Study Session

Fullerton City Council

DATE: **SEPTEMBER 15, 2020**

SUBJECT: **STUDY SESSION FOR CITY FINANCIAL UPDATE**

SUMMARY

At the August 18, 2020 City Council meeting it was requested by Councilman Zahra, and seconded by Mayor Fitzgerald, to have an update on the City's finances at the September 15, 2020 City Council meeting. The update includes the current fiscal condition of the City with an emphasis on assessing the City's long-term financial sustainability based on current revenue and expenditure projections with and without a new, substantial revenue source.

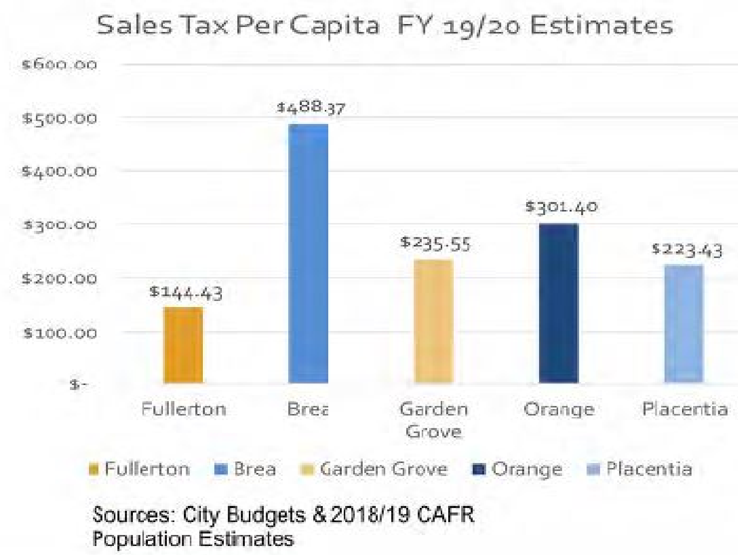
DISCUSSION

The City has identified that its ability to continue to provide an expected level of public services and improve critical infrastructure such as our streets is severely challenged by a long-standing financial imbalance in revenues and expenditures. The recent financial impact of the COVID-19 pandemic underscores the City's unsustainable fiscal condition. The City has been forced to resort to holding numerous positions vacant, institute pay cuts, separate non-regular (part-time) positions, issue notices of layoffs to seven full-time employees, reduce service levels across all departments, and identify use of limited contingency reserves to deal with the health crisis' fiscal impact.

<u>Historical Review</u>

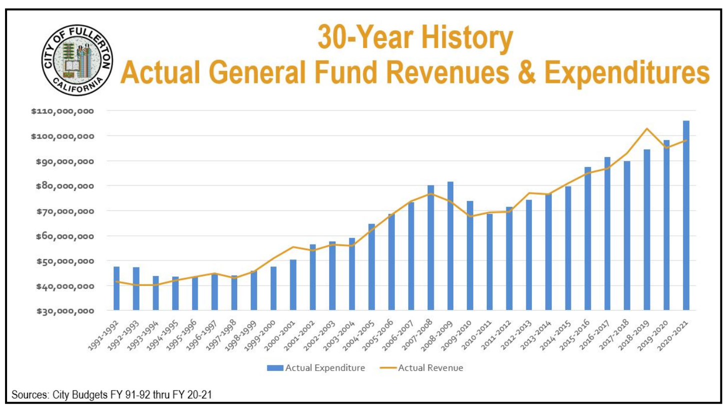
Long-term fiscal issues have been present in every decade since the 1980's and can best be described a roller-coaster approach to budgeting for services and personnel costs. From a review of historical budgets going back to 1978, and specifically the last 30 years to 1991, the City has seen cycles of surpluses and deficits in its General Fund. From a review of prior infrastructure reports and City Council meeting minutes, the City has utilized various budget balancing actions since the realignment of property taxes enacted by Proposition 13, approved by voters in 1978. Prior to Proposition 13, local governments and special districts (schools, community colleges, library districts, etc.) were able to set their expenditure budgets and then set a local property tax (millage rate) to obtain the revenues to fund the expenditures. School districts relied almost entirely upon the millage while cities set the millage rate in conjunction with revenue sources such as sales tax, grants, transient occupancy tax (TOT) or hotel taxes, and various assessment district opportunities.

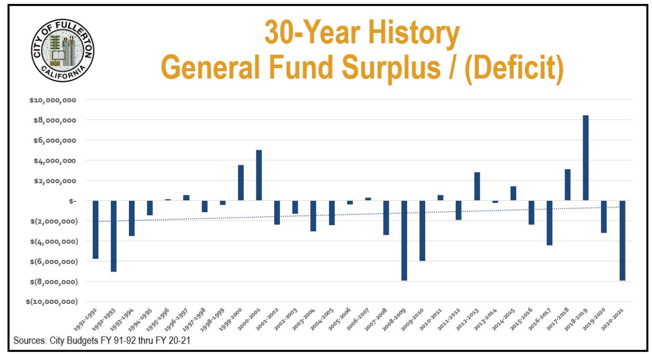
The City's structural budget issue has its origins decades ago in the City developing primarily as a residential community serving established aerospace and manufacturing firms as well as hosting institutes of higher education. After the property tax reform of the late 1970's, the City was limited in its ability to generate revenue due to our smaller percentage of commercial land use and retail opportunities. Sales tax in the late 1970's exceeded the collection of property tax for the General Fund (the Library Fund and Park Fund had their own property tax proceeds); however, collectively property tax collection exceeded sales tax collection by over 20%. Even though Fullerton had a well-defined downtown and commercial center area at Orangethorpe and Harbor, along with other nodes of commercial centers at major intersections and adjacent to Cal State Fullerton, sales tax generation was not sufficient for growth.



Currently, Fullerton has a lesser sales tax generating capacity than neighboring cities. Currently, Fullerton's sales tax at approximately $144 per capita, significantly lags behind others in the County. The City of Brea has a per capita amount of $488; Garden Grove - $235; Orange - $301, and Placentia at $223. The City's per capita for property tax revenue is about 21st out of the 34 cities. (data from www.californiacityfinance.com)

From a review of prior infrastructure reports and City Council meeting minutes, the City exhibited budget balancing issues since the early 1980's, with Councils deciding spending through "expenditure decision packages" presented by each Department. These expenditure decision packages were requests for additional funding or reduction in services and the minutes of budget discussions during the 1980's show a continuous theme of a struggle to deliver services within budgetary constraints. In 1993, prompted largely by State diversions of local property tax funds, the City Council at the time approved a utility user tax of 3% to generate about $2.6 million annually. That enactment was ultimately repealed by referendum. In 2001, an Infrastructure Report was presented to Council which detailed deferred maintenance and inability to adequately fund much needed infrastructure, including streets. Various recommendations were made and the final recommendation was that a new source of revenue be found. Yet despite this recommendation, no new source was put in place and eventually one of the preexisting significant sources that allowed the City to spend more per year than we do now, redevelopment tax increment, was eliminated by the State in 2012.





Sources: City Budgets FY 91-92 thru FY 20-21

The most recent infrastructure review, by the Infrastructure and Natural Resources Advisory Committee (INRAC) also recommended a new revenue source, a special sales tax, just for infrastructure. A special tax requires 2/3rds voter support. Based on polling conducted in November 2019, this special tax would not garner enough support from the voters to pass. Thus, on July 7, 2020, the City Council on a 4-1 vote approved the placement of a general sales tax of 1.25% for the November ballot.

Since that time, questions have arose from City Council and the public regarding the City's proposed budget plans for Fiscal Year 2021-22 and projections beyond. Based on the outcome of the sales tax measure on the November ballot, there are two paths that the City can travel, both with a shared beginning of setting future priorities through a strategic planning process which involves community participation.

<u>Strategic Planning Process</u>

Regardless of the November ballot measure outcome, the City needs to be able to set service level and expenditure priorities going forward. City Staff are currently drafting a Request for Qualifications/Proposal for Strategic Planning purposes with the intent to release the RFQ/P in October. The City of Fullerton has not gone through a full strategic planning process and so this will enable the City Council to have a fresh start in terms of setting priorities. Historically, on November 28, 2017 a City Council meeting was held to begin a strategic planning effort which was facilitated by former interim City Manager, Allan Roeder. The goal of that meeting was to provide an overview of the City's current and future fiscal year budget and agree on priority policy statements. The meeting was proposed as a first step to gradually build in a process of strategic planning, with an emphasis on reviewing 5 and 20 year financial forecasts, in order to implement a more sustainable budgeting process. The strategic planning process, therefore, was to take place in the first quarter of the calendar year, after the release of the audited Comprehensive Annual Financial Report (CAFR) and as Staff was building the next year fiscal year budget. On April 2, 2019, a recap of the prior year strategic planning session was held as a means to highlight the beginning of a two week, online community input survey in preparation for an April 23, 2019 special strategic planning session that was once again facilitated by Allan Roeder. In the fall of 2019, City Staff began to plan for a 2020 strategic planning session to be held in the April time frame, unfortunately, the COVID-19 pandemic caused these efforts to be tabled.

A strategic planning process beginning in February, 2021 will start with a community survey process to solicit initial feedback from the community on overall priorities. As the City budget process progresses, these two efforts will be combined around April in a

Study Session in which to have the City Council set priorities for the resources available and to review an updated 5, 10, and 20 year financial forecast.

While a strategic planning process will need to occur regardless of the outcome of the sales tax measure, the resulting availability of future resources will most certainly be the difference in the approach of the two resulting processes. Two other items which will require attention are the ending of employee labor agreements as of June 30, 2021, requiring the start of negotiations around February, 2021 and the creation of the new Infrastructure Fund per Ordinance 3284 as adopted on July 21, 2020. The new Infrastructure Fund, regardless of whether the measure passes, will require the transfer of a sales tax revenue and secured property taxes above a designated baseline into a restricted Infrastructure Fund for infrastructure related improvements. With a new revenue source, such as a the proposed sales tax, there will be more funds transferred on an annual basis, projected to be at least a minimum of $12 million once sales tax revenues are normalized. The transfer mechanism will trigger in most years to a limited degree without a new revenue source, mostly from property tax increases.

Plan of action if sales tax measure approved

With a successful sales tax measure in November, the City will go forward with the strategic planning process for the first quarter of 2021. Additionally, while the Public Works Department is already identifying and readying street and infrastructure projects, the City would be able to begin soliciting consultant services for developing plans and specifications for specific projects and to take the information in the most recent Pavement Management Plan in order to determine those street projects to undertake the first three years. Additional information gathering efforts will include actuarial reviews of the City's pension obligations, our liability funds (such as workers compensation, legal liability fund, etc), and a compensation and classification study of the City's employee classifications to both update various classification descriptions as well as provide information to the Council as to where we are in the market. Additionally, it will be recommended, for consideration during the budget process, to chart a path to increase the City's contingency reserve up to the 17% level.

As required by Ordinance 3284, which created the Infrastructure Fund, 50% of sales and secured property tax above the defined baseline will be transferred to the Infrastructure Fund to be used for infrastructure (residential and arterial streets, sidewalks, etc.). Additional funds can be transferred into the Infrastructure Fund to improve more streets at City Council direction. Remaining funds, based on prioritization, can be used for general purposes to include homeless services, community services, public safety, employee retention/recruitment, pension and liability pay down, building up contingency and other reserve funds, etc. This will occur starting in the February timeframe in order to be included in the May study sessions for the FY 21-22 budget. Using the long-range financial planning tool will help with the decision making as budgetary options can be reviewed for how each option impacts future sustainability of the City.

Plan of action if measure not approved

There have also been many questions, and concerns, about if the sales tax measure is not approved by the voters in November. Given the City's bleak financial picture, what are the options in order to continue to provide services?

If the measure is not approved, a strategic planning session will still be held to identify and prioritize City services and programs to be retained, reduced or eliminated and to discuss alternative revenue methods to improve infrastructure and to evaluate options to increase contingency reserves up to the 17% target. Given the importance of making infrastructure improvements, alternative methods will still be explored and pursued because the option of not investing more into our streets is not acceptable. Alternative methods include, but are not limited to:

- Re-prioritizing funding from current services/programs/personnel in order to re-allocate funding to infrastructure
- Individual assessment districts for street/alley improvements
- Landscape maintenance districts for specified area landscaped medians/parkways and parks
- Lighting assessment districts for street light improvements (high series circuits) and operations
- Potential community services or community facilities district elections to support services for current or future residential development.
- The creation of Development Impact Fees related to libraries, fire and police services and review of current Impact Fees for parks (Park Dwelling Fund).

All assessment districts are property-based, therefore the burden is shifted solely to property owners unlike the proposed sales tax which is spread across residents, visitors, businesses, and out-of-town shoppers. Development Impact Fees are tied to new residential and commercial development and therefore increase the cost of such developments. In order to set up various assessment districts, the City would need to work with third party firms to define the benefit district and to determine the costs required for each assessment. Because of a lack of economies of scale, conducting street improvements in this approach would be a more expansive approach to infrastructure improvements and would likely disparately benefit the district able and willing to incur the assessment.

The strategic planning process will more than likely include the need to hire an external consultant to conduct a fiscal sustainability review. A sustainability review is a third party assessment of budgeting practices, service requirements, and overview of best practices that could help the City identify and prioritize expenditure reductions in order to continue operations, however, with the understanding that service levels and programs will be drastically reduced without any future revenue enhancement.

Additionally, as it has been discussed at prior financial updates to the City Council, it must be recognized that the continued budget reduction measures required are only to be "balanced" with projected revenues. As such, there will be no enhancement to services and, more than likely, there will continue to be a degradation of services to the public. More importantly, this continuation of cutting as a means to balance does not include additional funding to the roads to actually improve them or stop them from deteriorating further. The City will need to identify an addition $6 million (minimum) from our current budget to re-allocate for infrastructure (streets) improvements. So under the scenario if the sales tax measure does not pass, the City would need to cut both labor (or to hold vacant) and operating costs at a minimum of $5 million a year, and then further re-allocate through program reductions and personnel reductions, funding to invest in our roads.

With the scenario that we are still able to have sustained budget reduction efforts of $5,000,000 a year, the City will use the last of its reserves in Fiscal Year 24-25 and still end the year with a negative fund balance of over $2,650,000, increasing annually thereafter. These estimates are based on projections at this time and recognize that many factors will dictate actual revenue/expenditure levels going forward. Once the City has utilized all of its contingency reserves, it would be necessary to match all expenditures thereafter with the available revenue sources so that the City has a zero fund balance at the end of the Fiscal Year.

Under a scenario of no new revenue, negotiations with employee labor groups will be concessionary in nature. Under California law (the “California Rule”) a city cannot unilaterally change a retirement benefit of an employee without replacing with similar benefits. Hence, if the City were to propose that employees pick up more of the City’s future retirement costs the City would have to provide an offsetting benefit. However, through negotiations, a labor group could agree to reduced benefits. Given the City’s compensation level with other cities, it is unlikely that reductions in overall compensation, including pensions, will be accepted. As the City has recruitment and retention issues with staffing at this time – both public safety and miscellaneous positions – the City will face more rapid turnover in positions in the future.

The bottom line for the future of the City if no sales tax is approved by the voters is that the City will need to review other revenue sources such as assessment districts and/or re-prioritize millions from current programs/services in order to make improvements to our infrastructure/streets. By Fiscal Year 2024-25 the City will exhaust its contingency reserves and at that time will have to make expenditure cuts commensurate with available on-going revenue in order to avoid annual, on-going deficits.

<u>Pension Related Debt</u>

The City contracted with CalPERS in 1946 to provide a pension plan for its employees. Some frequently asked questions related to the City’s contract with CalPERS:

Q. Can the City offer a 401(k) style of pension to its employees?

A. While the City can terminate its contract with CalPERS, it is financially infeasible to do so due to the “Hypothetical Termination Liability.” The hypothetical termination liability is an estimate of the financial position of the plan as if the contract is terminated as of June 30th and the assets are transferred to a risk free US Treasury account with a very low discount rate. That action greatly increases the unfunded liability, thereby making withdrawal from CalPERS financially impossible. Based on its contract with CalPERS the City cannot not offer a new employee a non-CalPERS pension.

Q. Is the amount the City pays for pension the reason we cannot fix our streets?
A. No, as demonstrated, the City's inability to fix its streets pre-exists the increased pension payments. But the City's increasing pension obligations, which will peak in about 13-15 years before reducing over the next decade, do greatly constrain operations. The Public Employee Pension Reform Act (PEPRA) of 2012 does help with future liabilities and obligations, but the City's implementation of the 3@50 benefit formula that included retroactivity for service in 2002 set the stage for our pension liabilities. At the time of the decision, the understanding was that the cost of implementing the increase would not cost the City in the immediate years; however, due to stock market hits to the CalPERS portfolio, the unfunded liability increased quickly.

Q. With interest rates very low, should the City issue a Pension Obligation Bond?
A. It is not recommended. Pension Obligation Bonds (POB) are normally designed to finance a city's Unfunded Actuarial Liability (UAL) with the hope that by pre-paying a sizable amount of its long-term pension liability in a lump sum, CalPERS will be in position to invest the bond proceeds at rates substantially higher than the City's cost of borrowing. The City, on the other hand, will have a flat payment schedule for its bond payments. However, issuing a POB does not stop CalPERS from creating more unfunded liabilities due to poor annual performance or changes to its actuarial assumptions such as lowering of the discount rate.

The Government Finance Officers Association (GFOA) recommends state and local governments use caution when issuing POBs and outlines their potential risks:

- POBs are complex instruments that carry considerable risk.
- Invested POB proceeds may fail to earn more than the interest rate owed over the term of the bonds, which could lead to an increase in pension liabilities.
- Issuing POBs increases debt burden / reduces debt capacity that could be used for other purposes.
- POBs have "make whole calls", which do not provide opportunity to refund bonds in the future.
- POBs should <u>not</u> be structured in a manner that defers the principal payments or extends repayment over a longer period.
- Rating agencies do not view POBs as a rating positive, particularly, if not part of a comprehensive plan to address pension shortfalls.