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September 14, 2018

RECEIVED

SEP 18 2018

BY:

Honorable Judge Patricia L. Kelly
Superior Court Presiding Judge
County of Santa Barbara
1100 Anacapa Street
Santa Barbara, CA 93101

City of Santa Barbara's responses to
Grand Jury Report on "Pensions in Santa Barbara County"

Honorable Judge Kelly:

The 2017-18 Santa Barbara County Civil Grand Jury recently released its report entitled *Pensions in Santa Barbara County.* The City of Santa Barbara is named as an affected agency and in thus required to respond to applicable findings and recommendations within 90 days of the receipt of the report.

FINDINGS

Finding #3

In Lompoc, Santa Maria and City of Santa Barbara, solvency risks are high in the pre-PEPRA plans that have most of the Actuarial Liabilities in the municipal plans.

Response
The City disagrees partially with this finding.

The Grand Jury developed three categories of solvency risk (high, moderate, low) based on the funded status of retirement plans, and rated all City's non-PEPRA plans as "High." This rating is misleading in that it does not take into consideration important factors as described below.

1. The rating suggests that the City's plans are at a high risk of essentially going bankrupt – that is, not being able to pay the benefits due to current retirees and future retirees into the foreseeable future. This is just not the case. While the City's plans' funded status are not ideal, the plans have sufficient assets to pay current benefits for many years. For example, the City's Miscellaneous Plan had total assets as of June 30, 2016 of $367.5 million and currently pays approximately $23.4 million in benefits annually. As such, it would take over 15 years to fully consume

existing assets if no additional contributions were made by employees/employers and no investment returns were generated.

2. The Grand Jury's use of the current funded ratio alone, without context, as a basis to draw its conclusions, does not tell the complete story. Between 2001 and 2008, the United States suffered two major economic downturns, one created by the "dot-com" bust (and exacerbated by the terrorist attacks on September 11, 2001) and then the real-estate driven Great Recession. In 2001 and 2002, CalPERS realized investment losses of 7.2% and 6.1%. Then in 2008 and 2009, CalPERS realized losses in its investments of 5.1% and 24%, respectively. The 24% loss is unprecedented and consistent with the fact that the last time the U.S. experienced a recession of that magnitude was during the Great Depression. Over a 23-year period (from FY 1993 through FY2015), the four losses noted above were the only years CalPERS realized investment losses. Prior to the Great Recession, all of the City's plans had a funded status of over 80%. Due to the Great Recession, the City's Miscellaneous Plan dropped from 80.9% as of June 30, 2007 to 72.4% as of June 30, 2015. Other plans experienced similar drops. The point is, a 70% funded status is certainly not ideal, but given the backdrop of the two recessions, one being of historical proportions, the funded status is not unreasonable and does not any in any way suggest pending insolvency.

3. The Grand Jury's assessment of solvency risk does not take into consideration the purpose and impacts of CalPERS recent actions, including: (1) eliminating previously implemented smoothing policies over starting in fiscal year 2016; and (2) lowering the discount rate from 7.5% to 7% starting with the actuarial valuations for the fiscal year ended June 30, 2016 (for fiscal year 2019 contribution rates). While putting more financial pressure on participating agencies and active employees, these actions actually strengthen the plans by relying less on investment returns and on more on employer/employee contributions to fund retirement benefits. In fact, with regards to the lowering of the discount rate, CalPERS' decision was less about its ability to earn the previous assumed rate of return target of 7.5%, as some may contend, and more about CalPERS intent to strengthen the plans and increase the likelihood of achieving fully funded status within the next ten years.

4. In 2012, the State of California enacted the Public Employees' Pension Reform Act (PEPRA), which took effect January 1, 2013. PEPRA added new benefit formulas for new members hired after December 31, 2012 that provide substantially less benefits than "classic" members. Over time, as classic members retire or other leave

the system and are replaced by PEPRA employees, the overall pension costs will reduce.

Finding #4:

In Lompoc and City of Santa Barbara, liquidity risks are high as measured by projected years of negative cash flow. Managing those risks will require employer's pension contributions of 40 percent of payroll in Lompoc and 50 percent in the City of Santa Barbara at least until 2030.

Response

Disagree Wholly.

The basis for the assertion that the City's liquidity risks are high is based strictly on the assumption that, absent any actions taken by the City of Santa Barbara or other factors that improve its finances, the City will see negative cash flows for the next 8 years as a result of increasing retirement contributions. In reality, the City has no plans or expectations that it will implement a strategy of deficit spending in the foreseeable future. In during the Great Recession, which was unexpected, the City only drew upon reserves minimally and largely relied on cost cutting measures to rebalance the General Fund budget to address a 10% structural deficit.

Unlike the unexpected losses from the Great Recession, the City has the benefit of knowing what is coming and taking measures to reduce the impacts of rising pension costs in the near future. Specifically, the City will balance its future budgets based on (1) measures to control non-pension costs and (2) new revenue not factored into the Grand Jury's projections. Each of these is described below.

1. Measures to Control Costs – Over the last several years, as revenue growth waned following very strong revenue growth in sales taxes and transient occupancy taxes, the City implemented cost controlling measures to ensure the City was able to adopt balanced budgets. These measures included the following:

   a. Shifting more of the responsibility of pension costs to employees. In the last several years, both Police and Fire Sworn personnel have gone from not paying into their pension plan to paying the full 9% employee share. In more recent negotiations, firefighters have agreed to pick up 1.5% of the employer share, increasing their contribution to 10.5%. The same thing will be asked of police sworn personnel when their MOU expires in June 2019. Police Managers have agreed to pick up an additional 4% of retirement costs, increasing their contributions to 13%. Non-safety employees are already

subject to a cost-sharing agreement implemented in 2006 whereby employees pay approximately 30% of any increase to the employer contribution rates. As a result, non-sworn employees will be paying almost 11% towards their retirement in fiscal year 2019. In addition, 30% of the expected rate increases in subsequent years as a result of the discount rate being lowered will be paid by the employee.

b. Negotiating Shorter-Termed Labor Contracts – The City has intentionally focused on shorter term contracts, such as for only 1 year, as a way to provide more flexibility in case unexpected events materialize that affect City finances, such as a recession. This limits the City's exposure and allows the City to cut salaries, lower future salary increases, etc.

c. Negotiating Smaller Salary Increases – Over the last two years (FY 2017 and 2018) the City has established through its budget a 1% salary increase across the board. This is following more generous salaries of 2-3% between FY 2012 and FY 2016. For virtually most employees, this means minimal, if any, increases to their net pay. Yet, City Council has shown its willingness to hold the line given the fiscal realities, even before CalPERS decided to lower its discount rates and increase employer rates through FY 2025. Depending on the amount of revenues generated by cannabis taxes and the collection of sales taxes stemming from the Supreme Court decision (see item 2 below), Council may have to continue to hold the line on salary increases to the 1% into the near future. If necessary, the City would negotiate NO salary increases. Even without the new revenues discussed below, the City would remain balanced with moderate revenue growth with salary growth of less than 1%.

2. New Revenues – In December 2016, Santa Barbara voters approved a new tax measure that imposes up to a 20% general tax on all cannabis businesses. Starting in fiscal year 2020, this could generate up to $1 million in new revenues to the General Fund.

   In addition, the U.S. Supreme Court decision in the South Dakota vs Wayfair case will result increased sales tax revenues. The decision overturned the 1992 case of North Dakota vs Quill which, at that time, prohibited states from requiring out of state businesses (primarily catalog and other mail order businesses) that sold to in-state purchasers from collecting sales taxes. Since mail order and catalog businesses have been replaced with online sales of commodities, the recent decision now will allow states from requiring out of state businesses that sell via the internet to in-state customers to collect sales taxes. The estimates of the additional revenues the

City will receive ranges from $500,000 to $1.5 million annually. The State of California has already issued guidelines requiring the collection of sales taxes starting August 2018. As such, the City will receive approximately 10 months of revenues in FY 2019 and a full year of revenues starting in FY 2020.

3. Ability of Other Funds to Address Increasing Pension Costs – While the General Fund is the single largest fund in the City, utility funds (water, sewer, and trash) make up approximately 35% of the City's overall budget. Unlike the General Fund, which is limited in its ability to raise revenues, utility funds are almost entirely funded from user rates. Certainly, we are very aware of ratepayer impacts overall, but pension costs represent a small portion of the overall utility bills, and the City has much greater flexibility to increase rates as needed to cover all operating costs, subject to Proposition 218.

Finding #5:

While the City of Santa Barbara does not have "PEPRA Police Plan," it does respect the 2013 PEPRA Law for those hired after December 31, 2012. Therefore, the absence of a "PEPRA Police Plan" does not adversely affect the funded ratio or other risk indicators for the City of Santa Barbara system.

Response

Agree.

Finding #6:

Liquidity risks in Santa Maria are lower than in Lompoc and the City of Santa Barbara, in that Santa Maria projects no years of negative cash flows. However, Santa Maria would have negative cash flow if CalPERS investment returns fall below their projected actuarial values. Managing that liquidity risk requires that Santa Maria maintain high total employer contributions to its pension plans until at least 2034.

Response

Disagree Partially. See response to Finding 4 above.

Finding #7:

The City of Santa Maria faces greater pension risks because of its comparatively low General Fund revenue per capita, which is less than 50 percent of that of the City of Santa Barbara and less than 67 percent of the of Lompoc. Santa Maria has taken steps

to end employer contributions in lieu of employee contributions in its pension plans; this step moves some of the burden of repaying its unfunded pension liabilities from the City to its active employees.

Response

Agree.

Finding #8:

The 12 PEPRA plans in the cities of the County of Santa Barbara have a funded ration of 0.90 and the 20 non-PEPRA plans have a funded ratio of 0.68. This is a small, but positive, sign that the PEPRA law is having the intended effect of strengthening the security of pension benefits in the County.

Response

Agree.

Finding #9:

Funded ratios of the municipal pension systems in Santa Barbara County are sensitive to the discount rate applies by CalPERS. A cut in the rate to 6 percent, from the 2018-19 rate of 7 percent, would push the funded ratios of several municipal systems close to 0.5 and might impose further increases in the employer's contributions in Lompoc, in the City of Santa Barbara and in Santa Maria.

Response

Agree.

Finding #10:

It is unlikely that the largest municipal plans – Lompoc Safety; City of Santa Barbara Miscellaneous; City of Santa Barbara Fire; City of Santa Barbara Police; and City of Santa Maria Miscellaneous – can apply to the revised CalPERS amortization schedule of 20 years to all their unfunded liabilities without higher new employer's contributions. Such new contributions would be particularly problematic in Lompoc and in the City of Santa Barbara given the high employer's contribution rates that already apply in those cities.

Response

Agree.

RECOMMENDATIONS

Recommendation #1:

That in view of the 12 Findings, the governments of the cities of Buellton, Carpinteria, Goleta, Guadalupe, Lompoc, Santa Barbara, Santa Maria and Solvang and of the County of Santa Barbara analyze capital spending, employer/employee contribution rates, staffing levels, and all existing taxes and revenue sources under their control to identify potential revenue gains and cost savings.

Response

This recommendation has already been implemented and will continue to be in place over the next several years to the extent revenue growth and new revenues are not sufficient to meet increasing pension costs. See Response to Finding 4 above.

Recommendation #2:

That the governments of the cities of Buellton, Carpinteria, Goleta, Guadalupe, Lompoc, Santa Barbara, Santa Maria and Solvang and of the County of Santa Barbara issue public reports, to be discussed at open sessions of their respective governing bodies, on the potential revenue gain and cost-saving measures that may be necessary to ensure continued adequate funding of their pension plans.

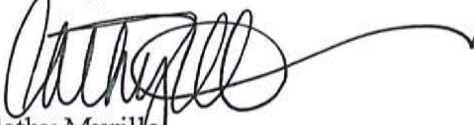
Response

The City plans on preparing and making a public a plan for addressing rising pension costs. To a large degree, it will outline what is already being done, but any new elements that may be implemented in the future.

We appreciate the opportunity to provide detailed responses and explanation to the Grand Jury's findings and recommendations. There is no question that addressing the unfunded liabilities of public pensions in a responsible manner is important. Coupled with CalPERS decision to lower the discount rate as a way to reduce volatility, all participating agencies will be fiscally challenged over the next 5-8 years. In some communities, the growing pension contribution requirements will require fairly draconian measures to balance their budgets. For the City of Santa Barbara, we are in a good financial condition based on the typical measures of financial health. We also have

a track record of responsibly and quickly reacting to events that affect local revenues or result in increased costs. Certainly the next eight years will be difficult; but with the combination of keeping costs in check and new revenue sources, we believe the City will be able to address the impacts of increasing pension costs with only minimal impacts, if any, to services.

Sincerely,



Cathy Murillo
Mayor of City of Santa Barbara

cc: Santa Barbara County Grand Jury
Santa Barbara Mayor & City Council
Paul Casey, City Administrator
Pam Antil, Assistant City Administrator
Robert Samario, Finance Director