieve the targeted rate of return burdens the issuer with both the debt service requirements of the taxable bonds and the unfunded liabilities that remain unmet because the investment portfolio did not perform as anticipated."

Employee Cost Sharing

Pros

- With the passage of PEPRA, the City's employees are permitted to agree to cost share the employer's pension contributions.
- The City would experience annual expenditure savings that could be directed to additional discretionary payments to pay down the unfunded liability.

Cons

- Cost sharing would require bargaining with the City employees through the collective bargaining process and is speculative as to whether or not an agreement could be reached between the City and its employees. The City is currently in process of negotiating with the Police Officers Association, but has committed agreements with SEIU and the Firefighters Association through June 30, 2020.

Bank Line of Credit

Pros

- This strategy essentially involves using monies set aside for contingencies such as the City's General Fund Emergency Reserves to pay down the unfunded liability. At the same time the City would secure a bank "line of credit" for similar amount that could be advanced by the bank at the time it would be needed, should a catastrophic or emergency event arise.
- No interest debt would be paid until the bank advances funds, so cost of borrowing other than annual costs charged by the bank to maintain the line of credit.

Cons

- The line of credit could be viewed by credit analysts as additional debt limiting new debt capacity in the future.
- There is an annual financing expense that would be incurred regardless of whether funds were advanced from the bank.

CONCLUSION

Staff has provided a variety of options to consider in addressing the unfunded pension liability. In helping to guide council direction, staff recommends that the following principles be kept in mind and considered in providing direction to staff:

Volatility: Experts in the field have advised local government councils in many cities that an important goal in managing the risk of the unfunded liability is to manage the volatility of the returns on the assets in the CalPERS pension trust.

Diversification of Risk: Volatility can be mitigated by diversifying the risk amongst various strategies and liabilities so that were an adverse event like a major stock market correction to occur, such an event's negative consequences to the unfunded liability would be lessened.

Local Control of Assets is Important: More local control of assets is preferable to less local control over the custody and risk tolerance of the invested assets.

Based upon these principles, staff recommends that Council not consider the issuance of Pension Obligation Bonds or the Bank Line of Credit. Similarly, staff recommends that the Council not consider the Fresh Start option as described.

ATTACHMENTS

1. Letter from Senior Nutrition
2. General Fund Ten-Year Forecast

RECEIVED
City of Morro Bay
MAY 14 2018
Administration

Council
Jen C
Kirk

5/10/2018

Project Description

The Senior Nutrition Program of SLO County provides free, hot, nutritious noon-time meals to seniors who are at least 60 years old. Seniors who are able to attend can eat meals at 10 community sites throughout the county in congregate dining. We also deliver meals, with frozen meals for Saturday and Sunday, to qualified seniors who are homebound. We rely on over 250 volunteers to deliver meals. We are the only program serving senior meals throughout San Luis Obispo County and the only program that includes congregate dining and an opportunity for socialization among the seniors. All of our meals are free to those who are eligible, although some clients choose to make voluntary anonymous donations. Our program has three goals: nutrition, socialization, and safety. Both the congregate dining and the home delivery provide socialization and human contact to help break the cycle of isolation. Finally, the daily home deliveries by volunteers, along with regular assessments by site supervisors, provide both friendly human contact and a safety net from accidents or physical or financial abuse. All staff and volunteers are mandated to report any suspected abuse. Currently, we are based in the former County Hospital complex in San Luis Obispo where we are able to prepare all our meals in the former hospital's kitchen and handle our administrative needs in a small adjacent office.

This past fiscal year, July 2016– June 2017, SNP prepared and delivered 148,985 meals to 1506 senior residents of San Luis Obispo County.

In the city of Morro Bay, SNP served 5,421 meals to 113 seniors in the dining room and 12,393 meals to 94 homebound seniors. Total of 192 unduplicated seniors.

This fiscal year, as of 3/31/2018 SNP served 4,287 meals to 111 seniors in the dining room and 8,802 meals to 80 homebound seniors.

Grant request:

Senior Nutrition Program of SLO County is requesting a grant of $10,000. This grant will help with the rising expenses every year and feeding the senior community in Morro Bay.

Thank You

Elias Nimeh
Executive Director
elias@mealsthatconnect.org

City of Morro Bay Budget Forecast ($ in 000)

General Fund	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
Property Tax	$3,377	$3,575	$3,724	$3,936	$3,968	$4,310	$4,328	$4,481	$4,657	$4,840	$4,991	$5,148	$5,199	$5,354	$5,515
Sales Tax	1,794	1,736	1,887	1,970	1,912	1,965	2,042	2,142	2,246	2,315	2,386	2,460	2,460	2,537	2,611
TOT	2,527	2,889	3,136	3,327	3,484	3,525	3,560	3,596	3,632	3,668	3,705	3,742	3,779	3,817	3,855
Other Revenue	2,341	2,559	3,545	3,535	3,158	2,925	3,097	3,137	3,171	3,213	3,256	3,299	3,324	3,391	3,443
Transfers	2,451	1,709	2,704	1,533	1,296	1,576	1,600	1,624	1,649	1,674	1,701	1,727	1,736	1,745	1,775
Total Revenue	12,491	12,468	14,996	14,301	13,818	14,301	14,627	14,980	15,354	15,710	16,038	16,376	16,499	16,844	17,198
Personnel	8,574	8,595	9,028	9,631	10,424	10,228	10,544	10,792	11,020	11,233	11,424	11,631	11,837	11,982	12,127
Other O&M	2,370	2,590	3,198	4,119	2,894	3,603	3,686	3,763	3,841	3,921	4,002	4,085	4,204	4,212	4,220
Transfers/Svc Adds	2,487	258	983	1,103	402	467	876	889	908	988	1,007	986	982	988	969
Future Budget Cuts	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total Expenditures	13,431	11,443	13,209	14,852	13,721	14,299	15,106	15,445	15,769	16,142	16,433	16,701	17,024	17,182	17,315
Net Annual	(940)	1,025	1,787	(551)	97	2	(479)	(465)	(415)	(432)	(394)	(325)	(525)	(338)	(117)
Beginning Balance	(2,503)	(797)	92	504	59	156	158	(321)	(786)	(1,201)	(1,633)	(2,027)	(2,353)	(2,878)	(3,216)
Cash Adjustments	2,646	(135)	(1,375)	106	0	0	0	0	0	0	0	0	0	0	0
Ending Balance	(797)	92	504	59	156	158	(321)	(786)	(1,201)	(1,633)	(2,027)	(2,353)	(2,878)	(3,216)	(3,333)

Emergency Reserve	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
Revenue	$56	$547	$350	$28	$28	$26	$26	$26	$26	$27	$27	$27	$27	$27	$28
Transfers Out	1	200	0	267	301	0	0	0	0	0	0	0	0	0	0
Net Annual	56	347	350	(239)	(273)	26	26	26	26	27	27	27	27	27	28
Cash Adjustments	1	(22)	19	0	0	0	0	0	0	0	0	0	0	0	0
Beginning Balance	2,854	2,910	3,235	3,603	3,364	3,090	3,116	3,142	3,168	3,194	3,221	3,247	3,274	3,301	3,329
Ending Balance	2,910	3,235	3,603	3,364	3,090	3,116	3,142	3,168	3,194	3,221	3,247	3,274	3,301	3,329	3,356

Total GF+ER Balance	**2,113**	**3,327**	**4,107**	**3,422**	**3,246**	**3,274**	**2,821**	**2,382**	**1,993**	**1,588**	**1,220**	**922**	**423**	**113**	**23**
% of GF Exp	15.7%	29.1%	31.1%	24.2%	26.1%	25.3%	20.9%	20.7%	17.8%	17.5%	14.9%	12.9%	9.7%	7.8%	7.3%