City of SACRAMENTO

City Council Report

915 I Street, 1st Floor
www.CityofSacramento.org

Meeting Date: **1/27/2015**

Report Type: Staff/Discussion

Report ID: 2015-00057

Title: The Long-Term Liabilities of the City of Sacramento 2015

Location: Citywide

Recommendation: Receive and file.

Contact: Russ Fehr, City Treasurer, (916) 808-5832; John Colville, Sr. Investment Officer, (916) 808-8297, Office of the City Treasurer

Presenter: Russ Fehr, City Treasurer, (916) 808-5832, Office of the City Treasurer

Department: City Treasurer

Division: City Treasurer

Dept ID: 05001011

Attachments:

1-Description/Analysis

2-Council Report Long-Term Liabilities 2015

City Attorney Review

Approved as to Form
Joseph Cerullo
1/21/2015 1:31:02 PM

Approvals/Acknowledgements

Department Director or Designee: Russell Fehr - 1/20/2015 12:01:27 PM

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Description/Analysis

Issue Detail: The long-term financial liabilities (or debts) of the City present on-going budgetary and debt-capacity challenges now and in the future. Over time, payment toward these obligations will make up increasing shares of the annual budget.

Policy Considerations: The information and comments in this report are intended to inform the upcoming budget development and to prioritize the future use of debt for capital projects.

Economic Impacts: None

Environmental Considerations: Not applicable

Sustainability: Not applicable

Commission/Committee Action: Not applicable

Rationale for Recommendation: The report is informational only, and no Council actions are recommended.

Financial Considerations: The long-term financial obligations of the City require an ever-growing commitment of funding, and the annual payments toward long-term liabilities are taking an increasing share of the budget. This erodes future City Council discretion over the budget.

Local Business Enterprise (LBE): Not applicable

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City of SACRAMENTO
Office of the City Treasurer

Background

The Long-Term Financial Liabilities of the City of Sacramento 2015

Russell Fehr
City Treasurer

January 27, 2015

INTRODUCTION

The City budget process, by charter, law, and policy, revolves around the development and adoption of an annual budget. The annual challenge is maintaining or enhancing service levels in the context of increasing employee compensation and benefit cost levels as well as increasing costs of services and supplies. It is very important for policy makers, the public, and employees to also be aware of longer-term financial realities as they participate in the annual budget process. Past and current decisions have long-term fiscal impacts that influence discretionary budget decision making.

This report presents and discusses the current long-term financial liabilities of the City of Sacramento. Long-term liabilities are financial obligations incurred in the past but paid in the future. Examples include repayment of funds borrowed for capital projects, payment of debt, and payment of funding shortfalls in the retirement plans. These future financial obligations may be paid either from funds previously set aside or from future revenues. Specifically, this report focuses on those long-term liabilities that will be paid from future revenues, also referred to as “unfunded liabilities,” because funds are not currently set aside to pay for these liabilities.

In the annual budget process, the City Manager and the Finance Director are focusing attention on the longer-term fiscal issues, and the issues are alarming. Payments toward long-term liabilities, over which there is no annual discretion, are taking up an increasing share of the overall spending in the General Fund, thereby limiting the City Council control over spending levels. This is the core issue with increasing the future obligations of the City.

The City’s disclosure of long-term liabilities is a standard and long standing aspect of the City’s annual financial reporting. However, in the standard summary financial presentations of the Annual Budget and Comprehensive Annual Financial Report (CAFR), the long-term liabilities are not presented together as a unit; they are, rather, found scattered throughout the presentations. The City Manager requested that the City Treasurer prepare this report focusing on the long-term liabilities of the City. This is the third annual report discussing the long-term financial liabilities of the City. The City Treasurer presented the first report to the City Council in January 2013.

<u>Long-term liabilities</u>

A long-term liability is a financial obligation arising from past events or transactions and payable more than one year in the future. Meeting these long-term financial obligations may take the form of future payments to individuals or organizations, the future provision of services, or the future transfer of assets. A critical point is that liabilities are current, and though the payments are made or the services rendered in the future, the obligations for which those payments are made have been incurred in the past up to the immediate present. The current level of long-term liabilities does not include any obligation that will be incurred in the future.

The City of Sacramento has currently unfunded long-term liabilities of nearly $2.3 billion, with the major categories being post-retirement employee benefits and debt for land, facilities, and equipment. The following table gives the values of the City's unfunded long-term liabilities compared to prior year levels:

Summary of Long Term Liabilities

Liability Type	Past Value	Current Value	Change
Benefits	$ 985 m	$1,166	$181 m
Other Costs	$166 m	$115	($51 m)
Debt	$1,023 m	$985 m	($38m)
Total	$2,174 m	$2,276 m	$102 m

The long-term liabilities have grown from year to year by $102 million. On an annual basis, the overall increase and the increase in benefits net liabilities is primarily due to an accounting change for retirement plan, partially offset by pension-plan investment performance exceeding expectations. Otherwise, debt has been paid down and other costs are lower.

POST-EMPLOYMENT BENEFITS

The City has just short of $1.2 billion in unfunded long-term liabilities for post-employment benefits to be paid to those who worked for the City and to their survivors. These benefits include pensions, the retiree medical benefit, and payoff of leave balances upon retirement. In very round numbers, and expressed in an actuarial basis, the long-term liability for these benefits is approximately $3 billion, but only $2 billion has been set aside to fund those benefits. The difference between required and actual funding is the unfunded liability. The following table summarizes the funding status of the long-term benefit plans:

Actuarial Liabilities and Assets
For Pensions and Retiree Medical Plans

Plan	Actuarial Liabilities	Market Value Assets	Unfunded Liability	Funding Ratio
PERS Safety	$1,370 m	$992 m	$378 m	72 %
PERS Misc.	$914 m	$677 m	$237 m	74 %
SCERS	$372 m	$312 m	$60 m	84 %
Retiree Medical	$456 m	$4 m	$452 m	1 %
Comp Absences	$39 m	$0 m	$39 m	0 %
Total	$3,151 m	$1,985 m	$1,166 m	63%

Funds are currently set aside only for the pension plans. The retiree medical benefit is funded on a current basis; payments are made to retirees out of the annual budget. The City has begun to put some funding in trust for this benefit. The compensated absences are recorded as liabilities and are paid out every year as employees retire.

The Pension Plans

City employees and retirees participate in one of three pension plans:

1. PERS Safety – Members of this plan receive the higher, and more costly, safety retirement benefit.
2. PERS Miscellaneous – Members of this plan receive a lower, and less costly, benefit.
3. SCERS – This was the pension plan for City employees until 1977, when the City entered CalPERS. All employees hired after this date became members of a PERS plan. During the 1980s, active safety members of SCERS migrated to the PERS safety plan funded with a transfer of assets. SCERS provides both a safety and miscellaneous benefit.

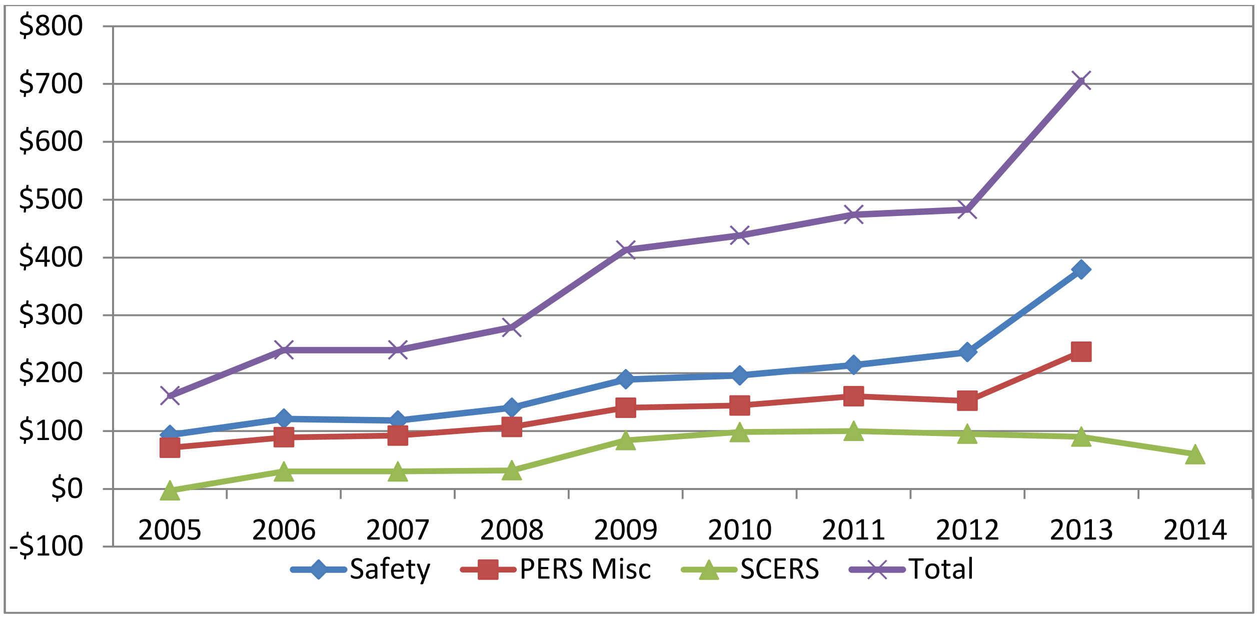
Normal Costs and Unfunded Liabilities

Payments to the pension plans are of two types: (1) normal costs and (2) payments against unfunded liabilities. Normal-cost payments are to keep the plans current according to the actuarial assumptions and are shared by the City and employees. Unfunded liability payments are made by the City only.

Pension Plan Unfunded Liabilities

The pension plans have a collective unfunded long-term liability of **$675 million**, and the unfunded long-term liabilities have grown significantly in recent years. The following graph presents pension-plan unfunded liabilities over the past decade:

RETIREMENT PLAN UNFUNDED LIABILTIES



(in $ millions)

Since the conclusion of the 2004-2005 Fiscal Year, the unfunded long-term liabilities in the pension plans have grown by $515 million, from $161 million to $676 million. The increase is due to both the economic performance of the plans in the past decade and an important reporting standard change. Beginning with the most recent actuarial reports, assets are now reported at their market value. In past reports, changes in investment performance above or below the earnings assumptions were spread over multiple years. With the changes, the two PERS plans now include previously unrecognized losses in excess of $200 million, and the SCERS plan includes deferred gains.

The unfunded liability is a debt the City, as the employer, owes to the three pension plans. And like the bonded debt, these long-term liabilities are payable with interest, at the pension-plan discount rates, currently 7.5% for PERS and 6.5% for SCERS.

Why There Are Unfunded Liabilities

The obvious reason for unfunded liabilities is the weak performance of investment markets in recent years. There are actually four fundamental reasons for unfunded liabilities in the pension plans:

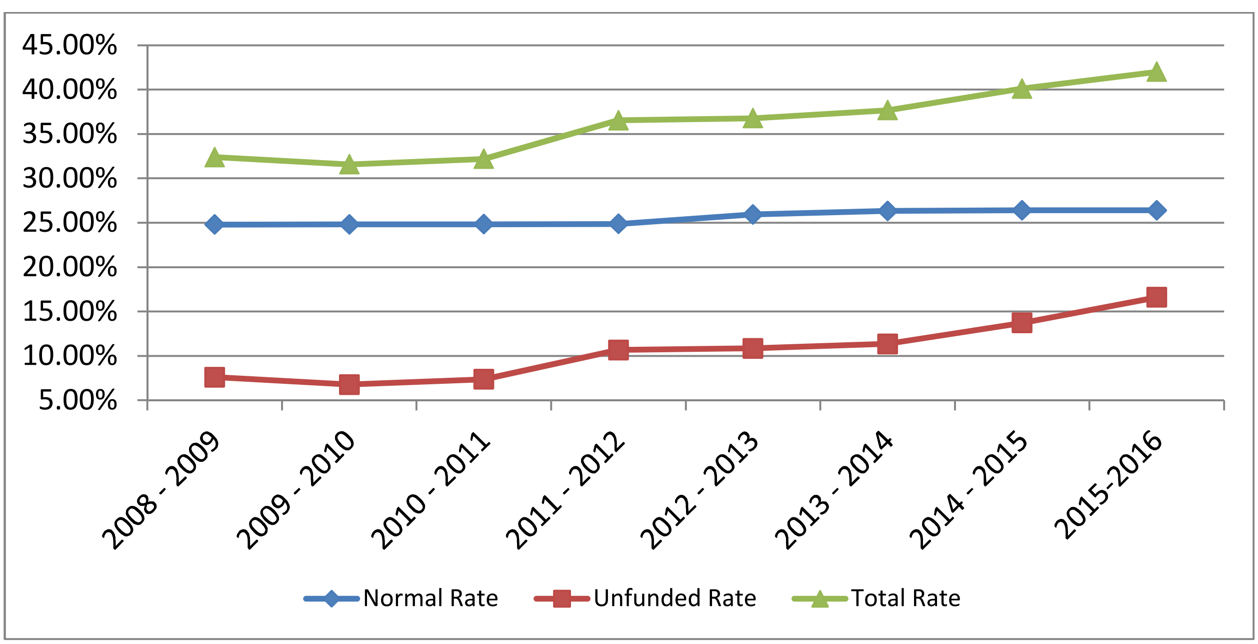
1. In nearly half the years since 2000, investment returns have fallen below assumptions. The result in Fiscal Year2008-2009 was far below assumptions.
2. Retiree benefit levels were enhanced, increasing the liabilities, without an increase in assets or annual contributions.
3. There has been an actuarial recognition that people live longer after retirement, resulting in both an increase in unfunded liability and an increase in normal cost to account for benefits paid over a longer period of time than previously assumed.
4. Both PERS and SCERS had employer contribution "holidays," depriving the funds of assets, a fiscal and policy mistake. The law now requires full payment of normal costs each year.

PERS Rates

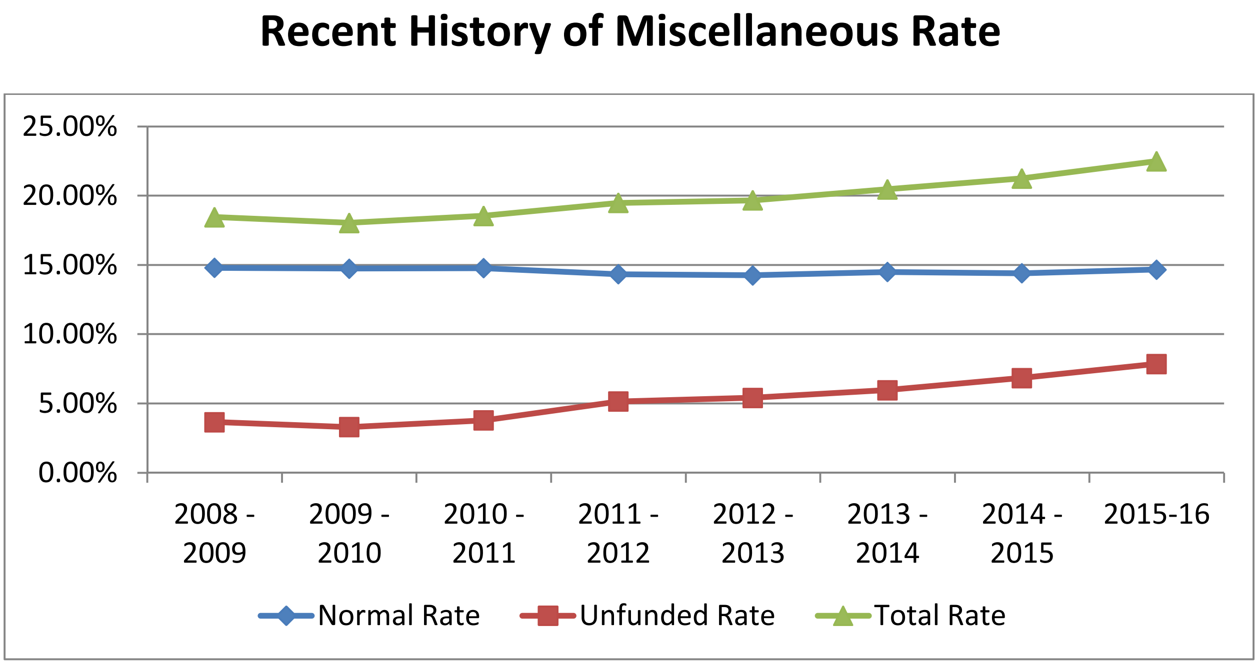
For the coming fiscal year, the pension rate for safety employees will be just over 41% of salary and other applicable compensation and the rate for other employees will be approximately 20.5%. Of the overall rate for both plans, approximately two-thirds of payments are for normal costs and one-third for the accumulated unfunded liabilities.

In recent years, the pension rates have grown with the unfunded liabilities. This trend is shown in the following tables:

Recent History of Safety Rates



The overall safety rate has increased by 10.6 percentage points, from 32.4% to 43% over the eight years since the City began to make budget and staffing reductions in reaction to the severe recession. Most of the increase, over 9 percentage points, has been due to payment toward the growing unfunded liabilities in the safety plan.



The miscellaneous rate has increased by approximately 4 percentage points, from 18.5% to 2

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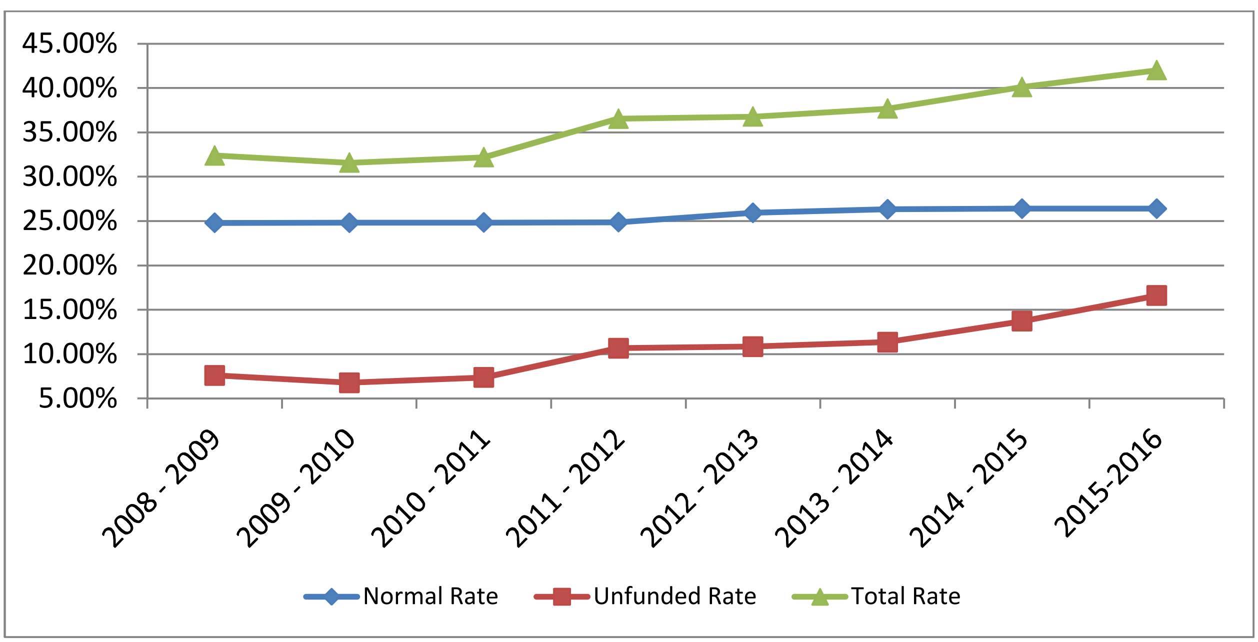

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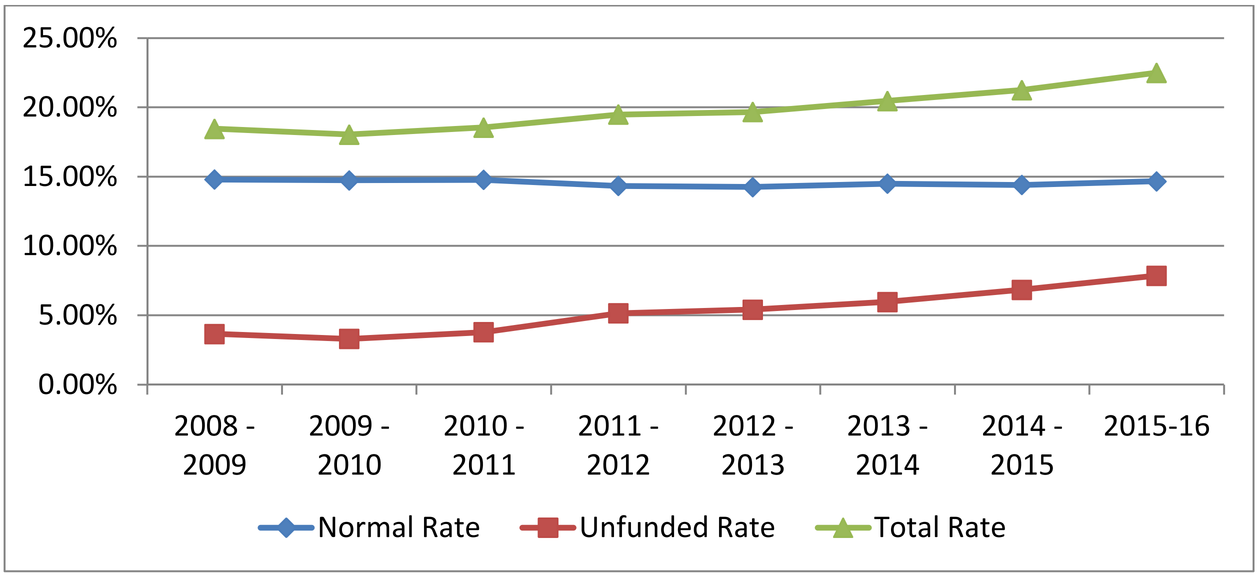
Recent History of Miscellaneous Rate



2.5%, entirely due to the increase in unfunded liabilities. The normal rate has declined slightly.

Future Pension Rates

One of the significant policy and budgetary impacts is the decision by PERS to accelerate payment of the $615 million in the safety and miscellaneous liabilities. After the very large losses in the investment portfolios in 2008, PERS initially chose both the actuarial recognition and the repayment of the new unfunded liability over long periods of time to lessen the financial impact on the State and local governments. PERS now requires paying down the unfunded liabilities over a shorter period of time, resulting in annual rate increases over a five-year period. In addition, new retiree longevity assumptions will increase rates in future years. This information is incorporated into the multi-year budget forecasts.

SCERS

The City also provides a retirement benefit through the SCERS pension plan, which was closed to new members when the City enrolled in PERS in 1978. As of June 30, 2013, there were 35 remaining active employees in the SCERS plan and approximately 1,230 individuals receiving payments from the system.

For the June 30, 2014 valuation, a combination of investment returns above benefit payments and the change in accounting standards has resulted in a significant reduction in the unfunded liability from $90 million to $60 million. The overall funding level for SCERS has increased to 84%.

Retiree Medical Benefit

The City provides medical benefits to retired employees. Retirees have access to the group medical plans. In addition, retirees meeting certain service thresholds are eligible to receive monthly payments. One-half the benefit is earned after 10 years of service, and the full benefit is earned after 20 years of service. The benefit is pro-rated for retirees between 10 and 20 years of service. Recent labor agreements call for the benefit not to be provided to new hires to the workforce for some, but not all, employee unions.

This benefit is paid from the annual budget to retirees; it is not pre-funded. Even though the benefit is funded on this pay-as-you-go basis, financial reporting standards require the City to account for the benefit as if it were actuarially funded. This results in an unfunded liability, currently $452 million.

The following table sets forth how the benefit would be funded actuarially and the changes since the 2007-2008 study:

Retiree Medical Plan Calculated Actuarial Funding			
	FY 2007/2008	FY 2013/2014	Change
Liability	$ 380 m	$ 452 m	$ 72 m
Payments			
Normal	$ 16.4 m	$ 17.0 m	$ 0.6 m
Unfunded	$ 15.1 m	$ 29.5 m	$ 14.4 m
Total	$ 31.5 m	$ 46.5 m	$ 15.0 m

In other words, to pay for this benefit on a sound actuarial basis, total payments into the trust fund in the current year would have to be $46.5 million, with $17 million being the normal cost proactively funding the benefit for the remaining career of active employees and $29.5 million paying down the

$452 million unfunded liability. This payment would be approximately $35 million greater than the current $11 million budget.

In the short run, the current method is less expensive. But under the current method, benefit payments are always made from principal, never with investment income. In the longer run, the actuarial method of funding the benefit is less expensive due to investment income. The practical problem is that it is clearly beyond the budgetary capacity of the City to absorb another $35 million increase to the budget.

The growing unfunded liability for the retiree medical benefit could erode the City's ability to issue debt by lowering the City's credit rating and discouraging prospective investors..

OTHER FUTURE COSTS

There is a series of future costs, classified as long-term liabilities, that are neither debt nor employee benefits. The long-term liabilities in this general category total $115 million. Prominent examples include:

1. Landfill Post-Closure Costs ($1 million). There are long-term costs associated with the City's closed refuse-disposal sites. A long-term liability is recorded while the actual costs are paid year to year.
2. Risk Claims ($73 million). Claims are paid by the City in the future for events that have already happened. Long-term liabilities are estimated and recorded. Reserves have been established to fund future claims payments
3. Development Impact Fee Credits ($41 million). A long-term liability is recorded when the credit is granted.

Funding of these separate liabilities is mixed. Costs associated with the closed landfills are funded from the solid-waste fund, and some reserves have been established. For liability claims, departments are assessed in the budget process, and reserves are established in the City Liability Fund. These reserves appear to be sufficient to meet known and anticipated claims over the next several years

DEBT

The City borrows funds for capital projects and other capital needs such as acquiring land, building and restoring facilities, and acquiring equipment. Debt results in the accumulation of assets: land, basic infrastructure and other facilities. With the exception of some equipment, the life of assets far exceeds the term of debt.

The outstanding principal balance of debt is the long-term liability; future interest payments are not included. The outstanding debt as of June 30, 2014, was $985 million.

The City's debt is in four forms:

1. Bonded debt – A security issued (sold) by the City paying principal and interest at regular intervals over time.
2. Leases – This is a form of short-term borrowing used for equipment. The equipment is leased over a fixed period, usually five years or less, with the City owning the equipment at the end of the lease.
3. Loans – Funds borrowed from other governmental entities or financial institutions. The outstanding loans are with state agencies.
4. Swap – This is associated with the 1997 Kings Loan and associated debt issue. The actual debt issue was variable rate. The swap to a fixed-rate provides the team with interest-rate risk protection. However, over time and at present, the variable rate has been far less than the fixed-rate swap, giving the swap future value. If the loan is prepaid, then the swap providers must be compensated. A rise in short-term interest rates and the passage of time will both reduce the value of the swap. The June 30, 2014 value was $ 8 million.

<u>Debt Levels</u>

The following table compares current and prior levels of outstanding debt:

City Outstanding Debt Principal
(amounts in millions)

Category	June 2013	June 2014	Change
Lease Revenue Bonds	$699	$662	($37)
Utility Revenue Bonds	$246	$246	
Loans	$50	$49	($1)
Equipment Leases	$18	$20	$2
Kings Loan Interest Rate Swap	$10	$8	($2)
Total	$1,023	$985	($38)

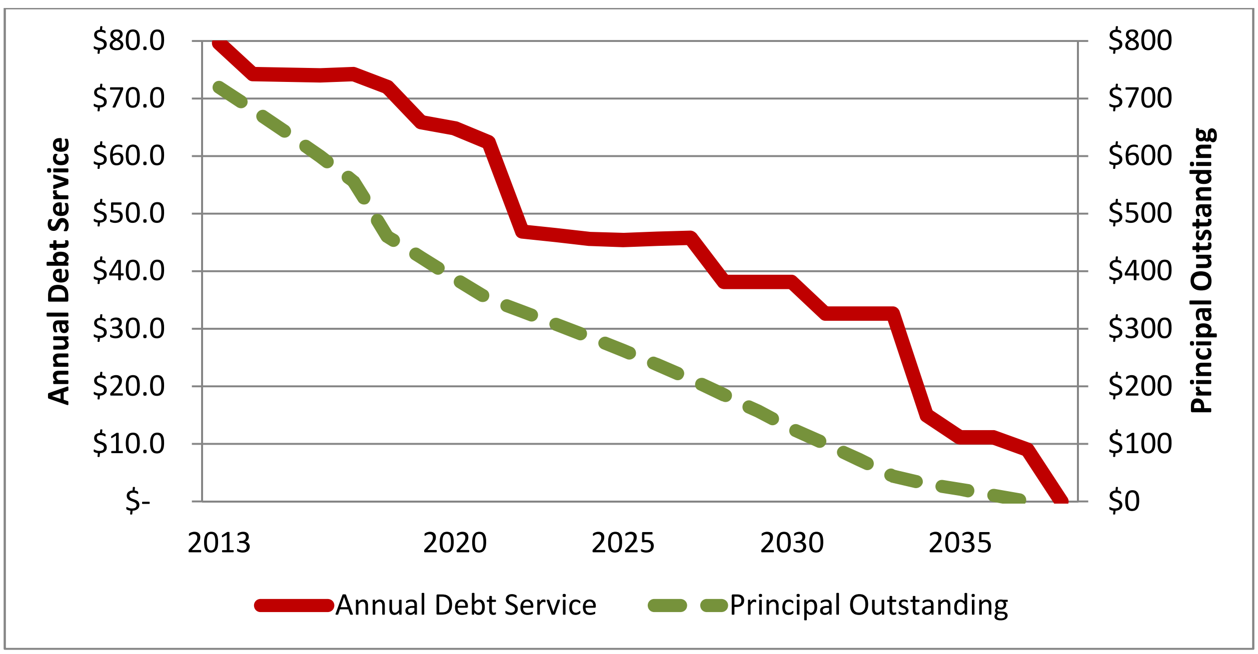
The total City debt not does include the debt of the former redevelopment agencies for which the City elected to become the successor agency. This debt is paid from a dedicated property tax allocation and is not a liability of the City. Nor is Community Facility District (CFD) debt included as a City obligation.

Reduction of Outstanding Debt and Debt Service

The paying down of debt does not directly result in reductions in debt service. Budgetary reduction only comes when debt issues, individual loans, or leases are paid off. The nearly $70 million in lease-revenue principal over the past two years has not resulted in reductions in annual debt-service payments.

It is important to note that debt service will not grow over time unless the City takes on new debt. There is no variable-rate exposure in the debt portfolio that could cause debt service to increase. The future reduction of principal and debt service is illustrated in the following graph. This does not include water-revenue and sewer-revenue bonds issued in 2013, as those obligations are confined to the Water and Wastewater Funds respectively:

Lease Revenue Debt Service and Principal Balances



Roughly one-third of the annual debt service is a net cost of the General Fund paid from discretionary resources, but this varies among the outstanding bond issues. Over the next six fiscal years, through Fiscal Year 2021, approximately $40 million per year in principal will be paid, reducing the long-term liability by the same amount. Yet over that period the only reduction in debt service comes from paying off short-term equipment leases.

In 2021, the final payment on a 1993 debt issue will be made with a debt-service reserve, and annual debt-service payments will be reduced by $15 million per year. Yet much of the benefit will fall outside the General Fund. A reduction of $3 million per year in debt service on parking garages is included in the ESC Finance Plan. An additional $8.2 million in Convention Center debt will be paid off.

Planned and Proposed New Debt

The City did not issue long-term bonded debt from 2006 until 2013, when the water-revenue and sewer-revenue bonds were sold. In avoiding increasing debt payments in the General Fund, the City did not compound the budget problems during the recession. Now there are several proposals, in varying states of specificity, for the use of debt in City and community-project funding. These include:

- Downtown ESC – The core of the City contribution to the project is $212.5 million from a debt issue. Including a reserve, borrowed debt payments during construction, and financing costs, the total bond issue will be in the range of $280 million to $290 million. At an assumed high interest rate, annual debt-service payments will be approximately $22 million, to be funded with project related and parking revenue.
- Downtown Theater / Performing Arts Center – A task force appointed by the Mayor has proposed construction of a new facility in the downtown. Current hotel-tax cash flow and future revenue becoming available with debt redemption might be included in a finance plan.
- Convention Center Expansion – A comprehensive renovation and expansion of the Convention Center could have a total cost of $300 million. Current hotel-tax cash flow and future revenue becoming available with debt redemption might be included in a finance plan, yet this is the same revenue mentioned in association with financing the Performing Arts Center.
- Energy Use Reduction Improvements – Debt would be used to finance facility improvements and equipment acquisition that would result in reduced usage of electricity and natural gas. Utility and other operational savings would provide the capacity to pay debt service, and perhaps additional savings.
- Fire Stations – Fire stations in the built-out urban area need replacement or significant renovation. Growth-related financing tools are not available for the built-out parts of the City.
- Other Amenities – Facilities such as community centers, pools, regional parks, and libraries are not present in some portions of the City. Acquiring or constructing those facilities would require the use of debt.

The needs and desires of the City and the community exceed the City's financing capacity. Priority setting will be a critical part of future debt-use decision making. Although there are no absolute limits on the City's debt and annual debt service, adding more debt after the ESC financing will likely result in lower credit ratings and higher borrowing costs.

COMMENTS

Sound financial management and planning integrates short-term, immediate needs with a long-term perspective. The City Manager has asked that this information be brought forward at the start of the Fiscal Year 2015-2016 budget process.

The real fiscal meaning of increasing long-term liabilities, pension rates, or debt service is that the **payments toward the liabilities are making up an increasing share of the General Fund on an annual basis.** This is a real loss in flexibility and City Council discretion over future spending. Credit-rating agencies cite this budget fact as a significant credit negative for the City.

The payment of long-term liabilities is by definition long-term. Payment of liabilities incurred in the past and the present will be passed to the next generation—to future residents of, and businesses within, the City. This poses the policy issue and concern of inter-generational equity. People pay taxes and fees in return for services and infrastructure. There should be some consideration of time in the determination of benefit. Who pays and when?

The City has issued water-revenue bonds to be repaid over 30 years. A major project is rehabilitation of the Sacramento River Water Treatment Plant. In looking at inter-generational equity, the benefit to future residents of clean, safe water from the Treatment Plant is clear; in 25 years residents will still be paying for the water-plant improvements, but they will still benefit from water treated at the plant.

It is a different matter to propose pushing payment on pension unfunded liabilities decades into the future. The benefit of paying on benefit liabilities in the future, when those liabilities have been incurred now or in the past, is impossible to establish. Yet there is the objective reality of the budget situation. Paying more for liabilities would impact services, staffing levels, and other types of employee compensation. Paying the increasing pension costs during the recession was financed by reductions in staffing levels. But this does not change the fundamental policy issue; there is no coherent policy justification to further defer these costs. Resolving the dilemma will be the central theme of the City budget process.

SUPPLEMENTAL INFORMATION

Detailed information regarding the status of and changes in pension plan liabilities and funding over time follows.

This table presents the level of pension plan unfunded liabilities over the past decade.

PENSION PLAN UNFUNDED LIABILITIES

Valuation Date June 30th	PERS Safety	PERS Misc	SCERS	Total
2005	$ 93 m	$ 71 m	($ 3 m)	$ 161 m
2006	$ 121 m	$ 89 m	$ 30 m	$ 240 m
2007	$ 118 m	$ 92 m	$ 30 m	$ 240 m
2008	$ 140 m	$ 107 m	$ 32 m	$ 279 m
2009	$ 189 m	$ 140 m	$ 84 m	$ 413 m
2010	$ 196 m	$ 144 m	$ 98 m	$ 438 m
2011	$ 214 m	$ 160 m	$ 100 m	$ 474 m
2012	$ 236 m	$ 152 m	$ 95 m	$ 483 m
2013	$379 m	$ 237 m	$ 90 m	$ 706 m
2014			$60 m	$676 m
Dollar Change	$ 286 m	$ 166 m	$63 m	$ 515 m

The overall unfunded liabilities for the three pension plans have increased threefold in the past decade.

This table presents the payroll rates for the PERS safety plan.

PERS SAFETY PLAN RATES

Fiscal Year	Normal Rate	Unfunded Rate	Total Rate
2008 – 2009	24.794 %	7.601 %	32.395 %
2009 – 2010	24.813 %	6.771 %	31.584 %
2010 – 2011	24.829 %	7.358 %	32.187 %
2011 – 2012	24.861 %	10.669 %	36.530 %
2012 – 2013	25.933 %	10.848 %	36.781 %
2013 – 2014	26.324 %	11.351 %	37.675 %
2014 – 2015	26.403 %	13.715 %	40.118 %
2015 --2016	26.397 %	16.608 %	43.005 %
8 Year Rate Change	1.603 %	9.007 %	10.610 %

The rates were stable until the investment losses of the recession began to be recognized in the actuarial calculations. There was an increase of over 3% for Fiscal Year 2011-2012 and continuing rate increases since.

This table presents the rates for the PERS pension plan for miscellaneous, non-safety employees.

Fiscal Year	Normal Rate	Unfunded Rate	Total Rate
2008 - 2009	14.792 %	3.660 %	18.452 %
2009 - 2010	14.740 %	3.302 %	18.042 %
2010 - 2011	14.767 %	3.780 %	18.547 %
2011 - 2012	14.337 %	5.142 %	19.479 %
2012 - 2013	14.253 %	5.411 %	19.664 %
2013 - 2014	14.496 %	5.969 %	20.465 %
2014 - 2015	14.405 %	6.837 %	21.242 %
2015 – 2016	14.663 %	7.859 %	22.492 %
8 Year Rate Change	(0.129%)	4.199 %	4.040 %

The overall increase of 4% is entirely due to payments toward unfunded liabilities. The normal rate has declined slightly.