MEMORANDUM

TO: CITY COUNCIL

FROM: JIM BERGMAN, CITY MANAGER
DEBBIE MALICOAT, DIRECTOR OF ADMINISTRATIVE SERVICES

SUBJECT: CONSIDERATION OF BUDGET BALANCING STRATEGIES FOR THE 2018-20 BIENNIAL BUDGET

DATE: APRIL 24, 2018

SUMMARY OF ACTION:
Approval of the budget balancing strategies will provide a plan for developing a balanced budget.

IMPACT ON FINANCIAL AND PERSONNEL RESOURCES:
There is no direct financial impact of the action other than the staff time required to prepare the report, however based on the General Fund 10 Year Fiscal Forecast, significant financial impacts are projected to the City's budget.

RECOMMENDATION:
It is recommended the City Council approve the budget balancing strategies presented for the FY 2018-20 Biennial Budget.

BACKGROUND:
The City's budget provides funding for all City services, infrastructure investments and activities performed during each fiscal year. The City Council discussed the results of the General Fund 10-Year Fiscal Forecast on January 23, 2018, which indicated that the City's expenditures are expected to exceed revenues and without intervention, all Fund Balance would be depleted within five years. At their February 13, 2018 meeting, the City Council discussed priorities and approved the following budget concepts for developing a draft FY 2018-20 Biennial Budget:

<u>Budget Concepts</u>

1. Correct and reverse the expenditure/revenue gap within two years by making services more efficient, more effectively recovering the true cost of services, and/or reducing non-core and non-essential services and attempting to shift the

provision of these wanted and needed public services to entities that are better able to perform them.

2. Increase revenues through strategic economic development efforts that encourage development of numerous vacant and underutilized parcels to not only fulfill desired retail and service needs of the community but also to ensure wise fiscal benefits to the City to fund inevitable cost increases of providing core and essential services.

3. Reduce exposure to volatility of pension payments from potential future actions by CalPERS such as further reduction of the discount rate or re-amortization of unfunded liabilities.

4. Once long-term economic and fiscal sustainability is achieved, start to build a community vision of future wants (i.e. long-term use of Camp Arroyo Grande, better sports facilities and fields, etc.) and identify new revenue sources to build and support these efforts such as increased taxes or bond measures.

The City Council also approved the following priorities and goals for the upcoming budget:

1. Within two years, reverse the expense/revenue gap by doing the following:

    a. Within the first year of the budget, reverse the gap between expenditures and revenues to result in approximately $157,000 surplus to be added to the reserves. This equates to reducing expenses by $450,000.

    b. By the end of the second year of the budget, reverse the gap between expenditures and revenues to result in a $1,386,000 surplus to be added to the reserves. This equates to further reducing expenses by $450,000.

    c. Goals a and b shall be accomplished by:

        i. Focusing City resources first to services identified as “Core and Essential” and fund these services to fully meet adopted City policies.
        ii. Ensuring that Core and Essential services are “Right Sized” based upon accepted metrics of service outcomes.
        iii. Analyzing “non-core and non-essential” services and make budget recommendations of how the City can more efficiently provide the service, find another entity to provide the service, or find additional revenues to support the service.

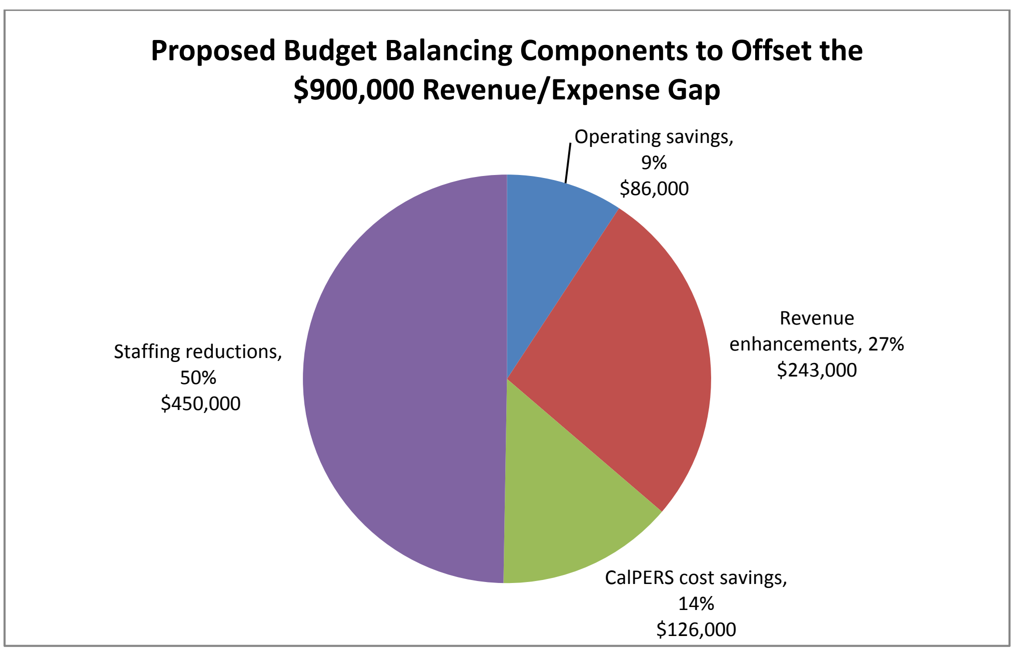
2. Increase revenues by:
    a. Analyzing City costs to provide services and consider achieving full cost recovery for a wider range of services.
    b. Encouraging economic development in order to achieve identified service outcomes for core and essential services (this will require the addition of $180,000 in revenue above and beyond normal assumptions starting in year three growing to total new revenue of $390,000 by year 10).

3. Reduce exposure to volatility of pension payments by the end of year two by:
    a. Analyzing and making recommendations on tools such as pension prepayments and Section 115 Trusts.

4. Begin to study options to develop new revenue sources such as a future tax measure for new or expanded services.

DISCUSSION:
Balancing the budget will require a multi-faceted approach that includes both revenue increases and expenditure reductions. The chart below represents the four major components proposed in balancing the budget, which are:

1. Reduction of operating budgets and development of efficiency measures
2. Prepayment of the CalPERS unfunded liability (debt)
3. Revenue enhancements including significant fee increases in Recreation Services and Community Development
4. Staffing reductions, eliminations and restructuring



ANALYSIS OF ISSUES:

Reduction of Operating Budgets and Efficiency Measures

Each department reviewed its operating budget to identify reductions that could be made to supplies and services. Overall, this resulted in reduced expenditures by about $86,000 in FY 2018-19 and $164,000 in FY 2019-20. Significant reductions and impacts are identified below.

- Eliminate OpenGov software license $4,900 - Minimal impact as full implementation has not been achieved yet and upgraded financial management software will be able to provide this functionality
- Two year hiatus in memberships to specific organizations:
    - League of California Cities and Channel Counties Division $7,400
    - Economic Vitality Corporation membership $5,000
    - Five Cities Diversity Coalition membership $1,500

Prepayment of CalPERS Unfunded Liability

The City's unfunded accrued liability (UAL) for promised defined pension benefits is analogous to a debt with a 7.0% interest rate. The most significant element that is causing an increase in costs is the future payments required by CalPERS for the UAL. Staff reviewed proactive approaches to paying down the City's UAL and managing future costs including contributing a lump sum payment toward the UAL, spreading the same prepayment amount over a 10 year period of time, contributing the amount towards an irrevocable Section 115 trust for pension stabilization, and amortizing the City's PERS plans over a new 20 year period.

Based on the analysis of these options, staff recommends utilizing the General Fund reserve above the 20% goal in FY 2018-19 and FY 2019-20 to make lump sum payments to CalPERS toward the UAL. This would result in a payment of $3 million in FY 2018-19 and an additional $2 million in FY 2019-20, for a total of $5 million during the Biennial Budget period. Staff recommends the full payment be allocated to the Safety Police CalPERS plan as this will result in the greatest total savings to the General Fund.

An analysis of the City's pension obligations and the impact of the prepayment is included as Attachment #1. Essentially, utilizing the City's excess reserves to pay off this debt will result in lower ongoing CalPERS payments. This ongoing savings reduces the financial obligations of the General Fund and helps reduce the gap between revenues and expenditures. The $5 million prepayment will generate total savings of $7.45 million over the 30 year UAL amortization period. During the Biennial Budget this is a reduction of approximately $130,000 in FY 18-19 and $200,000 in FY 2019-20. When viewed in the context of the 10 year fiscal forecast, the average annual savings provides $240,000 of the necessary $900,000 of ongoing cost reductions. Actual payments during the 10 year period will be between $106,000 and $430,000 less.

<u>Revenue Enhancements Including Fee Increases</u>
In nearly all cases, the fees charged for services provided are less than the total cost of providing the services. In some circumstances this is expected, perhaps even desired in order to achieve compliance with certain policies; however, given the fiscal circumstances, increasing fees for services received by the community is necessary.

The Council adopted a strategy by which fees in the Community Development department would be incrementally increased by an additional 5% per year until 75% cost recovery was achieved. This was expected to take 4 years. With the current fiscal conditions, staff is recommending accelerating the time frame to accomplish cost recovery and increasing the percentage of cost recovery achieved. Staff recommends a strategy of increasing these fees by 15% in FY 2018-19 and an additional 15% in 2019-20. This will result in cost recovery of about 80% of the department's costs, assuming the level of development activity remains relatively stable. This will generate $121,000 to $137,000 in additional revenue.

The Recreation Services department has analyzed the activities provided and revenues generated and identified a number of revenue enhancement options for consideration. Some of these ideas will be more fully explored during the coming months, others are recommended for immediate implementation. Staff recommends:

- Increasing Preschool fees from $4.50/hour to $6.05/hour (36% increase) beginning FY 2018-19
- Increasing Children in Motion fees by 25%, approximately $1/hour depending on the number of days per week enrolled, beginning FY 2018-19
- Increase youth sports field rental from $2/hour to $3/hour in FY 2018-19 and to $4/hour in FY 2019-20
- Increase fees for youth and adult sports beginning in FY 2018-19

Ideas for further consideration and evaluation include:

- Adopt a park use policy to enhance the class program, minimize impacts on maintenance schedules at parks, and increase the security and safety of community members
- Initiate a Recreation Foundation to offer scholarships for youth programming, support and fund community events, facilities, and supplies
- Raise or initiate fees at events such as Father/Daughter Dance, Family Fun Day, Halloween Maze, Turkey Trot, and Holiday Decorating Contest
- Raise fees for facility and park rentals
- Develop a formal sponsorship program to recruit additional sponsors for events and programs
- Initiate a banner program at the Soto Sports Complex in FY 2019-20
- Charge for parking at Soto Sports Complex on weekends
- Contract with a concessionaire to operate a business out of the snack bar/Jaycee Room at the Soto Sports Complex

- Attract traveling teams and host large tournaments 1 to 3 times per year in FY 2018-19 and increase to 5 tournaments in FY 2019-20

The recommended revenue enhancements are anticipated to generate an additional $130,000 to $250,000 per year, depending upon participation. The analysis assumes some level (between 10% and 30%) of participation decline with the increased fees; however, the actual participation could decrease more than this, which would result in lower revenue generation. Consistent and timely monitoring of actual results compared to these assumptions will be critical during the Biennial Budget to ensure that Recreation fees are generating sufficient revenue to recover costs.

The Soto Sports Complex provides a unique facility in the region and also presents challenges. The facility costs approximately $250,000 per year to operate and maintain, however field rentals are recovering just $18,000 per year. This revenue is barely enough to offset the cost of the staff time to coordinate field reservations and schedule play. It does not recoup any of the costs of maintenance or operations. Staff is working on several ideas in addition to those mentioned above to increase the revenue generated by this facility, thus making it more self-sustaining.

Staffing Reductions, Eliminations and Restructuring

While eliminating staff positions is always difficult and all other options are considered first, they are also an opportunity to examine business practices and identify possible areas for consolidation, change or efficiency. Discussion of these opportunities and proposed changes, as well as a brief analysis of mitigations or impacts, is provided in the following section.

The following positions are proposed for elimination:

FTE	Position	Department	Savings
1.0	Associate Planner	Community Development	$ 141,300
0.8	Part Time Planning Technician	Community Development	50,800
0.6	Part Time Planning Intern	Community Development	17,400
1.0	Administrative Secretary	Community Development	104,000
2.1	Part Time Maintenance Workers (3 positions)	Public Works	83,100
0.3	Part Time CIP Associate Engineer/Intern	Public Works	18,700
1.0	Property & Evidence Technician	Police (non-sworn)	124,200
0.6	Part Time Administrative Intern	Police (non-sworn)	17,400
0.2	Police Reserve	Police (sworn)	40,000
Total Savings*			$ 596,900

*After accounting for mitigations, which are discussed below, net savings from staffing is $447,000

Community Development

The Planning Division assists the community, the Planning Commission, and the City Council, in preparing for the City's future growth and development, as well as reviewing current development plans for consistency with local ordinances. The Planning Division administers the Development Code and deals with transportation, housing, community facilities, public safety, open space, design, and the use of land. The Planning Division is crucial to public health, safety, and wellness of the City and serves as a major community communication channel through the Planning Commission, Traffic Commission, Architectural Review Committee, Downtown Parking Advisory Board, and Historical Resources Committee. The Planning Division is currently staffed by a full time Planning Manager, full time Associate Planner, part time Planning Technician, part time Planning Intern, a volunteer (unpaid) Planning Intern, and an Administrative Secretary all reporting to the Community Development Director.

Net reductions of $82,000 are possible by restructuring the department by eliminating the Associate Planner and Planning Technician positions and replacing these positions with a full time Assistant Planner position. Eliminating the part time Planning Intern and moving to all volunteer intern positions will save an additional $17,400. Eliminating the Administrative Secretary position and reclassifying the existing part time Senior Office Assistant position to a full time Permit Technician will save $69,000.

These proposed reductions and consolidation of Planning staff will require shifts to major aspects of land use planning including reduction or elimination of selected commissions, revisions to selected lower impact land use regulations and streamlining of review processes. More specifically, it is anticipated that less or no permit review will occur for some Minor Use Permits or design review.

The reduction of the Associate Planner Position will delay the City's ability to accomplish long range planning initiatives including master plans (such as the East Grand Avenue Master Plan, the Halcyon Road Complete Streets Plan, East Branch Phase II), required programs (such as the Climate Action Plan, housing monitoring and reporting, and as needed water conservation programs), as well as General Plan work including the Housing Element, Circulation Element, Safety/Local Hazard Mitigation Plan, and Land Use Elements. This is due to the shifting of work to the Planning Manager.

Associated with this proposed reduction of staff at City Hall, staff also recommends closing City Hall to walk in customers one day per week, and to shorten counter hours on the other four days, to allow for longer periods of uninterrupted task completion. The functions of the Administrative Secretary position that are not covered by the increase in eight hours per week by the reclassification of the part-time Senior Office Assistant will result in additional workload for other divisions and management staff in the Community Development Department.

<u>Public Works</u>
Staff reductions in Public Works include eliminating four part time positions.

- Part time Associate Engineer/Intern position. This position is currently vacant and assists the Capital Improvement Project Manager with several of the Capital

Improvement Program projects along with data collection and updating records. Eliminating this position will save $18,700 and result in additional workload for the Capital Improvement Project Manager and other managers in the Public Works department.

- Three part time Maintenance Worker positions are also proposed for elimination. Two of these positions perform parks maintenance duties. These duties include daily trash/recycling pickup of over 150 trash cans and all public restroom maintenance in addition to mowing and landscaping. They also support the other crews in emergency situations such as a downed tree in the roadway and traffic control. This support extends to facilitating the multiple community events with equipment delivery and setup.

- The third position proposed for elimination is a part time Maintenance Worker in the Streets Division. A minimum crew of four is needed to conduct safe road closures and traffic control on medium to large jobs. The City's full time employee crew of three relies upon this part time position to schedule larger types of projects such as multiple pothole patching, striping and red curbing and other work on busier streets.

Each of these positions work 2.5 days per week and are responsible for mainly one set of duties (i.e. mowing all parks, all trash pickup and all public restroom maintenance, filing, data entry, records updating, etc.) the main impacts are:

- These responsibilities will fall to permanent and more senior staff increasing the cost of those duties and delaying other more technical and special jobs.
- Support to the Streets Division that currently has 3 staff will be lost, which will delay medium and larger street repair jobs due to lack of a safety team for street closures and traffic control. Three to four projects per week will be delayed.
- There will be about a **30% reduction** on the mowing, trash and trash can pick up, restroom maintenance and maintenance of facilities such as BBQ pits, parks picnic areas and other facilities rented out to the public. Example: Trash cans emptied about 30% less frequently and public restrooms will be cleaned about 30% less frequently – noticeable service reductions.
- A similar reduction in our ability to contribute staff to the Special Events throughout the year – especially the events that take place on weekends. Alternately, overtime for permanent staff will have to be used, increasing the cost of these events.
- This reduction will also affect our ability to maintain City Hall and Recreation Services since the department will have no back up or other staff to help with urgent issues like toilets that are backed up, trash that is overflowing, leaks, pest issues, and restroom maintenance. These responsibilities may transfer to the staff who work in these buildings and/or service will be delayed.

- These reductions will certainly have a visual impact on the streets, Village and parks, since these areas will not have the attention and routine maintenance currently provided.
- Our CIP programs are in full swing. The elimination of the Associate Engineer position will mean that more tedious and basic duties will be performed by the CIP Project Manager.

Police Department

An independent audit of the property and evidence function in the department determined that the volume of property and evidence does not warrant a full time position and further analysis determined that these duties could be reassigned to a records/evidence function. Elimination of the full time Property and Evidence Technician position with compensation adjustment for the Records Clerk that will likely assume these functions will result in net savings of approximately $109,000.

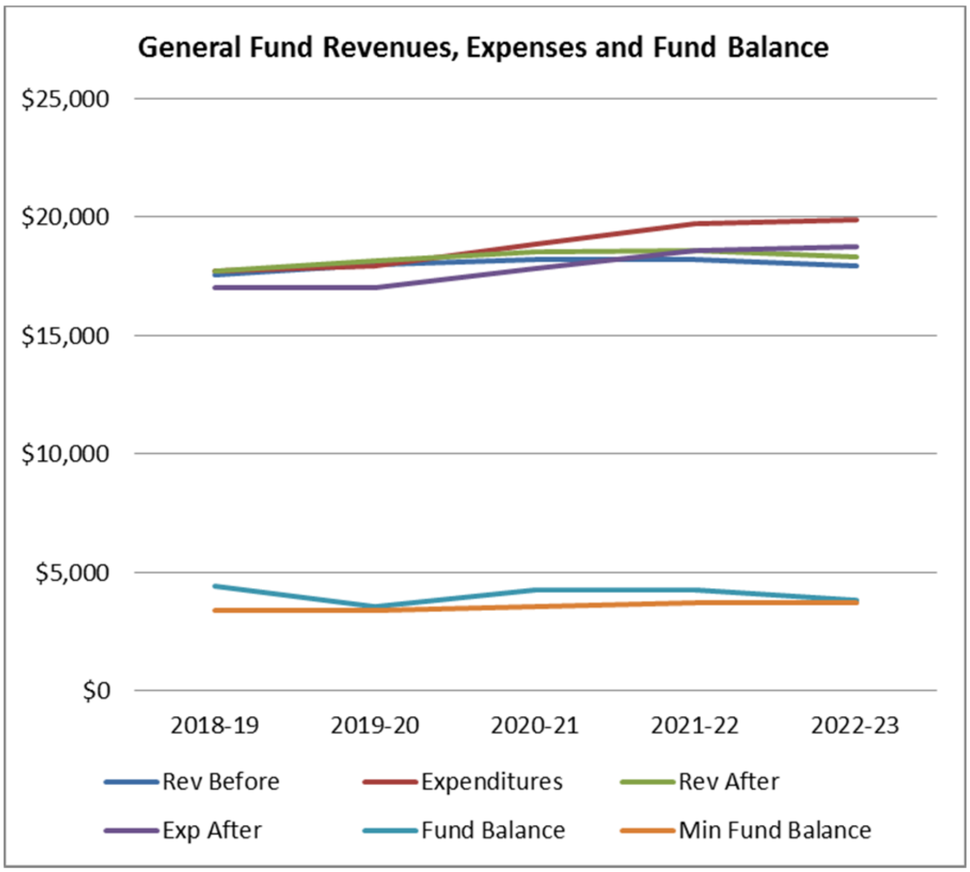
The Police Department has utilized a part time administrative intern to assist with crime mapping and data analysis. Currently the position is unfilled. Elimination of the position will result in greater reliance on the GIS Technician in the Community Development Department for assistance with mapping and other analysis. This is likely to result in reduced capacity for data analysis or delay in performing the analysis as the workload increases for the GIS Technician.

Reducing the number of hours for Reserve police officers will save $40,000. Reserve officers supplement police operations by providing specialized police service in the areas of traffic enforcement, traffic regulation and control, parking enforcement, special event operational planning and coordination and the implementation of special event plans. The Reserve Officer also provides civic, community, and school presentations and training on issues related to traffic safety, DUI, and the role of law enforcement in the community. Additional reliance on motorcycle officers from neighboring jurisdictions may help mitigate this reduction. No reduction is proposed for the number of hours that supports the Reserve Officer that performs the City's cyber-crime analysis.

Implementing these strategies will be impactful to the City's ability to provide service to the community in a number of areas; however it will result in a budget that is sustainable. Community expectations related to response times, park and facility conditions, services provided, and staff availability will need to be adjusted. Reduced public counter hours and additional investment in technology solutions may be required in order to maximize productivity; however, it is unlikely that current service levels will be maintained.

Although the decision to reduce or eliminate positions is not negotiable, the City may have to negotiate the impacts with employee organizations affected by the reductions.

The chart below illustrates the General Fund forecast revenues and expenditures over the next five years. Before implementing any changes or adjustments, expenditures were forecast to exceed revenues each year by an average of about $1.3 million during the five year period. After implementation of the recommended strategy, revenues will exceed expenditures by an average of about $440,000 each year during the same period. The fund balance will be used to prepay the CalPERS liability, drawing it down to the 20% policy goal and it will remain at or above this level.



<u>Next Steps</u>
Staff is seeking City Council direction related to the components of the balancing strategy in order to continue developing the Biennial Budget. The budgetary review of proposed capital projects will be presented to the City Council on May 8, 2018 and the Preliminary Budget will be presented at a special meeting on May 29, 2018.

ALTERNATIVES:
1. Approve the budget balancing strategy presented for the FY 2018-20 Biennial Budget;
2. Do not approve the budget balancing strategy presented; or
3. Provide other direction to staff

ADVANTAGES:
Approving the budget balancing strategy will assist staff in developing a Biennial Budget that is responsive to the City Council and community priorities, while maintaining economic feasibility.

DISADVANTAGES:
There are no disadvantages to providing information for the community, City Council and staff regarding the City Council's priorities and strategies for balancing the Biennial Budget.

ENVIRONMENTAL REVIEW:
No environmental review is required for this item.

PUBLIC NOTIFICATION AND COMMENTS:
The Agenda was posted at City Hall and on the City's website in accordance with Government Code Section 54954.2.

Attachment:

1. Memorandum: CalPERS Unfunded Accrued Pension Liability

ATTACHMENT 1

MEMORANDUM

TO: **JIM BERGMAN, CITY MANAGER**

FROM: **DEBBIE MALICOAT, DIRECTOR OF ADMINISTRATIVE SERVICES**

SUBJECT: **CALPERS UNFUNDED ACCRUED PENSION LIABILITY**

The City of Pismo Beach recently completed an analysis of their pension costs and strategies for managing them. The City of Arroyo Grande's situation is very similar and many of the overall concepts are not employer specific. The following memorandum is based on the City of Pismo Beach's analysis, but with City of Arroyo Grande-specific data. Many thanks go to Nadia Feeser, the Administrative Services Director in Pismo Beach for sharing her report and analysis.

EXECUTIVE SUMMARY:

The City of Arroyo Grande provides retirement benefits for full-time employees through the California Public Employees Retirement System (CalPERS). Unfortunately, CalPERS is underfunded meaning that as of January 2018, CalPERS had only 68% of the funds required to pay estimated retirement benefits. There are several factors contributing to the underfunding of the CalPERS system, largely due to past investment performance in the past two national recessions. Although the 2013 pension reform and CalPERS more conservative investment changes have reduced the potential for further decline in CalPERS funded status, there still remains large unfunded accrued liabilities (UAL) from promised defined benefits compared to the fiscal health of the CalPERS system.

The City of Arroyo Grande has taken a proactive approach to managing the City's UAL, which is essentially debt with a 7.0% interest rate. The most significant element of the City's management of these costs is maintaining level staffing, followed by a controlled spending plan. The City Council also renegotiated new retirement tiers and increased employee contributions. However, the City's funded status still hovers around the 68% mark. Based on what CalPERS is requiring from the City to pay down its UAL assuming reduced investment earnings performance, staff projects that these future payments could require the City Council to make tough decisions on maintaining current operations or paying into its retirement system.

Staff reviewed four additional proactive approaches to paying down the City's UAL and manage future costs including contributing $2.0 million to $3.0 million towards the UAL in a lump sum, spreading this prepayment over 10 years, contributing $2.0 million towards an irrevocable 115 trust for pension stabilization, and changing the City's plans to a 20 year amortization period. The impacts of these strategies are outlined below. Based on the impacts of these strategies, staff recommends prepaying $3.0 million in FY 2018-19 and $2.0 million in FY 2019-20 toward the Safety plan.

Background

The City of Arroyo Grande provides retirement benefits for full-time employees through the California Public Employees Retirement System (CalPERS). These retirement plans provide a defined benefit to each retired employee based on a set percentage of an employee's salary multiplied by the number of years that the employee contributed to the CalPERS system, starting at the stated retirement age of each Plan tier. The City has two main retirement plans, each with three benefit tiers:

Miscellaneous Plan (All Employees except Sworn Police Officers)

1. First tier provides a benefit of 2.5% at age 55
2. Second tier provides a benefit of 2.0% at age 55
3. Third tier provides a benefit of 2.0% at age 62

Safety Police Plan (for Sworn Police Officers)

1. First tier provides a benefit of 3.0% at age 50
2. Second tier provides a benefit of 3.0% at age 55
3. Third tier provides a benefit of 2.7% at age 57

Each tier within each plan calls for a different Employer and Employee cost, with the first tier costing the most and the third tier costing the least to the employer. The third tier plans came about as a result of the California Public Employees' Pension Reform Act, commonly referred to as PEPRA, which took effect in 2013.

The UAL as of June 30, 2016 for the Miscellaneous Plan tier 1 is $12.3 million and for the Safety Police Plan tier 1 is $9.4 million. The City also has a Safety Fire Plan for employees assigned to the Five Cities Fire Authority which has a total UAL of $1.3 million as of June 30, 2016, but is not the subject of this memorandum. The following table illustrates the funded status of the 6 main retirement plans, including the total UAL.

Table 1: Funded Status of Each Retirement Plan

		A	B	C = A-B	B/A
Plan Name	Tier	Accrued Liability	Market Value of Assets	Unfunded Accrued Liability (UAL)	Funded Ratio
Miscellaneous Plan	Tier 1	$ 36,672,064	$ 24,384,997	$ 12,287,067	66.5%
Miscellaneous Plan	Tier 2	164,775	156,870	7,905	95.2%
Miscellaneous Plan	PEPRA	89,380	80,647	8,733	90.2%
Safety Police Plan	Tier 1	30,069,932	20,628,187	9,441,745	68.6%
Safety Police Plan	Tier 2	370,473	350,368	20,105	94.6%
Safety Police Plan	PEPRA	53,118	47,233	5,885	88.9%
		$ 67,419,742	**$ 45,648,302**	**$ 21,771,440**	**67.7%**

Notes/Definitions:

- Accrued Liability – The total value of earned benefits; measures the full value of supporting the City's active and retired employees
- Market Value of Assets – The current market value of the City and employee contributions plus investment earnings
- Funded Status – An assessment of the need for future employer contributions based on the selected actuarial cost method used to fund the plan
- Unfunded Accrued Liability (UAL) – the difference between the estimated cost to pay retirement obligations and the market value of the assets currently set aside to fund them. It is the present value of future employer contributions for service that has already been earned and is in addition to future normal cost contributions for active members; which represents the City's debt or pension liability

Factors Contributing to CalPERS System Unsustainability

There are several factors contributing to the unsustainability of the CalPERS system, largely due to past investment performance, and exacerbated by other factors including demographic changes, automatic cost of living adjustments for retirees, and enhanced retiree benefits.

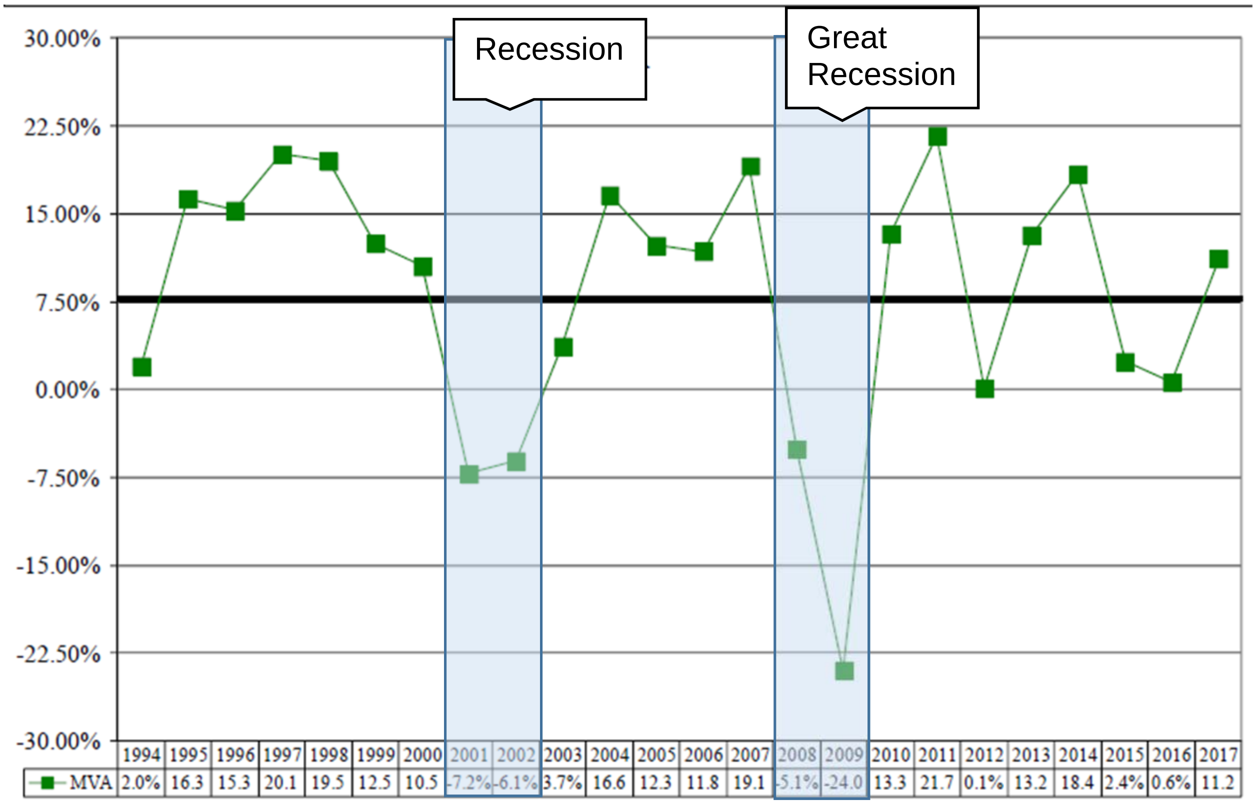
CalPERS Past Investment Performance and Rate of Return

Prior to 2017, CalPERS provided pension benefits based on a 7.5% annual long-term rate of return. This meant that CalPERS expected to earn 7.5% on average each year on the contributions into CalPERS. However, in the last two recessions, CalPERS has suffered significant losses.

- During the recession in 2000 and 2001, CalPERS had losses of 7.2% and 6.1%, respectively, in investment earnings.
- During the Great Recession in 2008 and 2009, CalPERS suffered losses of 5.1% and 24.0%, respectively, of investment earnings and since then, has been struggling to recover those losses.

The following chart illustrates CalPERS historical investment performance at the end of each year, demonstrating the two significant losses.

Chart 1: CalPERS Historical Investment Returns 1994 –2017



Above assumes contributions, payments, etc. received evenly throughout year.

As retirement benefits payments are made up by 62% from investment earnings, 25% from CalPERS employers, and 13% from CalPERS employee member contributions, the two recessions have led to a larger UAL for most CalPERS member agencies. When the pension plan's investment earnings are lower than expected, the fund needs to make better than expected earnings in future years, request higher contributions from employers and employees, or reduce retiree benefits.

Other Factors

Although past investment performance is the primary factor in the current unsustainability of CalPERS, the UAL is intensified by other factors including demographic changes, automatic cost of living adjustments (COLAs) for retirees, and enhanced retiree benefits. Regarding demographic changes, the number of annual retirees drawing down from CalPERS for pension payments is increasing compared to active employees contributing into CalPERS with reduced contributions. This factor decreases the amount of funds paid into CalPERS. In addition, several actuarial factors including mortality rates are improving, creating a larger liability. Regarding retiree cost of living adjustments (COLAs), these COLAs are automatic, increasing in years even when there is flat or negative inflation, which draws funds out of CalPERS. Finally, each plan has several enhanced benefits, including earlier retirement ages and larger compensation packages and resulting pensions as a percentage of salaries. All these factors contribute to an increase in the UAL and negatively impact the future stability of CalPERS.

What Has the State/CalPERS Done to Fix the Problem? CalPERS Pension Reform and Investment Changes

Due to the dramatic losses in the CalPERS system after the most recent two recessions, there was significant support for pension reform.

- In 2012, Governor Jerry Brown signed into law the California Public Employees' Pension Reform Act (PEPRA), which changed the way CalPERS retirement and health benefits are applied, and placed compensation limits on members hired after January 1, 2013. The cost savings of this legislation will be realized over 20 years as more PEPRA employees are hired.

- Beginning in July 2015, CalPERS changed the way employers contributions into the plan were calculated, placing an increased burden on employers. This resulted in requiring larger contributions by public agencies into the CalPERS system.

- In December 2016, the CalPERS Board voted to reduce the expected rate of return (discount rate[1]) on CalPERS investments from 7.5% to 7.0% over the next 3 years. This change is intended to reflect more realistic future investment returns. But because the retirement system is based on defined benefits, with a lower expected earnings rate, the result is that CalPERS member agencies will need to pay higher employer rates. This change also increases the City's UAL.

- In February 2018, the CalPERS Board voted to change the amortization period for any prospective gains/losses on investments to a 20 year amortization period (compared to a 30 year amortization period) starting with the FY 2019 valuation. This change will have the impact of increased volatility in the amount that Cities would need to contribute to CalPERS as the impacts are spread over a shorter time frame.

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[1] **Discount Rate**

The Discount rate, or the long-term expected rate of return, is based on the CalPERS actuarial assumptions that they will earn a certain percent investment return on all of the amount it invests as well as on all the amounts that are owed. If the actual rate of return is less than this amount and all other factors remain the same (i.e., number of annual retirements, mortality, compensation adjustments, etc.), later annual valuations will reflect a greater UAL. There is discussion among CalPERS staff that this discount rate could be further reduced from 7.0% to 6.5% or 6.0% as CalPERS changes the mix of investments from more growth earnings to fixed earning investments. CalPERS has stated that it expects to earn about 6.1% per year over the next 10 years, which will result in even higher pension costs.

Each time changes are implemented into member agencies' pension plans, they are reflected in the plans over a period of 20 years to minimize the impact of the investment losses and resulting impact in increased contributions by CalPERS member agencies. Although a smoothing policy is least impactful on a fiscal year basis, spreading out the losses means that member agencies will continue to pay interest costs equal to the discount rate over a longer term, ultimately costing more to member agencies.

What is the Fiscal Health of the City of Arroyo Grande's Pension Plans?
Every year, CalPERS performs an actuarial study to determine how much the City should contribute based on the most recent valuation of the Plan's funded status. Based on CalPERS actuarial valuation for the fiscal year ending on June 30, 2016, the June 30, 2018 estimated balance of the Miscellaneous Plan tier 1 has an UAL of $12.5 million and the Safety Police Plan UAL is $9.1 million.

CalPERS provided estimated payment schedules to the City for both tier 1 plans. Both of these plans have "side funds" that will be paid off in the next four years. After taking those into consideration, staff projects that the fiscal impact to the City for all plans will increase each year until it peaks in FY 2032 at 45% higher than current amounts, then ramp down until it is paid off in FY 2048. This represents an increase of about $100,000 per year compared to the previous year, or an ongoing increase of over $1.1 million by FY 2029. A $1.1 million ongoing increase in cost is unsustainable and could require the City to either increase taxes or support other ongoing revenue measures or decrease operations in order to support this cost. Further, this amount does not include pension related costs in the Five Cities Fire Authority, which will require additional contributions from the City.

City's Proactive Approach to CalPERS
The City recognizes that pension costs are rising, which places an increased burden on local taxpayers and the City to come up with funds sufficient to support its pension obligations. Although not in a critical situation compared to several public agencies who are facing large reductions in staff and operating costs or facing bankruptcy, the City continues to look for ways to be proactive and reduce this burden.

<u>What We've Done So Far</u>
So far, the City has taken the following steps:

- ✓ *Maintained level staffing*: The City has maintained level full-time staffing despite increased workloads. This factor has allowed the City to keep pension costs from rising as each new full-time employee is enrolled in CalPERS.

- ✓ *Creation of 2nd and 3rd Tiers with Reduced Benefits for New Employees*: The City of Arroyo Grande has taken a proactive approach to handling the increased cost of providing pension benefits to its employees. In 2012, the City successfully negotiated with its employees and labor unions to create a second tier of reduced retirement benefits, including a later retirement age, for new employees to the City.

With PEPRA in 2013 came a third tier of further reduced benefits and an even later retirement age.

✓ *Employees Increase Contributions*: In addition, the total contribution made by the City to CalPERS is made up partially from contributions by the City based on a percentage of payroll from taxpayer and rate payer dollars as well as the employee paying into the system as a percentage of their salary. Since 2011, the City successfully negotiated with its employees and labor unions for employees to increase their contribution to the full amount of the employees' portion and in some cases, a small part of the City's employer contribution.

What We Can Do Now

Going forward, the City continues to take a proactive approach to reduce its UAL.

- *Status Quo Option: If We Do Nothing:* If we continue to contribute to CalPERS by paying a fixed amount towards the City's UAL and a percentage of salaries for the City's normal ongoing costs, then the City can expect to see pension payments increase by 45%, or $1.1 million per year, until FY 2032 at its peak, and then ramp down until it is paid off in FY 2048. The majority of these costs are borne by the General Fund, or taxpayer dollars. In addition, there would likely be a similar increase in retirement costs as part of the City's participation in Five Cities Fire Authority. In order to support this $1.1 million plus ongoing cost, the City may need to increase taxes or put forward other ongoing revenue measures, or decrease operations and service levels. A $1.1 million ongoing cost could represent about 8 to 10 FTEs. As this cost is unsustainable and the City has the means to reduce this cost today, staff does not recommend doing nothing.

- *Prepay UAL in Lump Sum:* The City Council could use money from the General Fund unassigned fund balance to help manage future CalPERS discount rate reductions. The adopted minimum fund balance policy is 15% of appropriations, with a Council goal of 20%. Currently, the General Fund has reserves that equal about 38% of appropriations. During the FY 2018-20 Biennial Budget period, the General Fund is forecast to have $5 million more than the 20% goal ($3 million in FY 2018-19 and $2 million in FY 2019-20). This total of $5 million could be used to support a prepayment to CalPERS to reduce the City's unfunded accrued liability balance, save millions on interest costs, and save hundreds of thousands of dollars each year.

  Prepaying the UAL in a lump sum provides the highest amount of interest savings compared to making the annual payments in the current payment schedule. The City's independent actuaries have calculated that this option would save the city $7.45 million in interest costs. This is a net annual average savings of $240,476, which reduces the payment that must come from the General Fund each year. It will increase the percentage of assets in the fund, therefore improving the funded status by $5 million. It does not require committing to a new amortization period.

The payment to CalPERS is comprised of several “bases” of annual gains and losses. Each of these is amortized, or paid off, over a 20 or 30 year time period, depending on the adopted policy of the CalPERS Board. Recent policy changes indicate that all future gains and losses will be amortized over a 20 year period, rather than 30 years. Each “base” can be viewed as an independent payment plan, when combined they make up the total UAL. When prepaying the UAL, paying off the debt with the longest payment period results in the maximum amount of interest earnings. The Miscellaneous Plan and Safety Plan schedule of amortization bases is extracted from the full actuarial report and reproduced below.

Miscellaneous Plan:

							Amounts for Fiscal 2018-19	
Reason for Base	Date Established	Amortization Period	Balance 6/30/16	Payment 2016-17	Balance 6/30/17	Payment 2017-18	Balance 6/30/18	Scheduled Payment for 2018-19
SIDE FUND	2013 or Prior	4	$1,746,434	$334,947	$1,528,155	$344,995	$1,283,366	$353,485
SHARE OF PRE-2013 POOL UAL	06/30/13	18	$4,246,070	$320,601	$4,227,005	$330,219	$4,196,567	$336,176
ASSET (GAIN)/LOSS	06/30/13	27	$3,557,280	$97,196	$3,718,913	$150,168	$3,837,576	$203,240
NON-ASSET (GAIN)/LOSS	06/30/13	27	$(35,516)	$(970)	$(37,130)	$(1,499)	$(38,315)	$(2,029)
GOLDEN HANDSHAKE	06/30/13	17	$145,663	$11,366	$144,628	$11,707	$143,163	$11,923
ASSET (GAIN)/LOSS	06/30/14	28	$(2,499,665)	$(35,158)	$(2,647,584)	$(72,425)	$(2,767,795)	$(110,204)
NON-ASSET (GAIN)/LOSS	06/30/14	28	$3,058	$43	$3,239	$89	$3,386	$135
ASSUMPTION CHANGE	06/30/14	18	$1,750,554	$33,344	$1,845,106	$68,689	$1,910,006	$104,953
ASSET (GAIN)/LOSS	06/30/15	29	$1,455,114	$0	$1,562,429	$22,001	$1,654,860	$44,602
NON-ASSET (GAIN)/LOSS	06/30/15	29	$(132,717)	$0	$(142,505)	$(2,007)	$(150,935)	$(4,068)
ASSET (GAIN)/LOSS	06/30/16	30	$1,729,234	$0	$1,856,765	$0	$1,993,702	$27,634
NON-ASSET (GAIN)/LOSS	06/30/16	30	$(236,525)	$0	$(253,969)	$0	$(272,699)	$(3,780)
ASSUMPTION CHANGE	06/30/16	20	$558,082	$(10,176)	$609,785	$(10,481)	$665,617	$12,546
TOTAL			**$12,287,066**	**$751,193**	**$12,414,837**	**$841,456**	**$12,458,499**	**$974,613**

Safety Police Plan:

							Amounts for Fiscal 2018-19	
Reason for Base	Date Established	Amortization Period	Balance 6/30/16	Payment 2016-17	Balance 6/30/17	Payment 2017-18	Balance 6/30/18	Scheduled Payment for 2018-19
SIDE FUND	2013 or Prior	1	$1,446,934	$521,601	$1,013,152	$537,249	$531,164	$550,403
SHARE OF PRE-2013 POOL UAL	06/30/13	19	$2,706,240	$198,199	$2,700,448	$204,145	$2,688,067	$207,739
ASSET (GAIN)/LOSS	06/30/13	27	$2,975,361	$81,296	$3,110,553	$125,603	$3,209,804	$169,993
NON-ASSET (GAIN)/LOSS	06/30/13	27	$(37,533)	$(1,026)	$(39,238)	$(1,584)	$(40,490)	$(2,144)
ASSET (GAIN)/LOSS	06/30/14	28	$(2,066,648)	$(29,067)	$(2,188,944)	$(59,879)	$(2,288,331)	$(91,113)
NON-ASSET (GAIN)/LOSS	06/30/14	28	$27,883	$392	$29,533	$808	$30,874	$1,229
ASSUMPTION CHANGE	06/30/14	18	$1,525,113	$29,050	$1,607,488	$59,843	$1,664,030	$91,437
ASSET (GAIN)/LOSS	06/30/15	29	$1,185,274	$0	$1,272,688	$17,921	$1,347,979	$36,331
NON-ASSET (GAIN)/LOSS	06/30/15	29	$(4,683)	$0	$(5,028)	$(71)	$(5,325)	$(144)
ASSET (GAIN)/LOSS	06/30/16	30	$1,478,508	$0	$1,587,548	$0	$1,704,630	$23,627
NON-ASSET (GAIN)/LOSS	06/30/16	30	$(254,882)	$0	$(273,680)	$0	$(293,863)	$(4,073)
ASSUMPTION CHANGE	06/30/16	20	$460,178	$(11,865)	$506,411	$(12,221)	$556,423	$10,488
TOTAL			**$9,441,745**	**$788,580**	**$9,320,931**	**$871,814**	**$9,104,962**	**$993,773**

Since 2013, CalPERS assigns gains and losses each year to three different categories or bases. Gains and losses due to changes in market value or assets, gains or losses due to changes in CalPERS assumptions/methods (such as demographic changes, longevity assumptions) and gains or losses due to non-asset changes (such as larger than expected payroll growth, more or less actual retirements than expected). In addition, City specific bases, such as Side Funds and Golden Handshake agreements are included. Paying off any one loss base is akin to paying off a household credit card. If you pay just the monthly minimum (or annual required payment) you will pay a significant amount of interest compared to paying the balance in full. Paying off one loss base doesn't prevent future years from incurring losses, just as paying off your current credit card doesn't ensure you don't get another credit card in the future. However, ongoing proactive debt management and evaluation of the amortization bases with each budget should be undertaken to ensure that the City is minimizing interest costs.

Staff further recommends that the prepayment be applied to the Safety Plan because this cost is attributed solely to the General Fund. Similar interest savings could be realized by paying the Miscellaneous Plan; however it would require the participation of the Water Fund, Sewer Fund and Streets Fund. At this time, staff has not had the opportunity to calculate the required contribution from these other participating funds. This may be an option for the 2019-20 fiscal year prepayment if staff workload permits.

Staff recommends this option as it provides the most overall benefit: reduced annual payments, reduced UAL balances by $5 million, improved funded status, and savings on interest payments.

- *Prepay UAL Over Time:* The City could choose to take a portion of the City's net operating surplus each year and contribute an amount towards the UAL, which would allow the City to benefit from reducing the outstanding UAL balance, reduce interest costs without the risk of locking in a higher annual payment, and reduce future annual payments. In this option, staff recommends that all funds that have personnel costs submitting funds to CalPERs contribute to future prepayments rather than just drawing down from the General Fund.

  An example of a flexible procedure could state that if the funded status of the Plan tier is below 85%, operating revenues exceed the budget and operating expenditures are under budget for the previous year, and a large portion of the expenditure savings are from personnel costs, then 75% of salary and benefit savings over $250,000 could be used to prefund the City's UAL up to a maximum of $500,000 per year. In the event that there are extenuating circumstances that do not warrant an additional payment such as other financial obligations that take precedence, such as the desire to accumulate funds to support new large capital projects, debt avoidance, or other occurrences, the policy would need to remain flexible to account for these circumstances. Alternatively, staff could recommend that after the close of the fiscal year, that a certain amount be allocated towards paying down the City's UAL. Staff recommends this more flexible option after looking back at FY 2018-19 in order to avoid setting a strict policy that may not end up being the best fiscal option due to extenuating circumstances.

- *Reduce Amortization Period or Speed up Payments:* The City could reduce the amortization period (reduce the term) of its UAL from the current 30 year schedule to a shorter time frame, such as 20 years. This has the effect of increasing annual contributions with the benefit of saving in interest costs. If the City formally requested to shorten the amortization period, the City would be locked into the higher annual payments. This is not desirable as the ongoing costs could become unmanageable after an economic downturn. Staff does not recommend this option.

- *Establish Section 115 Trust:* City staff could establish an Irrevocable Pension Trust Internal Revenue Service Section 115 to prefund future CalPERS contributions and help the City stabilize its contributions to CalPERS. The City could transfer the same amount from the General Fund unassigned fund balance into this Trust account. The $5 million plus earnings could be drawn upon in future years to support CalPERS pension costs, but cannot be used for any other purposes. If this was implemented, staff could draw from this account in future years to offset future rate spikes and pension costs increases, while still maintaining operations and earning a better rate of return than in the City's managed portfolio. As the funds are placed in a trust where the funds can only be used for pension costs, these would show up as an asset on the City's balance sheet. Establishing a Trust would allow the City to earn a greater rate of return on the $5 million than the City's investment policy allows per California Government Code.

  However, like any higher yielding investment, this Trust is subject to the same economic downturns as CalPERS investments. The benefit of investing in the Trust would be if the Trust could potentially achieve a greater rate of return than the 7.0% interest cost on the UAL, but that also means that it could lose even more. Looking at historic earnings rates offset by administrative fees, a 4.9% earnings would be the City's most likely investment strategy. As such, based on past investment earnings history, it is more beneficial to pay down the City's debt/UAL with 7.0% interest costs rather than invest in the market earning 4.9%. Further, in the event of an economic downturn, the CalPERS pension costs would increase, which is when the City would want to draw funds from this account to offset those spikes. However, it is likely that the Trust would be experiencing the same economic hit as evidenced by historic losses, which would reduce the amount the City would have to offset those spikes in costs.

  At this point, staff does not recommend this option. However, staff views this option as beneficial to prefund future CalPERS payments to help stabilize future cost increases, but not paying down the current UAL. Staff may come back to the Council to establish the Trust to keep this option open, but not put money into the Trust until the City's funded status improves.

- Summary of Proactive Pension Options: Of the four options outlined above, staff recommends prepayment of the UAL by $3 million in 2018-19 and $2 million in 2019-20, assuming the General Fund unappropriated fund balance exceeds the Council adopted goal of 20% of appropriations. In addition, staff recommends continuation of a proactive approach to managing pension costs in the future.

- *Future Employee Contributions*: Since pension benefits are for City employees, City staff will work with its labor unions and City employees for further employee contributions to CalPERS as appropriate through the negotiation process.

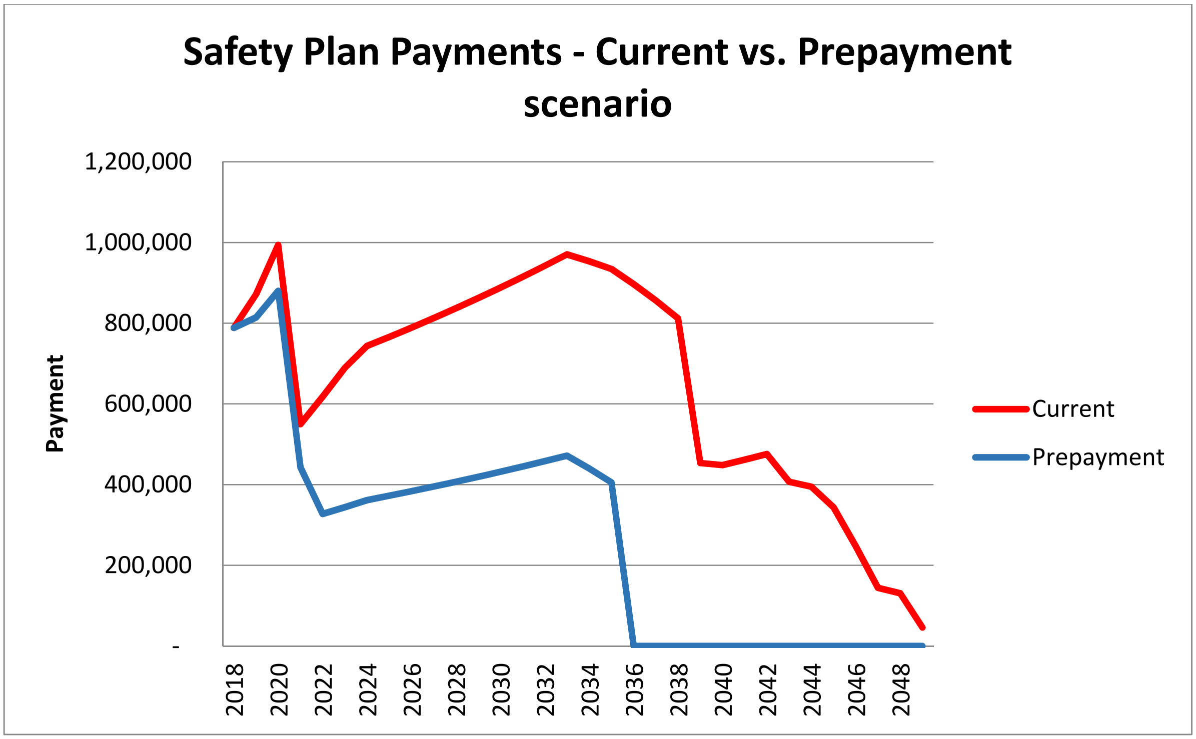
- *Voice for Pension Reform*: Finally, local City Managers are working with the California League of Cities to start discussions about pension reform as the current pension system is not sustainable. Arroyo Grande as well as other leaders in the State are working together to be a voice for pension reform and to take measures to resolve this upcoming crisis.

What Have Other Public Agencies Done to Pay Down Their Pension Liabilities?

Many other CalPERS member agencies are making at least one prepayment in an effort to begin paying down their liability with whatever resources they have available at the time. Cities typically use excess reserves or savings from unspent payroll budget to reduce their UAL either in one lump sum payment or put a policy or procedure into place to strategically reduce the outstanding UAL balance over time. Several cities are also establishing Section 115 Trust accounts to help stabilize their pension costs rather than sending full payments to CalPERS. Very few member agencies have changed their amortization schedule to 10 or 20 years.

Amortization and Payment Schedule Comparing Safety Police Plan
Current payment schedule versus prepaying $3 million in FY 2018-19 and $2 million in 2019-20

	TOTAL UAL - Current Payment Schdule		TOTAL UAL - Prepayments Applied		**Savings**
FY	Balance	Payment	Balance	Payment	
2018	9,441,745.00	788,580.00	9,441,745.00	788,580.00	**-**
2019	9,320,931.00	871,814.00	9,320,931.00	3,814,129.00	**(2,942,315.00)**
2020	9,104,959.35	993,771.79	6,052,351.02	2,879,958.43	**(1,886,186.64)**
2021	8,746,684.82	550,003.96	5,499,199.17	443,512.92	**106,491.04**
2022	8,821,828.19	618,120.17	3,459,274.64	327,370.15	**290,750.02**
2023	8,831,930.12	689,262.66	3,375,168.97	344,122.39	**345,140.27**
2024	8,769,057.83	743,752.83	3,267,501.48	361,665.90	**382,086.93**
2025	8,645,084.96	766,065.41	3,133,714.61	372,515.87	**393,549.54**
2026	8,488,848.38	789,047.40	2,978,818.00	383,691.37	**405,356.03**
2027	8,297,274.99	812,718.80	2,800,917.52	395,202.09	**417,516.71**
2028	8,067,044.28	837,100.36	2,597,969.23	407,058.16	**430,042.20**
2029	7,794,569.41	862,213.38	2,367,768.02	419,269.91	**442,943.47**
2030	7,475,976.96	888,079.77	2,107,935.45	431,848.00	**456,231.77**
2031	7,107,085.05	914,722.17	1,815,906.55	444,803.44	**469,918.73**
2032	6,683,379.97	942,163.84	1,488,915.83	458,147.55	**484,016.29**
2033	6,199,991.10	970,428.77	1,123,982.14	471,891.98	**498,536.79**
2034	5,651,663.67	953,439.40	717,892.37	439,946.51	**513,492.89**
2035	5,080,501.76	934,557.29	314,955.95	405,659.61	**528,897.68**
2036	4,486,782.65	896,854.26	(82,168.29)	-	**896,854.26**
2037	3,888,345.39	856,047.91	(453,070.21)	-	**856,047.91**
2038	3,288,057.66	811,986.05	(792,106.99)	-	**811,986.05**
2039	2,689,156.46	453,684.24	(1,093,047.07)	-	**453,684.24**
2040	2,417,365.47	448,352.57	(1,026,936.12)	-	**448,352.57**
2041	2,131,054.69	461,803.14	(931,919.52)	-	**461,803.14**
2042	1,809,690.75	475,657.24	(824,772.84)	-	**475,657.24**
2043	1,450,270.33	407,111.06	(704,447.83)	-	**407,111.06**
2044	1,135,371.52	394,929.23	(536,544.11)	-	**394,929.23**
2045	809,871.96	343,766.03	(379,367.80)	-	**343,766.03**
2046	513,383.09	247,007.72	(235,450.21)	-	**247,007.72**
2047	295,290.96	144,134.55	(116,539.47)	-	**144,134.55**
2048	167,713.70	130,872.97	(26,771.76)	-	**130,872.97**
2049	44,469.52	46,080.16	(9,263.04)	-	**46,080.16**
	167,655,380.99	21,044,129.13	54,652,541.69	13,589,373.29	**7,454,755.84**


Safety Plan Payments - Current vs. Prepayment scenario
Payment
1,200,000
1,000,000
800,000
600,000
400,000
200,000
-
2018
2020
2022
2024
2026
2028
2030
2032
2034
2036
2038
2040
2042
2044
2046
2048
Current
Prepayment