CITY OF MORRO BAY
CITY COUNCIL
AGENDA

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.

NOTICE OF SPECIAL MEETING

Tuesday, February 26, 2019 – 4:30 P.M.
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. Ten-Year Financial Forecast Study Session

RECOMMENDATION: Staff recommends the City Council receive information on the updated ten-year budget forecast and provide direction as appropriate.

ADJOURNMENT

DATED: February 22, 2019

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John Headding, Mayor

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.

AGENDA NO: I

MEETING DATE: February 26, 2019

Staff Report Addendum

TO: **Mayor and City Council** **DATE: February 25, 2019**

FROM: **Scott Collins, City Manager**
Jennifer Callaway, Finance Director

SUBJECT: **Ten-Year Financial Forecast Study Session**

RECOMMENDATION

Staff recommends the City Council receive information on the updated ten-year budget forecast and provide direction as appropriate.

DISCUSSION

Staff's update of the ten-year forecast for the fiscal year (FY) 2018/19 mid-year review cautions that unless significant expenditure reductions occur or new revenues are identified, the City will have to use one-time reserve funds to maintain current service levels. The ten-year financial update is provided in attachment I and the major revenue and expense category assumptions are provided as attachment II.

While use of reserves or one-time funds is appropriate for some circumstances, as a multi-year budget balancing mechanism, it is not a viable solution. And, that approach does not comply with the City's Long-Term Financial Planning Policy, recently adopted by the City Council and states as follows:

> *"Long-term structural balance is the goal of long-term financial planning at the City. Should the long-term forecasting and analysis show that the City is not structurally balanced over the ten-year projection period; staff would then make recommendations, for City Council consideration, on how the plan can be brought into balance within three-years."*

Not only does the ten-year update reflect an unbalanced budget in the out-years, the estimated budget deficit for FY 2019/20 is approximately $330,000, with growing deficits year after year. While the FY 2019/20 forecast includes COLA increases as per the negotiated labor agreements, the primary cause of this shortfall is employee pension and health costs outpacing revenues. These increases, while outside the City's control, threaten the City's ability to maintain current service levels and accumulate funds for much needed infrastructure, capital, vehicle and equipment investments. There are two primary areas for the Council to consider in order to realign the forecast and obtain a long-term structurally balance budget –

1) CalPERS pension paydowns which result in significant long-term savings, although increase short-term expenditures, and
2) identification and consideration of new revenues.

Prepared By: ___JC_____	**Dept Review: ___JC___**
City Manager Review: ____SC____	**City Attorney Review: ______**

Both options are discussed in detail below for the Council to consider.

CalPERS Pension Paydown Options:

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 Miscellaneous plan, which is a separate plan. A pooled plan was required by California law for those agencies who had fewer than 100 active members, which was applicable to Morro Bay's plans. These assets and liabilities are pooled with all other pooled 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 55
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 pension's 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 with lower returns expected over time will required contribution rates to increase 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 in FY 2018, 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 cities' 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.

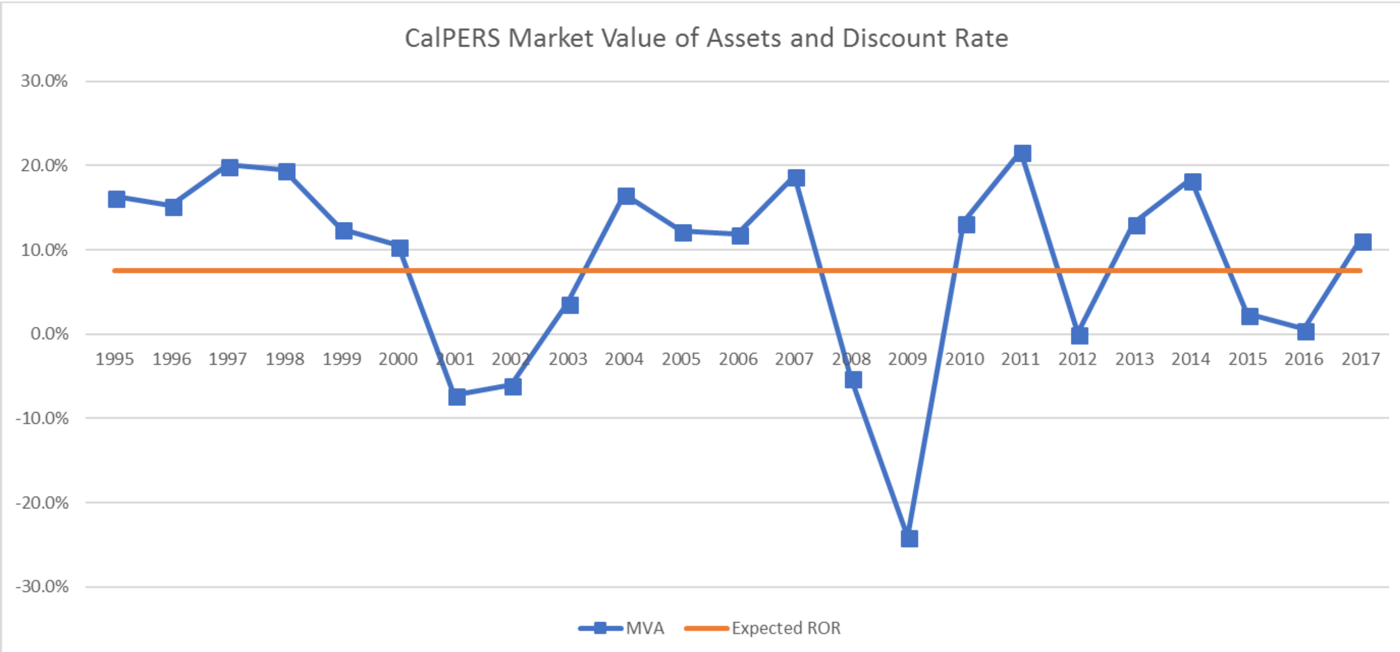
City's Proactive Steps Take to Date

The City prudently 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 (on the next page)



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 governments 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 as the average increase in payments is more affordable. 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 that 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 saving, paying off the unfunded liability in 20 years instead of 30 years. Based on the City’s current financial projections, an annual expenditure 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.

Analysis of Unfunded Liability Funding Strategies

Status Quo:
Pros

- 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.

Cons

- 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 $xxx 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.

Shorter Amortization Schedule – "Fresh Start"
Pros

- 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-years 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 disciple 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."

<u>Employee Cost Sharing</u>

<u>Pros</u>

- 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.

<u>Cons</u>

- 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 Police Officers Association is the first bargaining group to agree to terms that will allow for cost sharing. The City has committed agreements with SEIU and the Firefighters Association through June 30, 2020.

<u>Bank Line of Credit</u>

<u>Pros</u>

- 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.

<u>Cons</u>

- 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.

Revenue Options

This report identifies opportunities for new revenues that could be directed specifically to maintain current service levels, i.e. on-going operations or capital needs. While these revenue options should be vetted more thoroughly, they are provided as a framework for Council to begin considering options. The revenue options are organized into two categories: (I) Council authority to approve and (2) subject to voter approval. Establishing dedicated, reliable revenues to fund future needs is a solid budgeting and future planning practice which has been employed by many other cities.

Reliable and dedicated revenue source(s) would enable the City to plan and meet its existing and future infrastructure needs. Independent, City controlled revenue source(s) also buffer Morro Bay from the political uncertainty that surrounds the availability of federal and state funding. Such funding would not be subject to State policy impacts.

<u>Revenue Options under the Council's Approval Authority</u>

Staff has identified two revenue options that Council has authority to enact by majority vote after due notice:

- Sale or Lease of Property
- Certificates of Participation

Sale or Lease of Property

The City owns properties that are either in process of being advertised for lease or could be considered for potential sale or lease. The revenue generated from this would be based on assessed value and/or market rates at the time of sale or lease.

Council may direct the sale or lease of any or all of these properties and earmark funds to one-time Capital Projects, either for a specific project or general capital funding or paydown of the CalPERS unfunded accrued liability. Staff can provide Council a list of potential properties available for sale or lease should Council wish to consider this option.

Certificates of Participation

Certificates of Participation (COP) can be passed with a simple majority vote. However, if a COP were to be considered by the City, an ongoing funding source (e.g., parcel tax, increased sales tax, or increased transient occupancy tax) would need to be identified to make the annual debt service payment out of City's annual operating budget.

Revenue Options Subject to Voter Approval

Local agencies may impose taxes, subject to voter approval, using a variety of methods. Pursuant to Proposition 218, these taxes are classified as either "general" or "special."

Whether the ballot measure requires a simple majority (50% + 1 vote) or a super majority (two-thirds of those voting in the affirmative) depends upon the ballot language and whether the question is placed upon the ballot as a general tax increase or a special tax increase

A "general tax" may be used for any public purpose. The funds are fully discretionary and may be deposited into the General Fund. A majority vote (50%+ 1) of the electorate is required to impose, increase, or extend a general tax.

A "special tax" is a tax imposed for a specific purpose. For example, some cities dedicate tax revenues for the payment of law enforcement or street maintenance costs rather than using the taxes for the general operations of government. A two-thirds majority of voters is required to impose, increase, or extend a tax for a specific purpose. Special tax revenues must be accounted for in a separate fund.

General taxes may only be put on the ballot at the same general election when the City Council election is held, unless the Council unanimously finds that there is an urgent need to impose the tax measure. Upon such unanimous declaration, the general tax measure may be put before the voters at a special election. Special taxes may be placed before the electorate at any time, either during a general election or in a special election.

The following six new revenue options, all requiring voter approval, have been identified for Council consideration:

- Assessment Districts
- Utility User Tax (UUT)
- Increased Transient Occupancy Tax (TOT)
- Increased Sales Tax
- Parcel Tax-General or Special
- General Obligation Bonds

Assessment Districts

An Assessment District is a special district that includes property that will receive direct benefit from new public improvements or from the maintenance of existing public improvements. The most common types of assessments are for roads, storm water, parks, landscaping, and street lighting. Formation of an Assessment District requires voter approval, which must be done in the form of a mailed ballot. Assessment Districts require that at least as many ballots (as weighed by the amount of the assessment against the parcel submitting the ballot) are returned in favor of the assessment as are returned in opposition to the assessment.

Each property is assessed a certain amount based on the percentage of benefit received by the property. Factors that determine the amount of benefit received may include the size of the lot or the proximity to the improvement being financed. The collection of the assessment charges occurs through County property tax collections and is earmarked for the special assessment district as defined. Unless specified by a sunset clause, the collection will continue into the future at a minim um growth allowable by Proposition 13. A CPI (consumer price index) may also be added to the collection so as to keep revenues growing at a rate equal to expenditures.

Utility User Tax (UUT)

Government Code Section 37100.5 authorizes cities to collect a utility user's tax on electric, gas, cable television, water, and telephone services. The tax is collected by the utility as part of its regular billing and then remitted to the City. The tax rate set by the City Council is typically defined by the voter referendum used to authorize the tax. Statewide, there are approximately 150 cities and 4 counties with UUTs. The particular utility to which the tax is applied varies. In some cities, different rates apply to residential versus commercial users. The most common rate is 5%, applied broadly among many types of utilities. The average rate is 5.5%. Most large cities have UUTs, meaning roughly half of California residents and businesses pay a utility user tax.

An UUT may be imposed as a special tax earmarked for a specific purpose. However, all California cities impose the UUT as a general tax to be used for a variety of municipal service needs.

The City of Morro Bay does not have any UUT's. UUT’s are generally the least likely new tax to be passed by voters. Staff estimates that the City could generate approximately $2,000,000 in additional revenue should UUT's be imposed for Cable, gas, and electricity.

Increased Transient Occupancy Tax (TOT)

The City currently collects TOT at a rate of 10% per rental by all entities renting lodging for 30 days or less. Those taxes are remitted monthly to the City, and that revenue stream accounts for 25.0% of the General Fund revenues, budgeted for $3.5 million for FY 20 18/19. In addition, visitors staying at hotels incur assessments for the City managed tourism program and county tourism program. An increase from the current 10% to 11% will result in approximately $350,000 annually in increased TOT revenues. An increase to 12% would result in approximately $700,000 annually in increased TOT revenues. Because TOT taxes short-term rentals, it is primarily non-residents who pay this tax.

A TOT may be imposed as a special tax earmarked for a specific purpose. However, all other cities in California impose the TOT as a general tax to be used for a variety of municipal service needs at the discretion of the City Council.

Increased Sales Tax

California has many special taxing jurisdictions (districts), which are funded by a transaction (sales) and use tax rate that is added to the standard statewide rate of 7.50%. The tax rates for these districts range from 0.10% to 1.0% per district. In some areas, there is more than one district tax in effect (Capitola, El Cajon, El Cerrito, Eureka, Ft Bragg, Nevada Town, Placerville, Santa Rosa, Sebastopol and Woodland). In others, there is no district tax in effect. The City of Morro Bay has a one-half cent sales tax, Measure Q, already in place. While passed as a general tax measure, the funds are used for pavement work and public safety.

A Sales Tax increase may be imposed at a rate of 0.25% or a multiple thereof. The ordinance proposing the tax must be approved by majority vote of the voters in the city if the tax is for general purposes or two-thirds vote of all members of the governing body if the tax is for a specific purpose. The maximum combined rate of transactions and use taxes in any location may not exceed 2%.

With an additional 0.50% add-on the City is estimated to generate approximately $1,000,000 in additional sales tax revenue annually.

Parcel Tax – General or Special

A parcel tax (otherwise known as a property-tax override) is a special non-ad valorem (non-value based) tax on parcels of property generally based on either a flat per-parcel rate or a variable rate depending on the size, use, or number of units on the parcel. However, since this tax is not based on the value of the property, it is a "fixed" tax. Parcel taxes require two-thirds voter approval and are imposed for any number of purposes, including funding police and fire services, clean water watershed management and flood control, and neighborhood improvement and revitalization. There are approximately 5,200 taxable parcels in the City. Therefore a $100 parcel tax would generate approximately $520,000 in new revenue which could be designated for capital projects.

General Obligation Bond

General Obligation (GO) bonds are secured by a pledge of revenues legally available to the municipality. The bonds are typically secured by an annual property tax levy on real property equal to the annual debt service on the bonds. As the property tax levy on real property is considered to be the most secure of debt issuances a municipality can make, the ratings for GO bonds are usually the highest rated bonds a city can issue. The higher ratings lower the cost of borrowing (interest rate paid to the bondholders) which can lead to greater amounts issued at a lower cost. The bonds are a "general obligation" and as such the levy is usually made against all taxable properties in the city. These are not recommended as a GFO best practice.

Conclusion

Staff recommends that Council receive the ten-year financial update and consider CalPERS paydown options and various revenue options for future consideration and direction.

ATTACHMENTS

1. Ten-Year Update
2. Ten-Year Update Major Revenue and Expense Assumptions

City of Morro Bay Budget Forecast ($ in 000)

General Fund	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
Property Tax	$4,024	$4,310	$4,310	$4,491	$4,649	$4,832	$5,021	$5,177	$5,339	$5,391	$5,447	$5,502	$5,557
Sales Tax	1,970	1,971	1,965	2,167	2,193	2,209	2,193	2,176	2,190	2,210	2,249	2,283	2,329
TOT	3,327	3,429	3,525	3,560	3,596	3,632	3,668	3,705	3,742	3,779	3,817	3,855	3,894
Other Revenue	3,446	3,397	2,915	2,935	2,965	2,988	3,021	3,055	3,090	3,106	3,162	3,204	3,247
Transfers	1,533	1,529	1,606	1,627	1,648	1,670	1,692	1,715	1,738	1,738	1,738	1,763	1,789
Total Revenue	14,301	14,636	14,320	14,779	15,051	15,331	15,595	15,828	16,098	16,224	16,412	16,607	16,815
Personnel	9,631	10,400	10,312	10,752	11,040	11,358	11,636	11,859	12,065	12,353	12,665	13,003	13,370
Other O&M	4,103	3,060	3,585	3,608	3,683	3,760	3,838	3,917	3,998	4,116	4,124	4,131	356
Transfers/Svc Adds	666	428	467	749	738	749	760	772	809	821	833	821	834
Future Budget Cuts	0	0	0	0	0	0	0	0	0	0	0	0	0
Total Expenditures	14,400	13,888	14,365	15,109	15,461	15,867	16,234	16,548	16,872	17,289	17,621	17,955	14,560
Net Annual	(99)	748	(45)	(329)	(410)	(536)	(639)	(721)	(774)	(1,066)	(1,209)	(1,348)	2,256
Beginning Balance	504	(685)	49	4	(325)	(735)	(1,272)	(1,911)	(2,631)	(3,406)	(4,471)	(5,681)	(7,029)
Cash Adjustments	(1,090)	(15)	0	0	0	0	0	0	0	0	0	0	0
Ending Balance	(685)	49	4	(325)	(735)	(1,272)	(1,911)	(2,631)	(3,406)	(4,471)	(5,681)	(7,029)	(4,773)

Emergency Reserve	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
Revenue	$36	$36	$602	$38	$27	$27	$27	$27	$28	$28	$28	$28	$28
Transfers Out	267	322	0	0	0	0	0	0	0	0	0	0	0
Net Annual	(231)	(286)	602	38	27	27	27	27	28	28	28	28	28
Cash Adjustments	0	(356)	0	0	0	0	0	0	0	0	0	0	0
Beginning Balance	3,603	3,372	2,730	3,332	3,369	3,396	3,423	3,450	3,477	3,505	3,533	3,561	3,589
Ending Balance	3,372	2,730	3,332	3,369	3,396	3,423	3,450	3,477	3,505	3,533	3,561	3,589	3,617

Total GF+ER Balance	**2,687**	**2,778**	**3,336**	**3,044**	**2,660**	**2,151**	**1,539**	**846**	**99**	**(939)**	**(2,120)**	**(3,440)**	**(1,156)**
% of GF Exp	19.6%	21.4%	24.5%	21.4%	18.4%	14.7%	10.6%	6.2%	1.7%	-4.3%	-11.0%	-18.1%	-6.7%

	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	AVG
Revenues											
Property Tax	SLO County	3.53%	3.93%	3.90%	3.12%	3.12%	0.98%	1.20%	1.01%	1.01%	2.42%
Sales Tax	HDL Estimate	1.21%	0.75%	-0.76%	-0.76%	0.63%	0.92%	1.76%	1.54%	2.00%	0.81%
TOT	1.00%	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%	3.00%	2.00%	2.10%
Expenditures											
Salary	2%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0.20%
Pension	8.75%	11.42%	11.58%	8.60%	5.81%	4.76%	8.10%	8.22%	8.34%	8.45%	8.40%
Other Benefits	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Transfers											
Vehicle	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	
Technology	$ 427,507	$ 438,195	$ 449,150	$ 460,378	$ 471,888	$ 483,685	$ 495,777	$ 508,171	$ 520,876	$ 533,898	
Facilities	$ 100,000	$ 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	$ 100,000	
Fire Equip	$ 71,344	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 75,000	$ 75,000	$ 75,000	$ 50,000	$ 50,000	

AGENDA NO:	**I**
MEETING DATE:	**February 26, 2019**

Staff Report

TO: **Honorable Mayor and City Council** **DATE: February 22, 2019**

FROM: **Scott Collins, City Manager**
Jennifer Callaway, Finance Director

SUBJECT: **Ten-Year Financial Forecast Study Session**

RECOMMENDATION
Staff recommends the City Council receive information on the updated ten-year budget forecast and provide direction as appropriate.

DISCUSSION
In March 2015, the City received the first 10-year budget forecast. As an essential component of the City's annual budget process, the City Council then included a requirement for an annual 10-year forecast in the Strategic Planning Framework. The 2016 budget forecast was expanded to include the Harbor Enterprise Fund and the 2017 forecast was expanded to include the Water and Sewer Enterprise Funds.

The ten-year budget forecast provides the City Council and community with a better understanding of the City's financial situation in the decade ahead. In light of the changes to the California Public Employee's Retirement System (CalPERS), this forecasting model is even more crucial as the City faces significant expenditure increases due to CalPERS rate increases.

The updated ten-year budget forecast will provide a broad overview of the City's financial projection over the coming ten years and includes the most readily available CalPERS rate increase estimations, as well as other estimated benefit increases. It is important to note that these rate increases are estimates only and will fluctuate based on CalPERS actual investment earnings rate as well as any other methodology changes that CalPERS implements. As staff works through the FY 2019/20 budget development processes these estimates will be refined and presented to the Council again in May 2019 with the proposed budget.

With this budget update staff has reviewed the revenue projections and revised assumptions based on the current economic environment and indications ahead. Based on revenue trends the first half of the fiscal year, the City is on track to meet all budgeted revenue expectations. Given this, the 2% COLA increases have been included in the forecast for all full-time employees. All other assumptions are conservative but based on known conditions and are meant to provide Council, staff and the public with a solid understanding of the City's financial condition as we begin the FY 2019/20 budget process. As with all cities in California under the CalPERS retirement system, the City's impact of the CalPERS rate increases has substantially outpaced any revenue gains. This will force the City to make some difficult and challenging decisions not only in the upcoming FY 2019/20 budget but future years budgets as well.

Budget estimates will be presented at the meeting and made available to the public on the City website.

Prepared By: ___JC_____	**Dept Review:** ___JC___
City Manager Review: ____SC____	**City Attorney Review:** ______