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City of
SACRAMENTO
Office of the City Treasurer

Background

The Long-Term Financial Liabilities of the City of Sacramento

Russell Fehr
City Treasurer

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Along with the severe short-term fiscal challenges brought on by the deep and prolonged recession, the City also faces known long-term financial pressures. In developing short-term and intermediate budgetary plans it is important also to consider and plan for the long-term financial issues. The Finance Director and City Manager are directing attention to these issues in the budget process, and the issues are alarming.

This report is a presentation and discussion of the current long-term financial liabilities of the City of Sacramento. Specifically, the report and presentation focus on those long-term liabilities which will be paid from future revenues, also referred to as "unfunded liabilities," in that funds are not currently set aside to pay for these liabilities.

These long-term liabilities for which the City has not currently set aside funding total well over $2.1 billion. In the standard summary financial presentations of the Annual Budget and Annual Financial Report (CAFR) the long-term liabilities are not presented together as a unit; they are, rather, found scattered in the presentation. Over a year ago, the City Manager requested the City Treasurer prepare the report and presentation focusing on the long-term liabilities of the City. This is the second 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.

The goals of this report are:

1. Present the different types and values of long-term liabilities together;
2. Identify trends; and
3. Discuss prominent policy issues.

<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. This can take the form of future payments to individuals or organizations, the future provision of services, or future transfer of assets. Examples of City of Sacramento long-term liabilities include outstanding principal balances on City bond issues; future costs of remediation of toxics at City land fill sites, and future pension payments to retirees. A critical point is that though the payments are made for service 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 which will be incurred in the future.

The City of Sacramento has currently unfunded long-term liabilities in excess of $2.1 billion. The major categories of unfunded long-term liabilities include debt, post-retirement benefits, and other future costs. The following table gives the values of the City's unfunded long-term liabilities in comparison to prior year levels:

Summary of Long Term Liabilities

Liability	Prior Value	Current Value	Change
Debt	$823 million	$1,014 million	$191 million
Benefits	$950 million	$ 985 million	$35 million
Other Future Costs	$167 million	$166 million	($1 million)
Total	$1,940 million	$2,165 million	$245 million

The long-term liabilities have grown from year to year by $245 million. The growth in debt was due to the planned issue of water and wastewater bonds; other debt liabilities declined. Growth in benefit unfunded liabilities was confined to the safety retirement and retiree medical plans. The miscellaneous other future costs have remained unchanged.

Funding Long-Term Liabilities

Long-term liabilities, by their very nature, are paid in the future. Depending upon the type of liability and discretionary decisions made by financial entity (the City), long-term liabilities may be funded in different ways. There are two broad categories: (1) payment of the long-term liabilities out of future budgets with future revenues; and (2) setting aside funds at the time the long-term liabilities are being incurred. The first method is typically used to pay debt, and the second is used to fund and pay employee benefits. These two categories, however, are not mutually exclusive.

An example of the future payment category is debt and debt service. A long-term liability is established when bonds are issued and funds are borrowed. The long-term liability is the value of the outstanding principal on the debt. The payments of principal and interest over time are included in annual budgets. The debt service payments are funded with revenues collected in the future. This payment in the future is the plan when the funds are borrowed. The concept underlying this method is that those in the future paying the debt will receive benefit from the facilities constructed or improved with the debt. There is a plan to issue debt for projects and to include the debt service in future budgets. The capacity to pay the debt is assessed before the debt is issued.

An example of setting aside funds while liabilities are being incurred is the actuarial funding of pensions. In theory, an employee and the employer would annually contribute sufficient funds into a pension plan so that those funds plus future investment income on those funds would be sufficient to make pension payments to the employee after retirement. If sufficient funds are not set aside, or if investment income is not sufficient, then supplemental payments must be paid from future budgets. These payments then often extend beyond the careers of the individuals receiving pensions.

However, employee-benefit programs which could be funded on an actuarial set aside basis are not. Payments are being made out of budgets on an annual basis without the benefit of accumulated investment income. In the long term, this practice makes the benefits more costly, but in the short-term this funding method requires setting aside additional funds, putting pressure on stressed budgets.

The City of Sacramento's funding of its long-term liabilities is discussed in detail in this report. The reality is that the City will have to pay down these long-term liabilities, and the timing of paying down pension liabilities is a serious budgetary issue. Continuing to extend payments decades into the future presents serious issues of inter-generational equity: having future taxpayers pay for something from which they receive no benefit. Yet accelerating the paying down of the liabilities, as is being proposed, creates serious budgetary problems. Though the policy issues seem clear, the pragmatic budget problems are extraordinarily difficult.

DEBT

The City borrows funds for capital projects and other capital needs such as acquiring land, building and restoring facilities, and acquiring equipment. The long-term liability for debt is the outstanding principal balance of the debt. Even though interest payments will also be made in the future, the value of those interest payments is not included in the long-term liability.

The City's debt is in three forms:

1. Bonded debt – A security issued (sold) by the City paying principal and interest at regular intervals over time in exchange for up front funding. Bonds are negotiable, being traded on secondary markets.
2. Leases – This is a form of short-term borrowing used for equipment. The equipment is leased over a fixed period with the City typically owning the equipment at the end of the lease. Leases typically have a term of five years or less.
3. Loans – Funds borrowed from other governmental entities or financial institutions. Payment of principal and interest is specified in the terms of the loan. The outstanding loans are with state agencies.
4. Swap – This is associated with the Kings Loan and associated debt issue. The actual debt issue was variable rate. At the insistence of the former team owner, an interest rate swap which artificially fixes the interest rate was put into place. Over time, and at present, the variable rate has been far less than the fixed rate swap, giving the swap value to investors. If the loan

is prepaid, then the investors must be compensated for the future value of the interest rate swap at current interest rates. The June 30, 2012 value was $ 10 million.

The following table compares current debt levels with prior year levels:

City Outstanding Debt Principal
(amounts in millions)

Category	June 2013	June 2014	Change
Lease Revenue Bonds	$733	$699	($34)
Utility Revenue Bonds	$0	$246	$246
Loans	$56	$41	($14)
Equipment Leases	$20	$18	($2)
Kings Loan Interest Rate Swap	$14	$10	($4)
Total	$823	$1,014	$191

The increase in debt is solely attributable to the issue in 2013 of the water and wastewater bonds, and the liability for debt service is confined to the two enterprise funds. The last General Fund backed bond issues date to 2006.

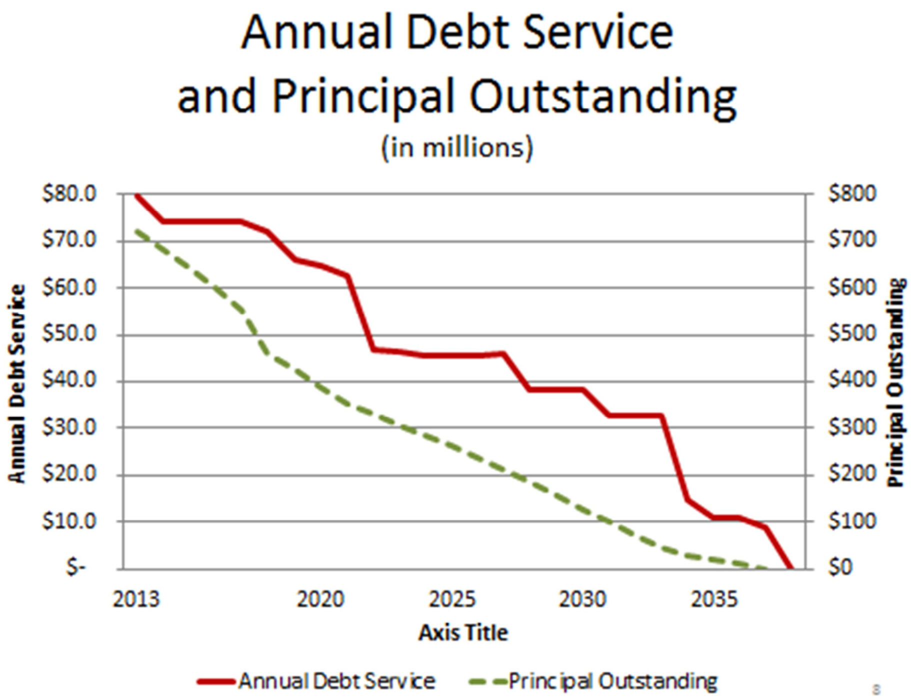
The total City debt not does include the debt of the former redevelopment agencies for which the City elected to become the successor agency. This debt is paid from a dedicated property tax allocation and is not a liability of the City.

Reduction of Outstanding Debt and Debt Service

The annual debt-service payments made on City debt issues, the loans, and the equipment leases include principal and interest components. The long-term liabilities are reduced with the principal payments. But reduction in debt-service payments does not match the reduction in the long-term liabilities. Budgetary reduction comes when debt issues and individual loans or leases are paid off. The over $50 million in long-term liabilities outside the new revenue bond issues 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. The debt portfolio contains no variable-rate exposure or derivative products that could cause debt service to increase.

The reduction of principal and debt service is illustrated in the following graph. This does not include utility revenue bonds issued in 2013, as that obligation is confined to the Water and Wastewater Funds:



Roughly one-third of the annual debt service is a net cost of the General Fund paid from discretionary resources. Over the next eight fiscal years, through Fiscal Year 2020-2021, approximately $40 million per year in principal is being paid with the long-term liability being reduced by a like 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.

The City did not issue long-term bonded debt between 2006 and 2013, and has not issued General Fund backed debt since 2006. After having issued the water and wastewater revenue bonds in 2013, current plans are to issue debt for the Downtown ESC in 2013, for the Community Center Theater in 2014 or 2015, and for additional water and wastewater projects in 2016.

OTHER FUTURE COSTS

There is a series of future costs classified as long-term liabilities which are neither debt nor employee benefits. The long-term liabilities in this general category total $166 million. Prominent examples include:

1. Landfill Post-Closure Costs ($20 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 ($63 million) – Claims are paid by the City in the future for events which have already happened. Long-term liabilities are estimated and recorded. Reserves have been established to fund future claims payments
3. Development Impact Fee Credits ($43 million) – A long-term liability is recorded with the credit is granted.

Funding of these separate liabilities is mixed. Costs associated with the closed landfill sites 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.

POST EMPLOYMENT BENEFITS

The City has $985 million in unfunded long-term liabilities for post-employment benefits to be paid to those who worked for the City and 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. In actuarial terms the retiree medical benefit is unfunded. The following table summarizes the funding status of the long-term benefit liabilities:

Actuarial Liabilities and Assets
For Pensions and Retiree Medical Plans

Plan	Actuarial Liabilities	Actuarial Assets	Unfunded Liability	Funding Ratio
PERS Safety	$1,313 m	$1,077 m	$237 m	82 %
PERS Misc.	$861 m	$709 m	$152 m	82 %
SCERS	$382 m	$292 m	$90 m	76 %
Retiree Medical	$473 m	$0 m	$473 m	0 %
Comp Absences	$34 m	$0 m	$34 m	0 %
Total	$3,063 m	$2,078 m	$985 m	67%

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 compensated absences are recorded as liabilities yet 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 1978 when the City entered CalPERS. All employees hired after this date became members on 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. Payments according to the actuarial assumptions are normal costs. These, in effect, keep the pension plans current. The normal costs are shared by the City and most employees. An employee share is calculated. Payments against any unfunded liabilities are made by the City only.

Unfunded Liabilities

The pension plans have a collective unfunded long-term liability of $479 million, and the unfunded long-term liabilities have grown significantly in recent years:

Pension Fund 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			$ 90 m	$ 479 m
Dollar Change	$ 143 m	$ 81 m	$93 m	$ 318 m

Since the conclusion of the Fiscal Year 2004-05, the unfunded long-term liabilities in the pension plans have grown by $318 million, from $161 million to $479 million. In the recent year, the overall increase is attributable to the safety plan, where the unfunded liability grew by $22 million. The unfunded liabilities in the PERS Miscellaneous Plan and the SCERS Plan both dropped.

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 rate, currently 7.5%.

The current discussion at CalPERS, which has significant policy and budgetary impacts, is how the $389 million in the safety and miscellaneous plans will be paid down. 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 is now proposing paying down the unfunded liabilities over a shorter period of time. This is a very significant multi-year budget issue.

Why There Are Unfunded Liabilities

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

1. In half the years since 2000, investment returns have fallen below assumptions. The aggregate return in the period is below the assumption. The result in Fiscal Year 2008-09 was far below assumptions. Financial markets have been volatile in the past decade and a half, after a decade of steady growth. The PERS pension plan investment income has failed to meet the target level in 6 of the past 13 years due to these market conditions.
2. There has been a recognition that people live longer after retirement. This increases the assumptions of how long retirement benefits will be paid and how much will be paid over time. This results in both an increase in unfunded liability and an increase in normal cost.
3. Both PERS and SCERS had employer contribution "holidays," depriving the funds of assets. That was a mistake. The normal cost should have been paid into the plans every year. The fact that bad market years are certain was ignored.
4. Retiree benefit levels were enhanced, increasing the liabilities, without an increase in assets or contributions. The argument was put forward that benefits could be increased with no cost. Again the certainty that bad market years were in the future was ignored. Plan trustees and custodians lost their way.

PERS Rates

Payments to the two active PERS pension plans are determined by applying rates to salary. The Fiscal Year 2014-15 rates are broken into components and are shown in the following table:

Components of PERS Rates FY 2014-15		
Rate Component	Safety Plan	Miscellaneous Plan
Employer Normal Cost	17.403 %	7.582 %
Employee Normal Cost	9.000 %	**6.820 %
Total Normal Cost	26.403 %	14.405 %
Unfunded Liability Cost	13.715 %	6.837 %
Total Rate	40.118 %	20.419 %
Share of Rate to Unfunded	34 %	33 %
Employee Share	9.000 %	6.820 %
Employer Share	31.118 %	14.419 %

**Employee share payment to PERS is 7%. This rate is an actuarial calculation

For the coming fiscal year, the pension rate for safety employees will be just over 40 percent of salary and other applicable compension, and the rate for other employees will be approximately 20.5 percent. 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 Rate

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 %
7 Year Rate Change	1.609 %	6.114 %	7.723 %

The overall safety rate has increased by 7.7 percentage points, or 23.8% over the seven years since the City began to make budget and staffing reductions in reaction to the severe recession. Most of the increase, over 6 percentage points, has been due to payment toward the growing unfunded liabilities in the safety plan.

Recent History of Miscellaneous Rate

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 %
7 Year Rate Change	(0.296%)	3.177 %	2.790 %

The miscellaneous rate has increased by approximately 2.8 percentage points, or 15.1%, over seven fiscal years. The normal rate has declined slightly while the rate for unfunded liabilities has increased.

Fiscal Year 2008-09 was when the City began making budget and staffing reductions in the General Fund. There also has been a significant overall decline in tax revenue in the period represented in the tables. In the General Fund the increase in pension costs due to the increasing rates has been financed by the reduction in positions.

Future Pension Rates

Future increases to PERS pension rates are certain. The Finance Director is very well aware of the economic trends and PERS's proposed actions. Information on a forward-looking basis is incorporated in the budget information being brought to the City Council.

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 annuitants. There was a significant increase in the SCERS unfunded liabilities in 2006 in recognition of the 14 years that the City made no contributions to SCERS. The increases in 2008 and 2009 were due to the losses in investment portfolios in the recession. The SCERS investment and fiscal management board, AIFM, chose to recognize the losses over a three-year period, unlike PERS. The unfunded liability and City contribution have now both declined for two years.

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 to offset medical insurance costs. 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.

This benefit is paid from the annual budget to retirees; it is not actuarially funded. Even though the benefit is funded on this pay-as-you-go basis, financial standards require the City to account for the benefit as if it were actuarially funded. This results in an unfunded liability currently of $472 million which has grown by $92 million since Fiscal Year 2007-08. A portion of this liability is on the balance sheet; the remainder is a note.

The City does an actuarial study of the retiree medical benefit on a regular basis. The last was completed during the current fiscal year. The following table sets forth how the benefit would be funded actuarially and changes since the study for Fiscal Year 2007-08:

Retiree Medical Plan
Calculated Actuarial Funding

	FY 2007-08	FY 2013-14	Change
Liability	$ 380 m	$ 472 m	$ 92 m
Payments			
Normal	$ 16.4 m	$ 18.3 m	$ 1.9 m
Unfunded	$ 15.1 m	$ 25.7 m	$ 10.6 m
Total	$ 31.5 m	$ 44.0 m	$ 11.5 m
Rates			
Normal	6.1 %	6.8 %	0.9 %
Unfunded	5.7 %	9.5 %	3.6 %
Total	11.8 %	16.3 %	4.5 %

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 $44 million with $18 million being the normal cost proactively funding the benefit for the remaining career of active employees and $26 million paying down the

$472 million unfunded liability. Most of this $44 million would come from the General Fund. Benefit payments would be made from the trust fund. In time, as the balance in the trust and investment income accumulated, contributions would drop significantly. This, however, would take decades.

This payment is far greater than the current $11 million under the pay-as-you-go method. 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 an increase to the budget of over $30 million, the difference from the current payment level to full actuarial funding.

The growing unfunded liability for the retiree medical benefit is an immediate problem for the City for debt issuance, credit rating, and investor evaluation. The credit-rating agencies are taking note of the growing unfunded liability, but this has not yet caused a rating downgrade. The institutional investors who hold City bonds and are the potential purchasers of future City debt issues are also interested in the funding status of this benefit.

From a long-term fiscal perspective, the status quo for the retiree medical benefit is not sustainable. The City has established a retiree medical trust fund with PERS and has seeded that trust fund with an initial deposit of $2 million. Additional funds need to be deposited in the trust fund every year.

COMMENTS

Sound financial management and planning integrates the 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 2014-15 budget process. This is an example of the sound fiscal management of the City. The short-term budget financial planning will consider that the General Fund has very little or no debt capacity, that financial markets are changing, that pension rates continue to rise, and that the retiree medical benefit presents a financial challenge. Difficult issues will be addressed rather than deferred or ignored.

In the short-term, the debt-service burden on the General Fund will remain more or less unchanged until debt issues are paid off in the decade of the 2020s. Yet debt service will not increase over time unless new debt is issued. The level of debt and debt service is controlled by the City.

The costs of employee benefits are different and will continue to increase with no change in the workforce and in compensation to which pensions apply. As PERS shortens the period for the payment of unfunded liabilities and the City continues with the current funding of the retiree medical benefit, the costs of employee benefits will increase. PERS has modeled the rate increase over the next six fiscal years for accelerating the payment of unfunded liabilities and has given estimates of the additional rate increases due to changes in longevity assumptions.

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 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 temporal consideration in the determination of benefit.

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.

Standards have been established matching debt term and infrastructure types proposed for financing. The policy issue is more the level of debt taken on and the amount of debt service being incurred. In the ideal situation, as is usually modeled when debt is issued, level debt service becomes a lessening burden over time as the community and revenue grow. As the recent recession has shown, this is not always the case. Level debt service in the General Fund became a larger share of the budget as revenues fell.

It is a different matter to propose pushing payment on unfunded pension 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. Payments on some liabilities have been purposely pushed into the future to avoid the impact of paying in the present, putting the responsibility for difficult decisions on others.

Yet there is the objective reality that paying more for liabilities now will have devastating impacts on services, staffing levels, and perhaps other types of employee compensation. Paying the increasing pension costs in recent years has been 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. Indeed, arguments of fairness and equity have been distorted to the point that not paying toward liabilities or continuing to push payments off into the future is presented as the right thing to do in order to preserve a status quo ante. Resolving the dilemma will be the central theme of the City's budget process.