May 29, 2013

City Council of Piedmont, California
Mayor John Chiang, Vice Mayor Margaret Fujioka, Council Member Garrett Keating, Council Member Robert McBain, Council Member Jeff Wieler

RE: 2013 Report of the Piedmont Budget Advisory and Financial Planning Committee

Dear Mayor Chiang and Honorable City Council:

We are pleased to present our annual review of the 5 year projections in the draft 2013-2014 Budget presented to City Council on May 6, 2013, thoughts on risks to these projections and the financial health of the City, as well as some specific suggestions to help address those risks. Specifically, our objectives are to (1) understand and provide comment to the process of preparing the projections, (2) evaluate the reasonableness of assumptions, and (3) provide more discussion for those areas that present more risk to the long term financial health of the City (in the opinion of the Committee).

In an effort to improve the readability, this year we have prepared four short pieces covering different topics:

1. Overall review of 5 year projections for reasonableness and risks,
2. Discussion on retiree healthcare costs and risks,
3. Review of the Sewer Fund, and
4. Study of a potential refinance of the CalPERS Side Fund

In summary, the four pieces provide the following conclusions/recommendations:

- The five year projections are reasonable based on the information we reviewed. Overall, the City looks to be in improving financial shape, recovering as expected from the recent recession, and appears able financially to continue to provide exceptional basic public services. However there are still risks facing the City in retirement costs as well as sewer replacement and operating costs that need to be addressed.
- The Committee recommends the City continue with phased sewer replacement in order to save substantial costs over the currently planned small scale emergency repair/replacement strategy. The financial issues are temporary in nature as the sewer fund does not appear to need permanent additional funds, but short term financing either from the general fund and/or another shorter term financing mechanism.
- Retirement costs present a continued risk despite the recent efforts by the City and more steps should be taken to further reduce the amount and improve the controllability of these costs.

The Committee is not privy to negotiations with employees, but we suggest exploring ways to further reduce uncontrollable retirement benefit costs such as:

- o Taking advantage of current low rates by refinancing the CalPERS pension side fund and negotiating a lower corresponding cap from Safety and Miscellaneous employees,
- o Compensating employees with non-PERSable methods that can appropriately pay City employees but not to exacerbate the already uncontrollable retirement costs (such as using bonuses instead of salary increases),
- o Continuing to bargain for caps/sharing on pension retirement costs and begin negotiating in caps for Tier II/III (even if they are slightly above where payments are required today). It is essential to control these costs long term as they are not today, and
- o In retiree healthcare, reducing current and retiree healthcare benefit cost coverage to 75% of costs or lower from 100%, extend retiree healthcare benefit vesting to 20 years, and investigate putting more burden on Tier I retirement employees if possible.

- The City negotiates with employees every few years and, given the recent focus on retirement and other costs, is working to reduce and control these costs, which the Committee supports. However, the Committee does not believe the City has enough financial advice to fully understand the costs and ramifications of employee negotiations over the long term – especially with regard to new plans that affect future costs. The City should seek to involve the BAC in helping to understand and project these costs before proposing or agreeing to certain changes. It is not the Committee's place to "negotiate" with employees, but to help the Council understand the future cost impacts of those negotiations.
- The City needs to continue to explore ways over the long term to convert future employees to a defined contribution from a defined benefit retirement. It is not just a matter of lower cost, but a matter of controllable costs. The City can never be truly secure in its financial future with the uncontrollable nature of these costs.
- As stated last year, we recommend "saving" any Property Transfer Tax in excess of $2.5 million by specific allocation into the equipment replacement, facilities replacement, sewer, Other Post-Employment Benefits (OPEB), or other "future cost" funds over and above the contributions already planned for in the 5 year projections - and specifically not assuming these excess funds can be spent on new programs or projects until we have seen several years of surplus and the capital funds are fully funded.
- With regard to capital and facilities replacement, the City needs to verify that $400k annually is enough for facilities replacement over the long term once the currently underway study in complete.
- With regard to the pool and other City facility usage, the City should attempt to not only understand and document the subsidies provided by the General Fund overall, but specify which groups are receiving such subsidies. The pool subsidy to the School District was one such example that should be calculated and noted in the annual budget. The Committee was not questioning whether the subsidy should be provided, only that the cost should be determined and noted for Council and public information.

In preparing this memorandum, the Committee met several hours each week with Mayor Chiang, Councilmember Wieler, Finance Director Erick Cheung, and other City staff. We received presentations about various budget line items and their history, and we asked for additional information about certain budget categories, bringing in third party experts as needed. We would like to thank Finance Director Cheung who has just recently joined Piedmont and by all accounts, it appears Piedmont is lucky to have him. We also want to thank Director of Public Works Chester Nakahara, who has helped us navigate the complex sewer system in Piedmont. Lastly we want to thank Bartel Associates for their help in untangling the complicated world of post-retirement benefits.

As always, we stand ready to help the City Council in any financial matters.

Respectfully submitted,

Piedmont Budget Advisory and Financial Planning Committee
Bill Hosler, Chair
Mary Geong, Steve Hollis, Tom Lehrkind, and Tim Rood

2013 Five Year Projections

Overall, we feel the projections are reasonable and show a healthy level of General Fund balances, but the City still faces the same two significant risks as last year; the sewer fund and its likely negative impact on the General Fund, and the uncertainty and deferred funding relating to future CalPERS retirement and healthcare payments. Although the Committee spent time on those issues that represent the most significant financial risks to the City, we did not focus on areas of lesser risk including non-property revenues, workers comp and liability insurance, litigation costs, and non-employee related costs. Nor did we investigate staffing and service levels, but instead assumed the full staffing model presented. In general, we undertook to understand the risks to City finances from the existing programs and services rather than attempting to identify service cuts or efficiencies.

Review

After reviewing the history of the General Fund and the various assumptions included in the projections, we have highlighted several areas of risk to achieving the projections and discuss them below. Although most of these areas represent risks of higher expenses or lower revenues, the Committee did feel that there were some areas of potential upside in terms of higher revenues or lower costs.

Impact on General Fund from the Sewer Fund – See separate memo. The Committee is concerned at the current projections for the Sewer Fund, based upon detailed conversations with staff and our own research. We have prepared a separate memo to discuss the Sewer Fund specifically. As described in that memo, we believe the Sewer Fund will require an injection of funding from some source to remain viable, which could include a transfer of funds from the General Fund. The current General Fund projections do not assume any extraordinary funding from the General Fund which we feel is likely to occur.

Property Revenue Assumptions – A significant part of the City's revenues comes from the Alameda County Property Tax and the Real Property Transfer Tax, which together are estimated to provide $12.89 million in revenue in FY13-14, representing 60% of revenues. In the projections, the Property Tax revenues are projected to grow at a 4.1% rate, which is below the 30-year average of 7% but above the more recent 5 year average of 2.4%. Overall, the Committee believes it is possible that the Property Tax revenue will grow faster than the projections.

The Transfer Tax is levied at $13 per thousand of the value of the real property at the time of the transfer, and collections have been very volatile over the last 30 years, ranging as high as $3.3 million and as low as $1.7 million and averaging just over $2.5 million over the last 10 years. The projections assume the amount collected will remain steady at an average amount of $2.8 million, or $300,000 above the average, which the Committee feels may be optimistic. The amount collected is very dependent on the number and average price of properties transferred in a given year and the

Committee agreed that a level average amount collected, with surpluses assumed to be set aside to offset “lean” years, was a more prudent assumption (and practice) going forward. However, on balance, the larger than recommended Transfer Tax assumption is nearly offset by the lower than likely Property Tax growth assumption. Note that the Committee has arranged for staff to receive a monthly review of Piedmont Realty Data from the Multiple Listing Service so that the transfer tax revenue can be tracked more accurately.

Parcel Tax Impact – As the Committee noted, particularly given the rising cost of employee benefits, in recent years, the City’s budgets and projections have assumed continued voter renewal, maximum levy and maximum escalation of the parcel tax, which now accounts for approximately $1.6 million annually, about 7.5% of total revenues. Because the voters renewed the parcel tax in November 2012 and the Council has levied the full amount with the full CPI inflator each year since 2009, the projections assume continued full levy with a CPI inflator, leading to a positive and growing General Fund balance that reaches 20% of annual expenditures by the end of the 5-year period. As before, failure to levy the parcel tax or to renew it when it expires could subject the General Fund to significant pressure.

Salaries – The salary projections reflect continued frozen salaries for FY13-14 and growth at 2% annually thereafter. However, it is worth noting that the salaries line item contains two assumptions that appear conservative. First, the projections assume full staffing at current pay levels 100% of the time over the five year period, not accounting for routine vacancy and turnover. Second, the FY13-14 budget provides about $150,000 for temporary overstaffing costs – hiring safety officers in advance of known retirements. This presumably temporary condition is actually carried forward in the five year projections, adding approximately $600,000 of salary and associated benefit costs in the projections that are unlikely to occur. As a result, the Committee feels the salary numbers are likely to come in below projections. Nonetheless, although the Committee recognizes that salaries have been frozen for several years and increases may be due, we strongly recommend that the City investigate ways to effectuate the 2% cost increases in a way that does not increase the retirement liability - such as through a non-PERSable bonus plan.

Retirement Contributions – The City provides a defined benefit plan for its employees, and, although the actual retirement benefits to employees have not changed for some time, the cost of providing those benefits to employees has risen significantly. Table 1 below shows how much CalPERS has increased the out year funding rates for the historical employee plans (Tier I) just in the last year. As shown, the CalPERS rates are expected to rise to 55% for safety in FY17-18. However, the 5 year projections assume the current Safety MOU continues through the 5 years, resulting in the City’s contribution rate of 46.8% in FY17-18 vs. the 55% rate, with the employee picking up the difference. Note that a portion or the CalPERS rates shown are due to the Side Fund, which is addressed in a separate memo.

Table 1

Fiscal Year	Current Projections*(1)*		Prior Projections*(2)*		City 5 Year Projections*(3)*	
	Safety	**Misc.**	**Safety**	**Misc.**	**Safety**	**Misc.**
FY14-15	47.80%	24.80%	46.80%	23.60%	43.01%	22.09%
FY15-16	51.30%	25.90%	47.00%	23.50%	44.76%	22.09%
FY16-17	53.30%	27.10%	47.20%	23.30%	45.76%	22.09%
FY17-18	55.30%	28.30%	47.30%	23.10%	46.76%	22.09%

(1) Based on recent CalPERS information
(2) Based on 2012 Projections as provided by Bartel Associates
(3) 5 Year Projection assumptions incorporating current CalPERS rates and existing employee MOUs

The reasons for the increase are driven by CalPERS investment history, the new state law which prohibits new employees going into the "rich" benefit plans and thus requiring CalPERS to more quickly make up for the unfunded liabilities, and other demographic issues within the funds. Although the City has taken steps to reduce the risk of further cost increases by negotiating a cap on the amount the City contributes, the fact that the labor contracts only last a short while, the likelihood that CalPERS rates will increase even further, and the absolutely uncontrollable nature of the costs from CalPERS subject the City to considerable risks. Therefore, although the City has taken welcome steps, further work needs to be done to control these costs.

In 2012, the City put in place a lower tier (Tier II) retirement plan for new hires that provided for, among other things, benefit levels of 2.7%@55 and 2%@60 for Safety and Miscellaneous employees, respectively (compared to the existing Tier I plan of 3%@50 and 3%@60). Additionally, the State passed AB 340, known as PEPRA, which essentially created a third tier (Tier III) which provides benefits of 2.7%@57 and 2%@62, for Safety and Miscellaneous, respectively. Historic City employees are in Tier I, new employees who have previously been in the CalPERS system are in Tier II, and new employees new to CalPERS are in Tier III. The new Tiers will result in savings to the City over time as contributions rates are substantially lower. As compared to the above Tier I rates, Tier II rates are 22.56% and 7.85% for Safety and Miscellaneous employees, respectively and Tier III rates are 12.25% and 6.25% for Safety and Miscellaneous employees, respectively.

Employee Demographics and Turnover Impacts – The City faces the likelihood of substantial turnover in the next 5-10 years, as 23 employees have over 20 years of service and an additional 28 have over 10 years of service. We estimate that approximately 40 of the City employees are likely to retire over the next 10 years, with a significant portion in the next five years. The combination of substantial turnover combined with the new Tiers II and III and the payoff of the Side Fund should provide a downward trajectory for CalPERS benefit costs over the next 5-10 years. However, the City should be aware that

the near-term substantial increases to Tier I employee costs will make the current "cap" a very important measure of controlling costs.

Healthcare Contributions – The City provides for healthcare benefits for current employees as well as for retirees, the cost of which has been growing steadily over the years. The current law requires the City to provide a benefit for retirees similar to that of current employees. Unlike the CalPERS pension benefit, the City has not been required to fund this cost other than on a "pay-as-you-go" system. The projections show funding costs as incurred for retiree healthcare of $224k per year, growing at 7%, plus an additional $312k per year to fund a healthcare trust to help pay for future obligations. However, even with these funding levels, the retiree healthcare costs in the projections are inadequate to satisfy "actuarially" the full costs of providing retiree healthcare, which poses substantial economic risks to the City long term. A separate memo provides further details and recommendations.

Overall Capital Transfers – The 5-year projections include transfers out from the General Fund to the Facilities Maintenance Fund and Equipment Replacement Fund totaling $800,000 annually for three years and then increasing to $900,000 annually for the remaining two years. Together with the Measure B funds that the City expects to receive, the projections anticipate capital investment of $1.25 million per year. The amounts fund all expected equipment replacement needs based upon projected useful lives of the City's equipment stock while still maintaining an adequate ending fund balance. In addition to equipment, $400,000 annually would go into the new Facilities Maintenance Fund for major projects. Acting on a key recommendation of this Committee, earlier this year the City commissioned a long-range replacement/maintenance plan for City facilities, which staff expects to present to the Council in June 2013. As the Facilities Maintenance Plan is still under development, the Committee has not had the opportunity to review it and notes that the illustrative $200,000 in expenditures from the Facility Maintenance fund over the course of the 5-year projections may understate the actual expenditures needed. Upon review of the plan, the Council should verify that the $400,000 transfer into this fund is adequate.

Aquatics Issues – City operation of the swimming pool, beginning in FY11-12, has led to past and anticipated ongoing costs to the City, despite the admirable but ambitious goal, supported by this Committee, of making pool operation revenue-neutral. For FY12-13, aquatics expenditures exceeded revenues by $158,000. The 5-year projections, based on the FY13-14 aquatics budget, assume ongoing program expenditures for staffing, management, operations and facility maintenance that are offset only partially by aquatics revenues from gate fees, lessons and pass sales, resulting in an annual General Fund subsidy conservatively estimated at $200,000. While this figure exceeds the current year subsidy, the current year figures assume only $35,000 in capital improvements, and more costly maintenance projects, such as replacement of the pool liner, are likely to be needed within the 5-year planning horizon.

Potential budgetary liabilities associated with pool operation include lower than anticipated pass sales, higher than anticipated capital and maintenance costs, and potential future capital expenditures for a new or expanded swim facility. Changes in pass structure and pricing could have either a positive or

negative effect on pool revenues, depending on pass sales and pool usage. There is also a potential fiscal upside from new or revised cost-sharing agreements with pool user groups such as the Piedmont Unified School District, which currently does not pay for pool use, and the private Piedmont Swim Team which pays a below-market rate for its usage amounting to about $17,000 annually. The Committee recommends that, regardless of the policy with respect to the School District, proper accounting should reflect the capital/operational costs per user which includes the School District usage, as a footnote to the budget.

Summary

In summary, the Committee feels the 5-years projections are reasonable (subject to the two significant risks discussed above) and indicate a relatively strong financial position compared to the recent past. However, the risks to the City still exist and Council must stay vigilant to find ways to adequately compensate employees in a controllable way and continue to work to improve the stability of the City's finances.

The Committee would like to especially thank Erick Cheung, City Finance Director, for all of the education and effort he and his team have provided to the Committee.

Retiree Healthcare

The City historically has paid for healthcare coverage for current employees and provided a healthcare retirement benefit for retired employees who worked for the City for five years or more. Although the City pays up to 100% of the "Kaiser" premium for current employees, it had previously negotiated to pay a lesser amount for retirees. When the City joined PERS healthcare retirement plans, it projected significant savings and even began putting aside some money in a separate fund to help provide for future costs, but no work was done to determine if the amounts were sufficient.

For the City, the lesser benefit to retirees seemed affordable until Assembly Bill 2544 made effective in 2008 led to a substantial increase in healthcare liabilities for the City. The new law required the City to increase the amount it contributed to retiree healthcare to provide "parity" between active employee and retired employee contribution rates – i.e., the City was required to pay more of the healthcare costs of retirees – up to the same level of support as required for current employees, but the City could phase it in. As of today, the City provides 75% of the Kaiser Plan premium going to 100% over the next 5 years (subject to a cap on the increase of $100/month). This law has resulted in a substantial increase in obligations and financial risk to the City. Additionally, a new accounting pronouncement in 2009 of Governmental Accounting Standards Board Statement Number 45, Fund Balance Reporting and Governmental Fund Type Definitions, required the City to begin calculating and capturing its liability to retiree healthcare. Beginning in 2009, the City formed a fund called OPEB (Other Post Employment Benefits) which as of June 30, 2013, will have over $3.7 million to help meet these liabilities in the future.

Piedmont has two separate liabilities associated with retiree healthcare. The first is the "earned" benefit cost and represents what has accrued so far and will have to be paid in the future based on the previous service of employees. The present value of these costs total $12.5 million, with $3.7 million based on current retirees (49 retirees of which only 25 participate with an average age of 67) and $8.8 million for current employees (based on 92 employees with an average age of 46). These costs are only the present value and actual costs will be substantially higher over the years. The second liability is the future costs of current employees based on future service. That cost has a present value of $6.9 million and again real costs will be higher.

By comparison, annual costs for current employees for healthcare this year will total $1.7 million as Kaiser costs are $600-$1200/month for 1 and 2 party, respectively. However, once a retiree qualifies for Medicare, the premiums drop to $275-$550. Based on demographic assumptions and healthcare cost growth, the actuary has calculated that the City should set aside over $900,000 per year for retiree healthcare known as the "normal costs." ***This does not include current retirees' costs or costs for prior service of current employees.*** The assumptions include:

- 3% salary increases which if they don't happen will tend to increase normal costs in the future, and

- 8% annual growth in premium costs (which is somewhat limited by caps)

The $900,000 normal costs will continue into the foreseeable future depending on health care rates, participation, etc. Add to that the current retiree costs estimated to be about $4-$5 million in total over the next ten plus years (relates to the $3.7 million above) and the unfunded costs for current employees at the $8.8 mil present value above less the $3.7 mil of funding in the OPEB (net $5.1 mil of underfunding), and the Committee estimates the City's true "set-aside" costs for the retiree healthcare over the next 10 years would be in excess of $1.5 mil per year versus the approximately $600 k annually in the five year plan. The result is a likely increase in the unfunded liability by as much as $5 mil over the next five years.

Somewhat offsetting the $5.1 mil unfunded liability growing to $10 million is the existing Police and Fire Pension Fund, serving retirees who retired prior to 1982, which currently has about $10 million in assets but likely less that $3 million in liabilities. The net overfunding of $7 mil in surplus assets could one day support the unfunded liability of the retiree healthcare.

Based on our review, the Committee has a few suggestions relating controlling the retiree healthcare costs going forward:

1. We strongly recommend reduce the benefit provided to current employees (and thus retirees) from 100% to 75% or a lower number which would correspondingly lower the liability approximately by a like amount. The advantage of doing it today is that current retirees are already only at 75% and as such they would not feel an impact today.
2. We strongly recommend extending the current City vesting requirement for retirement healthcare from 5 years to something much longer – as long as 20 years. Retirement healthcare coverage costs are uncontrollable and quite expensive, running as much as $600,000 in current, un-inflated, costs per employee ($20 k/yr times 30 years of benefits in today's costs). An employee should provide extra-ordinary service to earn such a benefit.
3. If possible, try to shoulder more healthcare burden on Tier 1 pension employees post retirement (such as covering only 50% or less, if possible) as they have a much higher pension benefit.

Sewer Fund

As part of our work in evaluating the ongoing expense commitments of the City, we have spent some time understanding the issues associated with the Sewer Fund, particularly the funding, financing and phasing options for rehabilitation of the remaining 93,000 lineal feet of mainline sanitary sewer and the likely resulting costs.

Based on our review, as further described below, the Committee unanimously recommends beginning the process of obtaining a low-interest State loan to restart the phased rehabilitation of the City's remaining sanitary sewer mains and investigating potential funding sources to address the projected temporary shortfall in the Sewer Fund beginning in FY16-17. Funding sources could include a temporary sewer tax surcharge measure, which would require approval of 2/3 of the voters, borrowing from the General Fund to cover the projected shortfall in the Sewer Fund, or some combination of the two.

Background

The Sewer Fund accounts for all operation and capital expenses of maintaining the City's sewer and storm drain system and is separately funded by a permanent, voter-approved sewer tax. However, in the event that sewer tax receipts are insufficient to fund expenditures, the General Fund will likely have to cover any shortfall (and has done so in the past; such a transfer of $275k was made in FY11-12). Sewer fund expenditures are primarily made up of (1) operating/ maintenance expenses, (2) ongoing general sewer projects including emergency repairs, and (3) debt service on borrowings used for capital replacement of sewer lines. In the past two years, new operating costs have arisen for EPA compliance, which consist primarily of monitoring and professional services.

Revenues from the sewer tax are approximately $2.2 million annually and increase at approximately 2% per year. A sizeable portion of the sewer tax revenue is transferred into the General Fund each year as compensation for Public Works staff, equipment and fuel costs attributed to the sanitary and storm sewer systems. This transfer has grown in response to regulatory mandates, going from $600k–$700k in years prior to 2006 to $900k for the current fiscal year, about 40% of the sewer revenue. Staff time attributed to the sewer systems is estimated rather than tracked directly.

The current Sewer Fund balance is about $1.2 million, but it is projected to decline rapidly over the 5-year projection period, with a projected shortfall of about $180k by FY16-17. Table 1 shows a history and projection of the Sewer Fund revenues and expenditures, net of the loan proceeds and capital costs for the loan-financed major sewer replacement projects, and net of transfers in from the General Fund. Because the existing sewer tax was not necessarily sized to cover the debt service for the sewer rehabilitation master plan, and because Measure A, the proposed ten-year 50% sewer surcharge, was rejected by the voters in 2012, the fund's revenue growth has not kept pace with the expenditure growth, leading to a projected fund shortfall in FY16-17. Long-range projections undertaken by this committee and staff found, however, that as debt service is retired, revenues are projected to exceed expenditures beginning in FY23-24 and the fund balance to turn positive by FY29-30, even with no additional source of revenue. Thus, the fund balance problem is temporary and driven more by debt service, currently $553,700 annually for the next ten years and declining thereafter, than by the costs of EPA compliance, which are estimated by staff at $300k annually.

Table 1. Sewer Fund Historic and Projected Annual Averages

	Annual Average FY08-FY12	Annual Average FY13-FY17
Revenues *(1)*	2,018,044	2,254,521
Operating Costs *(2)*	1,453,303	1,604,990
Capital Costs		
(Major Equipment/Emergency Repairs) *(3)*	396,240	421,390
Debt Service	447,635	553,700
Net Total	(279,134)	(325,559)
Average Fund Balance	1,411,243	585,972

(1) General fund transfers in and loan proceeds not included
(2) Includes EPA compliance beginning in FY10-11; includes transfers out to General Fund
(3) Phased mainline replacement projects not included

Because of the volatile nature of emergency repair costs, it is desirable to maintain a minimum fund balance to avoid unexpected stresses on the General Fund. Due of the age of the sewer system, when mainline breaks occur, complete reaches of old terra cotta pipe are replaced with new high-density polyethylene (HDPE) pipe from manhole to manhole, resulting in incremental replacement of the mainline in response to emergencies. This system appears effective, in that staff is not aware of any leaks from the portions of the system that have been replaced. In the past five years, emergency repair costs have varied greatly, from a low of about $54k in FY09-10 to a high of $1.05m in FY08-09, with an average of about $362k. Going forward, $340k is projected to be spent annually on sewer replacement.

Opportunity

In our report last year, this Committee noted that the $340k projected to be spent each year on mainline replacement as part of the "General Sewer Projects/Emergency Repairs" line item exceeded the average debt service cost of $106k to $161k for the completed phases of the rehabilitation program. We thus encouraged the City to take out low-cost State loans to finance the rehabilitation of at least the highest-priority reaches of the remaining system, which have been identified by staff as including 26,000 lineal feet. As the most deteriorated portions of the system are replaced, the amount spent on emergency repairs would presumably decline in even greater proportion than the percentage of the remaining mainline replaced.

We acknowledge that projections indicate a shortfall in the Sewer Fund, regardless of how quickly or slowly the remaining sewers are replaced, but we believe the total cost to the City of a logically phased rehabilitation program would be lower than that of incremental repairs, due to the (1) likely lower cost per lineal foot for larger scale, contiguous phased projects; (2) the availability of low-interest State loans, currently at 1% interest; (3) lower exposure to cost escalation if the rehabilitation is completed over a period of years rather than decades; and (4) reduced risk of non-attainment of regulatory requirements that may be imposed under the forthcoming Consent Decree.

Options for Sewer Rehabilitation

As of 2012, the City had completed the phased rehabilitation of the most problematic 167,000 lineal feet of mainline sanitary sewers, or about 64% of the system, using low interest, 20-year amortization loans from a State revolving fund. Our investigation studied two primary options for phasing, funding and financing the remaining 93,000 lineal feet of mainline.

A baseline for the pace of the rehabilitation over the next three years is set by Piedmont's legal responsibilities. In response to an EPA Stipulated Order, the City has committed to a ten-year Asset Management Implementation Plan (AMIP), a draft of which was approved by the City Council for submittal to EPA in 2012 and revised in January 2013 in response to EPA comments. Developed in collaboration with EBMUD and the other EMBUD satellites subject to the Stipulated Order, Piedmont's AMIP includes numerous sewer monitoring, reporting and maintenance activities to improve water quality, as well as a commitment to a 3 year Priority Rehabilitation Project involving an annual expenditure of approximately $340k in each of the next three fiscal years for mainline sewer replacement, estimated to cover approximately 8,800 lineal feet, or 9.5% of the remaining mainline. (Note, however, that the City's commitment is to the dollar amount, rather than the lineal footage, and the specific reaches to be replaced may vary based on observed infiltration/inflow.) We understand that conclusion of the Consent Decree negotiations is expected before the end of 2013, which will provide more definitive direction regarding the pace of mainline replacement needed to meet regulatory requirements beyond FY15-16.

One option for the remaining mainline rehabilitation is to continue the minimal replacement of approximately 1% of the mainline sewer each year, in effect continuing the pace established for the next three years by the AMIP, until the entire system has been replaced. This is considered by staff to be the slowest pace of progress the EPA would likely accept. Staff estimates that small, scattered replacement projects in response to emergencies could cost an average of $120 per lineal foot, inclusive of 20% soft costs. At this rate, the $340k annual expenditure would fund about 3,000 lineal feet, meaning it could take over 30 years to complete the rehabilitation. Assuming 2.2% cost inflation, the total cost of the incremental rehabilitation at this pace would be $14.6 million. This estimate does not include any allowance for any additional repairs needed to address major emergencies.

A second option, which this Committee recommends, is to undertake additional phases of mainline replacement using state loans. These do not need to be taken out all at once, and in fact it would not be desirable to rehabilitate all the remaining mainline simultaneously, due to the resulting drain on staff time, widespread disruption of streets and neighborhoods, and likelihood that smaller contractors would choose not to bid on such a large project. Past phases have typically encompassed about three sub-basins, or 30,000 lineal feet, and been spaced three or more years apart to spread out the loan payments. Under such a scenario, given the City's experience with recent phases, staff anticipates that the hard and soft costs could be in the range of $90 per lineal foot. After accounting for debt service costs (currently 1%, projected conservatively as rising to 1.25% and 1.5% for the second and third remaining phases) and assuming 2.2% annual inflation, the total cost for this phased rehabilitation over a nine-year period is projected at $10.2 million, a savings of $4.4 million over the incremental replacement scenario. In addition, repair costs would presumably decline more rapidly as the replacement of the mainline system would be 100% complete by FY21-22. (The projections conservatively assume a baseline 50k in annual emergency repair costs even after 100% of the mainline has been replaced).

Funding Options

As noted earlier, the projected shortfall in the Sewer Fund is temporary and is driven primarily by debt service for previous phases, and to a lesser degree by additional regulatory requirements. Adding additional debt service would increase the cost burden in the near term but reduce the drain on the fund for emergency repairs in the longer term. Under the phased replacement scenario, a total of approximately $2.3 million in additional revenue is needed to maintain a positive fund balance and approach a reserve target of $500k. There are two primary options for addressing this temporary shortfall: a dedicated, temporary sewer tax surcharge, or transfers in from the General Fund (which would effectively reduce the $900k currently transferred annually from the Sewer Fund to the General Fund).

We estimate that a 25% sewer tax surcharge for 4 years beginning in FY14-15 (assuming a measure on the February 2014 ballot is approved by 2/3 of the voters), generating a total of $2.3m in additional revenue, would be sufficient to maintain a positive fund balance, with the lowest fund balance of approximately $350k projected in FY15-16, when the purchase of a $300k vactor truck is assumed. In the following years, the projected Sewer Fund balance would never drop below $500k and would increase rapidly beginning in FY26-27 as debt service from earlier phases is retired.

Alternatively, transfers from the General Fund could be used to maintain a positive Sewer Fund balance while completing the phased rehabilitation. Under the same conservative assumptions regarding interest rate increases, we project that five annual transfers in of $450k beginning in FY13-14, for a total of $2.25m, would be sufficient to maintain a positive Sewer Fund balance while completing all three phases of the remaining mainline rehabilitation over a nine-year period. Except for a one-year low fund balance of $279k in FY21-22, the projected fund balance would remain over $600k and in many years would be over $1m.

With these transfers to the sewer fund, the projected General Fund balance under this scenario would remain above $2.8m and above 12.4% of annual expenditures, which is less than the reserve target of 15% of expenditures but greater than the actual General Fund reserve from FY08-09 through FY10-11. Beginning in FY20-21, when the transfers were no longer required, the projected General Fund balance would exceed 16.8% of expenditures and continue to rise. As the Sewer Fund built up a positive balance, the funds borrowed from the General Fund could be transferred back.

Recommendation and Next Steps

Given the uncertainty surrounding the forthcoming Consent Decree, this Committee's only immediate recommendation regarding the Sewer Fund is to begin the process of obtaining State loan financing for the rehabilitation of a next phase that includes the highest-priority reaches.[1] The State loans can now be used to finance both hard and soft costs, so while the City would need to lay out approximately $525k in soft costs, these could be reimbursed from the loan proceeds.

As maintaining the sewer system is a basic and high-priority function of City government, we encourage

[1] The scattered "emergency" reaches identified by staff total 26,500 lineal feet and the next-highest priority sub-basin adds another 5,700 lineal feet, for a total of 32,200 lineal feet, approximately the size of previous mainline replacement phases.

the Council to consider borrowing from the General Fund to cover the projected temporary Sewer Fund shortfall. If the Council chooses to place a temporary sewer tax surcharge measure before the voters, we urge that it be sized to minimize the additional burden on taxpayers. We also urge that if such a measure is proposed, the ballot information should be clear regarding the purpose of the tax, which would be to finance the replacement of the remaining mainline sanitary sewers, saving the City millions in the long run, as opposed to paying for EPA compliance activities, which the City is already obligated to do and is already doing.

CalPERS Side Fund Refinance

As part of our work in evaluating the ongoing expense commitments of the City, particularly around employee benefit costs, we have spent some time understanding the costs associated with the Side Fund obligations. Based on our review, as further described below, the Committee unanimously recommends beginning the process of refinancing the Side Fund obligation at a substantially lower rate, potentially saving the City over $1 million in payments over the next 9 years. We believe the first step is to engage Bond Counsel and a financing team to advise the City as to the best process to enable the City to issue debt and refinance the obligation with CalPERS. Staff should do further work to determine which Bond Counsel would be most acceptable.

Background

Prior to 2003, the City Council voted to increase the pension benefits of the current employees on a retro-active basis. In 2005, a new State Law provided for employers with less than 100 employees to join a State-wide pool (in part to make it easier for CalPERS to manage the program). One of the conditions of entry to the pool was that each City had a true-up of unfunded liability, in part due to prior service, in their former stand-alone plan. The true-up could be paid in cash or through future contribution rates through a "Side-Fund" that would be incorporated in the employer contribution rates. The terms of the future contribution rates included (at the time) a 7.75% “interest rate” to the City and a 20 year amortization. The rate has subsequently been reduced to 7.5%. These payments are “normalized” to a projected constant percentage of expected salary and are added to the overall pension benefit costs the City is required to pay. For example, in FY13-14, the Side Fund obligation cost is approximately 8% of salary for miscellaneous employees and 18% of salary for safety employees, compared to total pension benefit costs of 23.8% and 46.0%, respectively. This Side Fund obligation has been a factor in the high annual costs of pension benefits, but will end in 7-9 years (see table below). Table 1 below shows the size, current rate, and term of the Side Funds.

Table 1 – Side Fund Amount and Terms

Fiscal Year	Safety Employees	Miscellaneous Employees	Total
Balance (as of 6/30/13)	$5,532,124	$2,311,901	$7,844,025
Interest Rate	7.50%	7.50%	7.50%
Remaining Term (years)	7	9	9

Table 2 below shows the annual cost as projected by CalPERS over the remaining life of the obligation. Note that historically CalPERS methodology has slightly overstated the actual cost to the City due to the CalPERS assumption of 3% salary growth, so the expected costs to the City will likely be slightly lower than shown. It is also worth noting that the cost of the Side Fund payments in FY13-14 represent over 20% of the total benefit costs of the City – these costs will go away after 7-9 years.

Table 2 - CalPERS Projected Side Fund Payments

Fiscal Year*(1)*	Safety Employees	Miscellaneous Employees	Total
FY14	$928,164	$314,103	$1,242,267
FY15	956,009	323,526	1,279,535
FY16	984,689	333,232	1,317,921
FY17	1,014,230	343,229	1,357,459
FY18	1,044,657	353,526	1,398,183
FY19	1,075,996	364,131	1,440,127
FY20	1,108,276	375,055	1,483,331
FY21	-	386,307	386,307
FY22	-	397,896	397,896
Total	$7,112,021	$3,191,005	$10,303,026

(1) FY14 denotes the fiscal year ending in June 2014

Opportunity

Under the CalPERS plan, the City is allowed to pay off the Side Fund obligations at any time at the then CalPERS calculated balance (approximately $7.8 million as of 6/30/13) and avoid the 7.5% cost of money imposed by CalPERS. Given today's low interest rates, the City could borrow the $7.8 million at a substantially lower rate and achieve significant savings. Table 3 shows the potential annual savings at a 3.5% interest rate. Note that these savings assume a refinance starting July 1, 2013, which isn't practical – actual savings would include only a partial FY13-14.

Table 3 - Refinance Savings

Fiscal Year*(1)*	CalPERS Projected Payment	Hypothetical Refinance Payment*(2)*	Potential Savings
FY14	$1,242,267	$1,220,610	$21,657
FY15	1,279,535	1,220,610	58,925
FY16	1,317,921	1,220,610	97,311
FY17	1,357,459	1,220,610	136,849
FY18	1,398,183	1,220,610	177,573
FY19	1,440,127	1,220,610	219,517
FY20	1,483,331	1,220,610	262,721
FY21	386,307	307,402	78,905
FY22	397,896	307,402	90,494
Total	$10,303,026	$9,159,078	$1,143,948

(1) FY14 denotes the fiscal year ending in June 2014
(2) Based on a straight line amortization at 3.5% before issuance costs

Note that the City will only learn the actual interest rate it would pay on the refinancing at the end of an issuance process that will take several months, hence the savings shown above are estimates only. Table 4 shows the impact of various interest rates on the potential savings. In general, each 0.25% change in rates is worth about $90,000 in savings to the City.

Table 4 - Effects of Interest Rates

Refinance Rate	**3.00%**	**3.25%**	**3.50%**	**3.75%**
Total CalPERS Payments	$10,303,026	$10,303,026	$10,303,026	$10,303,026
Hypothetical Refinance Payments	8,887,925	8,977,865	9,068,250	9,159,078
Assumed Issuance Costs*(3)*	(125,000)	(125,000)	(125,000)	(125,000)
Savings Over 9 Remaining Years	$1,290,101	$1,200,161	$1,109,776	$1,018,948

(3) In the presentations, issuance costs ranged from $103,975 to $220,000

As part of our study, we heard presentations from two investment banking firms that could assist the City with the refinance, Brandis Tallman and Raymond James. Both firms are active on the Side Fund refinancing business. Both firms stated that Piedmont should be able to refinance the Side Fund obligations in this calendar year in the range of rates shown above.

However, the City has various methods of effectuating a refinance including a general obligation bond (“GO”), a publicly offered general fund bond (“POB”), and a private placement (“PP”). Although the GO and POB would likely have the lower interest rate, they are dependent on getting a public rating which has uncertainty as well as requiring higher levels of City staff time, higher issuance costs, and ongoing disclosure. Additionally, based on the City’s charter, any issuance may require the vote of the people which adds cost and likely delay beyond the current calendar year. The PP would likely occur at the higher end of the rates (depending on the purchaser’s assessment of Piedmont’s credit worthiness versus Piedmont’s actual credit rating), but would likely have the lowest issuance costs and would not require an independent rating.

At this point, the Committee is not recommending a particular method of issuance, but any method requires outside counsel (“Bond Counsel”) to determine what legal steps must occur to allow the refinancing. Many cities in California go through a legal process called “validation” that would allow the City to issue debt and not require the time and expense of a citizen vote. However, Piedmont’s charter does not appear to allow validation, and it is likely the City will have to proceed with a vote by the people. The Committee strongly recommends proceeding with Bond Counsel to confirm the process and timing in order to complete a refinancing as expeditiously as possible.

It is important to note that these potential savings would be affected by the current employee cost sharing and “cap” arrangements between the City and its employees in the last approved contract. The upcoming year CalPERS pension rate for Safety employees is 46%, of which the Side Fund is 18%. Without the Side Fund, the rate would be only 28%. Based on the prior contract, Safety employees share in any cost above 37% of salaries for CalPERS. Since the current CalPERS rate is 46% (and rising),

employees are paying about 4.5% (one half of the 9% difference). If the Side Fund were refinanced, the CalPERS rate would drop for the upcoming year to 28% and thus would be below the sharing cap. As a result, the City would be obligated for Side Fund payments and the employees would not provide any payment towards the CalPERS pension. As a result, without a contract change in the mechanics of the cap, the refinancing of the Side Fund would save the employees substantial money but actually cost the City more money. If the cap can be adjusted downward by 18%, the employee is still ahead as he/she would remove the risk of the Side Fund payment growing over time (which it is expected to do) from 18% and thus causing a further increase in their sharing.

Recommendation and Next Steps

Based on the potential savings, the Committee unanimously recommends engaging Bond Counsel to begin the next steps in refinancing the Side Fund. City staff should confirm with Bond Counsel the cost of pursuing the process that is payable by the City regardless of whether debt is ever issued – our assumption was that the City would be at risk for paying no more than $20,000 before issuance as the remaining issuance costs are typically contingent on completing a financing.

City staff should prepare a recommendation for the Committee and City Council for the firm to use and the method of issuance. At this point, the Committee recommends selecting Brandis Tallman as the firm most suited to the type of work needed by the City based on their experience and market share. The Committee would ask that staff work with the Committee to determine the best structure of bond payment regarding amortization, term, etc., to optimize savings and City financial flexibility. Most importantly, negotiations with employees should immediately take into account the potential refinancing of the Side Fund to make sure the savings to the City are optimized.