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City of Pomona

FISCAL STABILITY AND FINANCIAL SUSTAINABILITY REPORT FOR THE GENERAL FUND

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Contents

I. Introduction

Urban Futures, Inc. (UFI) was engaged by the City of Pomona ("City") to develop a baseline financial forecast model for the General Fund and accompanying fiscal stability and financial sustainability plan. UFI's forecast looks at the City's General Fund revenues and expenditures over a 10-year horizon. The City has a strategic interest in taking a long-term perspective for purposes of assessing the impact of decisions today on the City's financial position in the future. As part of the scope of the engagement, UFI was tasked with assessing and analyzing the following key areas:

- General Fund revenue streams with recommendations for restructuring at-risk or under-optimized revenue streams, changes to financial structures or procedures that will enhance current revenue streams, and opportunities for new revenue streams to improve the City's fiscal stability; and
- Key cost drivers in the General Fund – the financial and organizational determinants that significantly dictate the expenses required to deliver municipal services -- and what actions can help control or mitigate these key cost drivers.

In preparing the forecast and analysis, UFI worked with city staff in the Finance Department, Human Resources Department, and others. To develop its projections, UFI relied on the City's historical data, published financial documents, CalPERS reports and projections, the City's auditors for other post-employment benefits (OEPB), and the City's labor costing data. This information was used to construct a long-range budget model tailored to the City's specific financial circumstances and condition.

The results of the forecast and analysis, along with the development of findings and recommendations, is presented in this report for use by City staff and elected officials. The forecast model provides city management a tool to transparently communicate the General Fund's financial condition and risks to the City Council, and to help ensure the City's strategies, policy-making and ultimate implementation of operational decisions are informed by solid fiscal analysis and made with consideration of the long-term financial impacts to the General Fund. This report provides measurements and findings as to the General Fund's fiscal health (based on the forecast) and recommendations for financial and operational changes that can improve the solvency and sustainability of the General Fund.

II. Ten-Year Baseline Forecast

A. Background on Development of Baseline Forecast Model

We began our engagement with building a Ten-Year Baseline Financial Forecast Model for the General Fund ("Baseline Forecast"). The Baseline Forecast is designed to be a politically neutral, fiscal tool intended to create an agreed-upon common understanding of the status quo: if the

City makes no changes to its organization or operations, and there are no significant external economic impacts to the City, what is the predicted financial condition of the General Fund over the next ten years? Working with staff, we collected the necessary data required to understand, aggregate and model the various revenue streams and expenditure drivers for the General Fund, including but not limited to: ongoing programs and services; one-time funding requirements (policy or otherwise); cost allocation models used citywide; reserve funding thresholds; revenue streams from local taxes, fees, reimbursements and other collections; and key transfers in and out of the General Fund.

To ensure accuracy and capacity for ongoing updates, we built the Baseline Forecast from the City's general ledger data and chart of accounts. After disaggregating one-time expenses and revenues that often distort an accurate picture of the current financial position of the General Fund, the general ledger data was rolled-up into revenue and expense categories that mirror the City's annual budgeting documents. Even more importantly, we worked to ensure solid reconciliation in the Baseline Forecast between the City's labor costing data and departmental personnel budgets. The Baseline Forecast contains a labor data table for each department that classifies employees by bargaining group with associated cost details for each position. The individual position costs are rolled-up into personnel budget categories, providing a solid basis on which to forecast personnel expenses by department based on agency-wide labor cost drivers such as: expected pension increases, negotiated MOU provisions, ongoing OPEB liabilities, anticipated vacancy factors and increasing health care costs.

Next, we developed variables and indices for each revenue and expense category that enable the Baseline Forecast to produce a ten-year projection of the General Fund's financial condition given its current structure, operations, service delivery methods, debt structure, future obligations and fiscal realities. The forecast provides a "baseline" understanding of the City's present and future financial condition. The Baseline Forecast also includes a "dashboard" of basic measurements and metrics that help to tell the story of the General Fund's projected financial condition in understandable terms to policy-makers, stakeholder groups and the general public.

Finally, we expanded the usability of the Baseline Forecast by adding capacity that allows the it to reflect the impact of proposed changes, potential decisions and strategic initiatives. The hypothetical scenarios are isolated from the Baseline Forecast so the impact can be measured – baseline vs. proposal. By adding the capacity to adjust assumptions, inputs and variables, the enhanced model enables the City to conduct rigorous fiscal analysis and provide immediate feedback on the short-and long-term impact of strategic choices and operational decisions, and to engage stakeholders and decision-makers in quantitatively-supported discussions and consensus-building exercises that help the City address any structural operating deficit and future financial obligations.

B. Key Assumptions in Baseline Forecast

The following are key assumptions for purposes of understanding the Baseline Forecast and the analysis that follows therefrom in this report.

- **Revenue and expense assumptions in the Baseline Forecast are considered moderate.** The indices and variables used to drive the various categories of General Fund revenues and expenses are derived from regional economic indicators, the City's own revenue and expense history (if there was strong correlation between the data and trendline) or other moderate/rational indices. Under or over performance of the regional, state or national economy can affect these assumptions.

- **The Baseline Forecast does not assume any recessionary period over the ten years.** There is no rational method to accurately predict the timing, magnitude, duration and consequence of the next economic contraction or recession and the impact to various local revenue streams. Recessions, however, are cyclical and have occurred on average every 6.5 years since 1928. Recessions occurring after 1945 have peak-to-trough GDP declines ranging from a low of 0.3% to the Great Recession's 4.3% decline, with an average of 2.21%. These declines have had varying impacts on local government revenues (and expenditures). Some revenues like the sales tax (monthly revenues, trued-up quarterly) reflect an immediate impact, while others like the property tax (with an annual lien date) have an effective one-year lag in recognizing economic impacts. For long-term liabilities like pensions or adjustable debt, the full impact can take even longer to appear because of amortization or "ramping" provisions. So even though the Baseline Forecast does not contain a recessionary assumption, it is prudent to expect that there will likely be some period of economic contraction during the ten-year forecast period.

- **Revenue and expense assumptions in the Baseline Forecast become less reliable in years three to five and are simply trend-based predictions or static constants in years five through ten.** Most economists are reticent to look much beyond 24 to 36 months in their fiscal predications about the factors that drive the economy and the impact to local revenues and expenses. Many economists refuse to make assumptions beyond 12 months. Despite these reluctances among the researchers and academia, it is imperative for cities to develop and maintain long-term financial forecasts because government organizations have historically proven to be unable of effectuating substantive fiscal change or reform in the near-term (two to three years). Fiscal change, either through revenue augmentation, expenditure reduction or organizational restructuring, often takes years to accomplish and see the results. Thus, it is important for cities maintain a long-term financial perspective when making strategic decisions, so slower moving changes can be fully implemented before fiscal cliffs are reached.

- **The Baseline Forecast assumes no salary increases or benefit adjustments during the ten-year period.** The salary growth assumption in the Baseline Forecast is set at 0% and all benefit levels remain the same. The only adjustments that impact labor costs are inflationary effects to existing benefits such as increased costs of employer-provided health benefits or projected actuarial adjustments to pension and OPEB liabilities. This allows the City to more clearly understand the impact of any proposed adjustment to employee compensation.

- **For City pension liabilities, the Baseline Forecast incorporates the six years of projected costs provided by California Public Employee Retirement System (PERS) but assumes a flattening or stabilizing of pension costs for the final four years of the forecast.** The most recent PERS actuarial reports provide cities with their projected pension costs for six years. For Pomona (as with almost all local government agencies in California), PERS projects significant annual increases over the next six-years with the rate of increase diminishing slightly in the later years. The City's pension is a "defined benefit" plan, which means when an employee retires, the retiree is entitled to receive the benefit for the remainder of their life. PERS is the administrator and trustee for the City's pension plan and currently holds approximately $445 million in trust for payment to beneficiaries of the City's plan. Because the City's pension is a defined benefit plan, PERS uses actuarial assumptions to ensure the plan has sufficient funds to pay all retirees their defined benefit during retirement. These actuarial assumptions are subject to change by action of the PERS Board to account for changing conditions which affects the City's future contribution rates. In particular, the City should consider the following risks inherent in actuarial assumptions used for defined benefit pension plans:

    - ✓ **Adopted Rate of Return (Discount Rate).** Pension contributions made by the City and its employees to the City's pension plan are invested by PERS, the trustee for the plan. PERS establishes an annual expected "rate of return" for its investment portfolio (also referred to as the "discount rate"). If actual returns on the PERS investment portfolio are lower or higher than the established rate of return, the loss or gain is amortized into the City's pension plan and future contribution amounts are adjusted (see below for amortization explanation). Higher than expected returns means lower future City contributions. Lower than expected returns means higher future City contributions. Between 2000 and 2012, the average annual return on the PERS investment portfolio was lower than expected. The resulting losses were amortized into all PERS plans and are a major factor driving the sharp rise in contribution amounts over the next five years. As a result of this long-term experience, and to lower the risk of future losses, the PERS Board has steadily lowered its expected rate of return from 8.25% in 2000, to 7.38% currently and then to 7% beginning in FY 2019-20.

    - ✓ **Longevity of Beneficiaries (Mortality Rate).** As noted above, the City's pension plan provides a "defined benefit" for a retiree's remaining life. To ensure the City's pension plan remains financially viable, PERS must make assumptions about the longevity of pension beneficiaries – how long will PERS be obligated to pay the defined retirement benefit to beneficiaries. This is often referred to as a mortality rate. Due to improving health outcomes and increasing longevity across population groups, PERS has had to periodically adjust its mortality rate assumptions. Continuing increases to the longevity of beneficiaries means higher future City contributions.

✓ **Amortization Policy.** When actuarial assumptions used by PERS differ from actual experience (e.g., lower returns on PERS investment portfolio, beneficiaries living longer, etc.), the City's pension plan and future contribution rates must be adjusted to account for the resulting gain or loss in plan value. To avoid sharp increases or decreases in City contribution amounts, and to improve long-term financial planning and overall stability, PERS "amortizes" any annual gain or loss over a defined period of time. Longer amortization periods reduce the volatility of City contribution rates but increase overall pension plan costs (from amortized losses). Shorter amortization periods increase contribution volatility but reduce overall pension plan costs. Recently PERS changed its policy to create a level amortization period of 20 years for future gains and losses (previously it was 30 years, with a five-year of ramping up and down period). This change goes into effect in FY 2021-22 and will increase the amount of future City contributions if there is a loss in plan value, but also reduce the overall cost to the City from such losses if value.

C. Initial Baseline Forecast (December 2017)

In December 2017, UFI presented the City with an initial Baseline Forecast that was based on the FY 2017-18 adopted operating budget for the General Fund ("Initial Baseline Forecast"). A summary of the Initial Baseline Forecast was provided to the City Council in its meeting on December 11, 2017 with the following preliminary observations and assessments:

- The General Fund was forecasted to begin a sustained period of annual operating deficits growing from \$1.7 million in the current fiscal year to \$4.3 million in approximately six years, then declining back to \$1.4 million in year ten of the forecast;
- General Fund reserves would be required to balance the annual budget, but continual annual operating deficits would consume the reserves in approximate 4.5 years;
- The City was increasingly dependent on vacancy savings, miscellaneous revenues and operational cost savings to avoid incurring deficits in the General Fund;
- Municipal service levels were being impacted by the lack of financial capacity in the General Fund for capital outlays required for consistent maintenance, repair and replacement of capital assets; and
- Steep increases in the City's annual PERS costs were the biggest cost driver in the ongoing General Fund operating deficit.

D. Updated Baseline Forecast (May 2018)

In April 2018, the City Finance Department provided UFI with updates to the General Fund budget for FY 2017-18 based on changes to the City's financial condition and substantial actions adopted by the City Council since the Initial Baseline Forecast. The following is a list of the major changes reported by the finance staff that impacted the Initial Baseline Forecast:

- $2.1 million in added personnel costs to the General Fund resulting from new salary increases approved for current employees;
- $1.4 million in added personnel costs to fill all positional vacancies in General Fund departments (full staffing);
- $1.4 million in reduced General Fund cost recovery due to updates and restructuring of the following cost recovery methodologies and plans: utility franchise fees, general sanitation fees and the City's administrative cost allocation plan; and
- $500,000 in additional General Fund expenses to absorb police program costs previously paid from forfeiture asset funds (which experienced a permanent reduction).

The above fiscal adjustments are not one-time expenses or revenue losses. They represent a sustained additional annual cost to the General Fund of $5.4 million. Finance staff also reported the following estimated additional growth to the General Fund revenue base that either occurred in FY 2017-18 or is being projected for FY 2018-19:

- $1.2 million in additional property tax revenue growth experienced in FY 2017-18; and
- $770,000 in projected additional growth in combined revenues from sales, utility and other taxes beginning in FY 2019-20.

The reported increases in General Fund revenue were carried forward in the Baseline Forecast because they represent growth in the tax base above the amount initially forecasted, not one-time revenues or volatile revenues such as like fees, licenses and permits. In addition, staff asked UFI to consider the impact of one-time net revenues the General Fund is expected to receive in FY 2018-19 from the sale of property.

Based on these added costs and revenues to the General Fund, UFI performed a summary update of the Initial Baseline Forecast for purposes of this report ("Updated Baseline Forecast"). The fiscal stability and financial sustainability findings and recommendations contained herein are based on the Updated Baseline Forecast.

III. Summary of Findings

A. Defining Fiscal Stability and Financial Sustainability

A public agency's inability to provide essential services is a strong indication fiscal instability and possible fiscal emergency. As noted by the Governmental Accounting Standards Board (GASB), common themes that have been formalized or are working definitions of fiscal stability and financial sustainability include the ability to continue public services and/or existing programs. This comports with the definition of "financial condition" adopted by the International City/County Management Association (ICMA). In particular, ICMA defines a municipality's financial condition as the ability to: (1) maintain existing service levels, (2) withstand local and regional economic disruptions, and (3) meet the demands of natural growth, decline, and change.

A primary goal of the City in commissioning this work is to stabilize the General Fund's fiscal condition and develop increasing financial sustainability. Achieving these twin goals requires the City to recognize the impact of its near-term decisions on the long-term General Fund finances. Using guidance from GASB and ICMA, UFI evaluated the General Fund's fiscal stability and financial sustainability on four basic measurements of solvency:

- **Cash Flow Solvency (no fiscal stability).** Ability to generate sufficient cash over a 30- to 60-day period to meet obligations.
- **Budget Solvency (basic fiscal stability).** Ability within the normal budgetary period to (1) generate sufficient revenues to meet expenditures, (2) avoid an operating deficit and (3) maintain reserve at minimum level required for operating cash flow.
- **Structural Solvency (good fiscal stability and basic financial sustainability).** Ability over multiple years to (1) maintain basic municipal service-levels and recommended minimum reserve levels without incurring operating deficits, (2) fund long-term liabilities such as pension, retiree healthcare, etc., and (3) fund maintenance of existing capital assets (government facilities, infrastructure, equipment and networks) to ensure basic operational condition.
- **Service Solvency (good financial sustainability).** Ability over time to (1) achieve and sustain the municipal service-levels desired by the community to meet its goals, (2) provide for the full replacement (asset recapitalization) and/or make additional improvements to public infrastructure and facilities desired by the community, and (3) adequately respond to changing community preferences and needs, including local and regional economic and environmental stresses.

B. Cash Flow Solvency Findings (no fiscal stability)

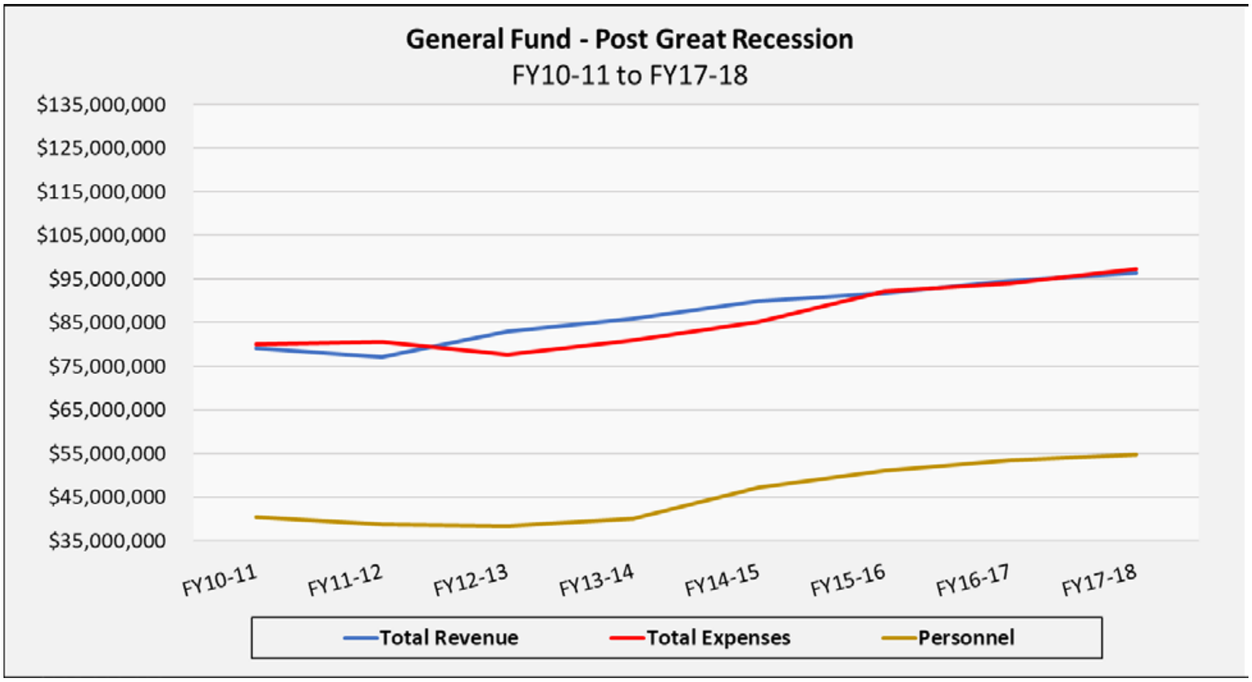
Cash flow solvency is not a measurement of fiscal stability. It is instead an indicator of an entity's proximity to a fiscal cliff that leads to a downward fiscal spiral from which the entity may not recover. The City's General Fund will likely conclude this fiscal year with a fund balance of just over $16 million, almost all of which is unrestricted and committed to fiscal sustainability. Thus, the General Fund is currently cash flow solvent and adequately positioned in the short-run to pay its obligations when due and withstand some economic uncertainty in the near-term.

However, as discussed in the next section, the Updated Baseline Forecast shows the General Fund's current cash flow solvency quickly deteriorating over the next 12 to 24 months because of a structural operating deficit and budget insolvency. If no immediate changes are made to reduce the City's expenses or increase its revenues, the General Fund is projected to become cash flow insolvent sometime in FY 2020-21.

C. Budget Solvency Findings (basic fiscal stability)

The Updated Baseline Forecast reveals the General Fund is currently budget insolvent, and without substantial changes, the General Fund will remain budget insolvent for well-beyond the next ten years. The General Fund is facing a continuous significant operating deficit of $8 to $10 million annually. In other words, for the next ten years, assuming no changes, the General Fund is structured to spend $8 to $10 million more per year than it receives. At this rate, the City will burn through its $16 million in General Fund reserves in the next two fiscal years and likely become cash insolvent in FY 2020-21.

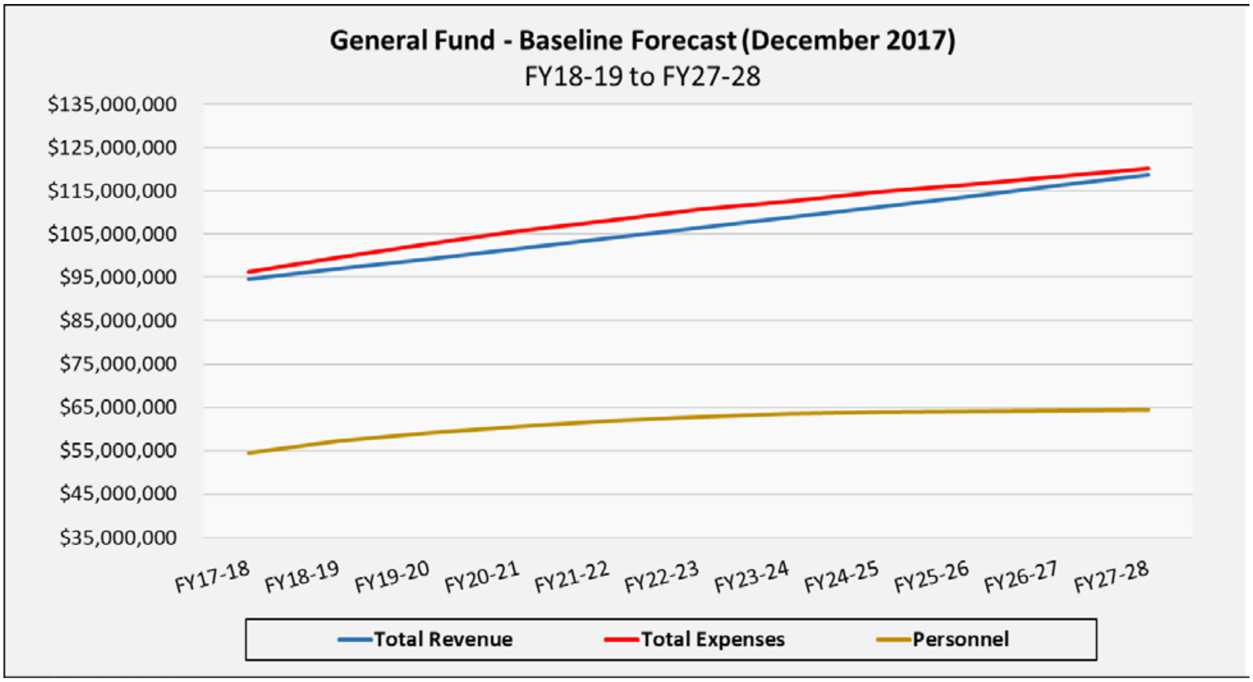
While General Fund revenue levels have recovered from the Great Recession (2008 to 2011), annual revenue growth has slowed over the past several years from a high of over 7% in FY 2012-13 to an expected less than 2% in this fiscal year. The average annual growth rate for General Fund revenues during the last five years is approximately 3%. In contrast, the growth rate in General Fund expenses, primarily in the area of labor costs, has consistently outpaced revenues. Year-over-year expense growth reached a high of over 8% in FY 2015-16 and has averaged approximately 4.6% during the last five years. For labor expenses, the average annual growth rate during the last five years is almost 7.5%. The data above is summarized in the following chart:



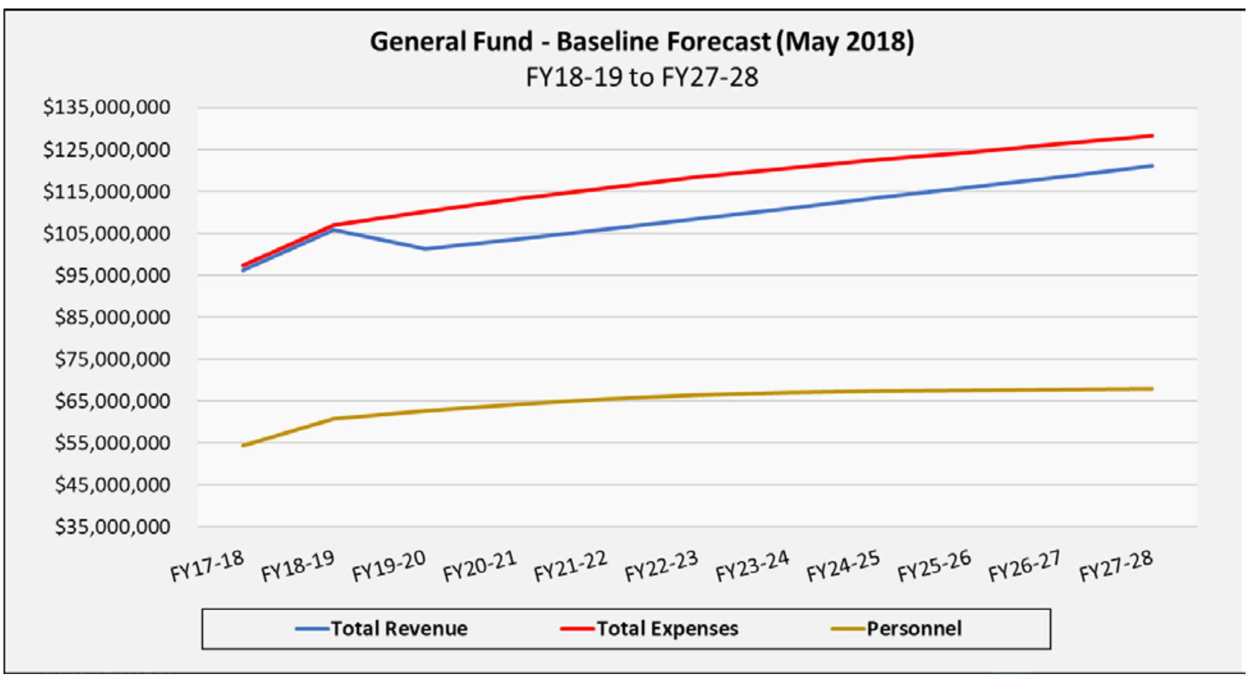
While the City has been able to maintain budget solvency in each year since FY2012-13 – creating a Fund Balance of just over $16 million – it has also experienced rising expense growth and slowing revenue growth which have eroded the annual surplus. In FY 2017-18, the City has finally reached a point of inflexion. For the first time in five years, the General Fund is expected to have more expenses than revenues, creating an operating deficit of just under $1 million for FY 2017-18.

If the City's current budget insolvency was caused by one-time or short-term expenses or revenue losses, the City could address the fiscal challenge through the use of reserve funds in its Fund Balance. This is a common practice and purpose for economic contingency reserves. The baseline forecast, however, reveals the General Fund budget solvency problem is structural and has become significantly worse since the Initial Baseline Forecast was presented to the City in December 2017.

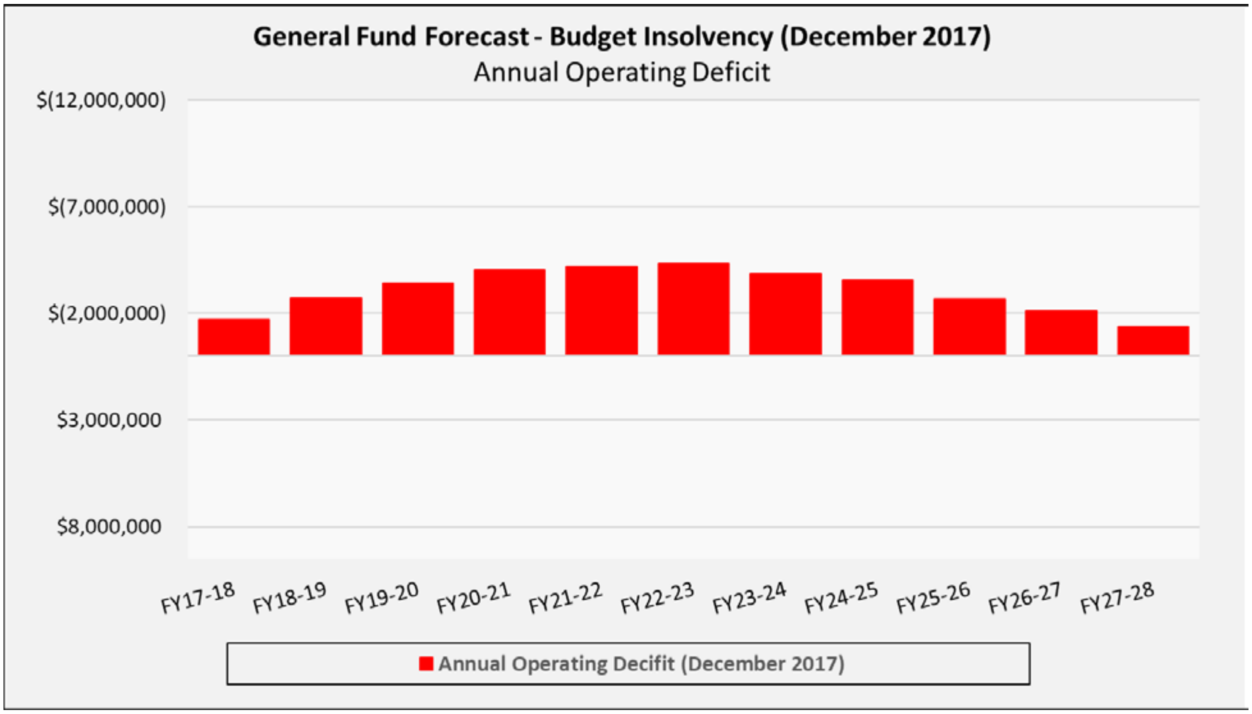
The chart below shows the Initial Baseline Forecast for the General Fund presented in December 2017. Assuming no adjustment in baseline expenditures (only increases due to moderate inflation and/or legally required adjustments), and assuming moderate growth to existing/baseline revenue streams, the General Fund was forecasted to have an annual operating deficit of approximately $2.5 to $4.5 million for the next ten years.

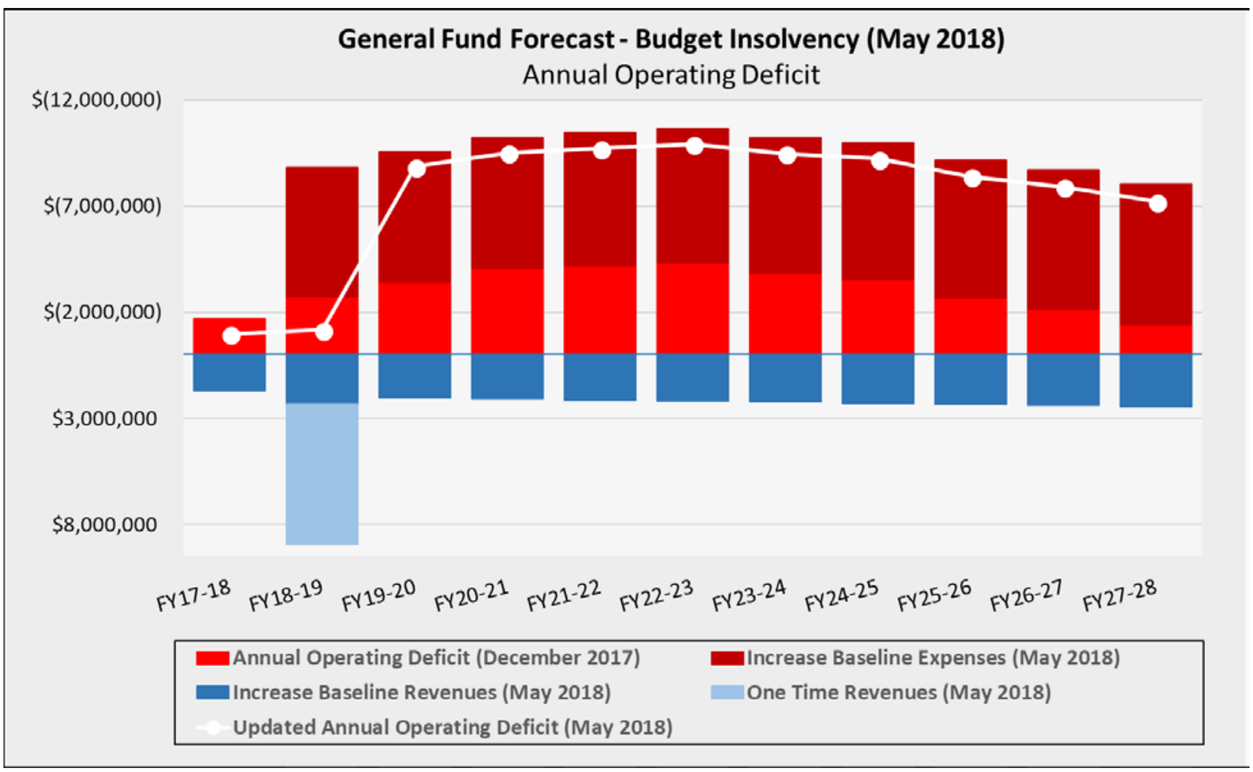


The Updated Baseline Forecast shows the extent to which the General Fund annual operating deficit has worsened in the last five months with the additional $5.4 million in net costs despite additional revenue growth. In the next two years, the annual operating deficit will have mushroomed to $8 to $10 million with no shows of closing over the updated ten-year forecast.

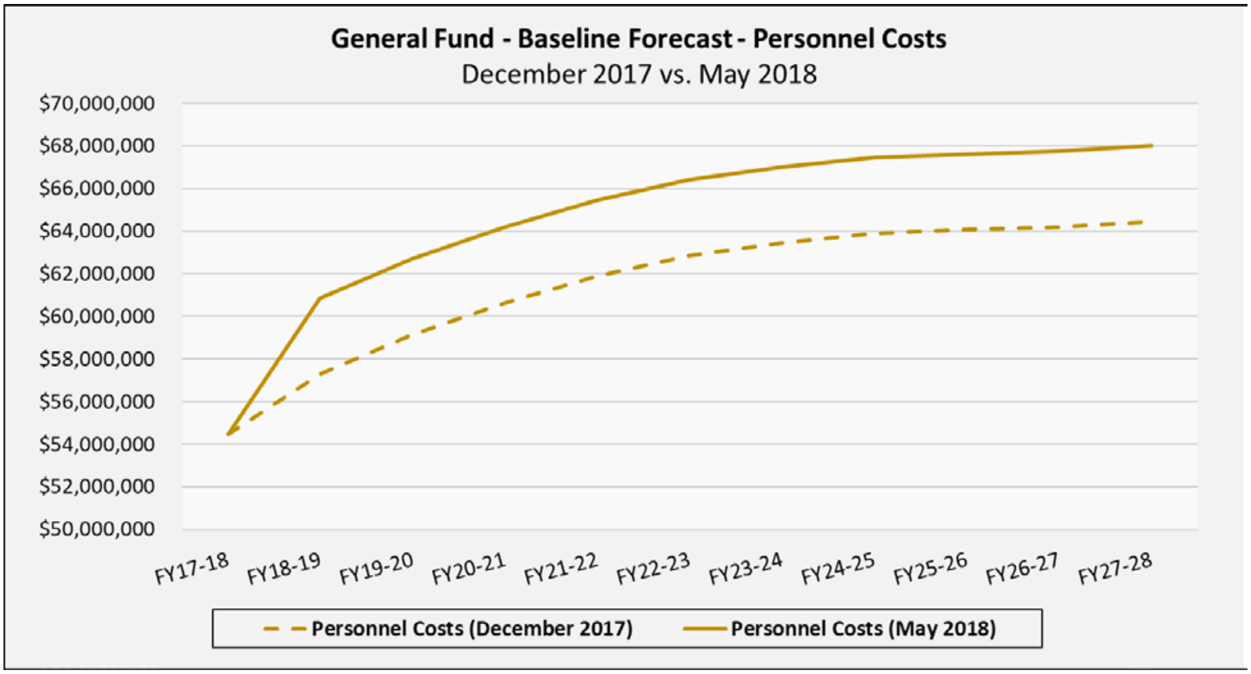


The following charts provide a more graphic look at the forecasted annual operating deficit (the delta between expenses and revenues) over the ten-year baseline forecast period, and the dramatic worsening of the General Fund's budget insolvency during the last five months despite the benefit of both the increased tax base growth and one-time revenues.





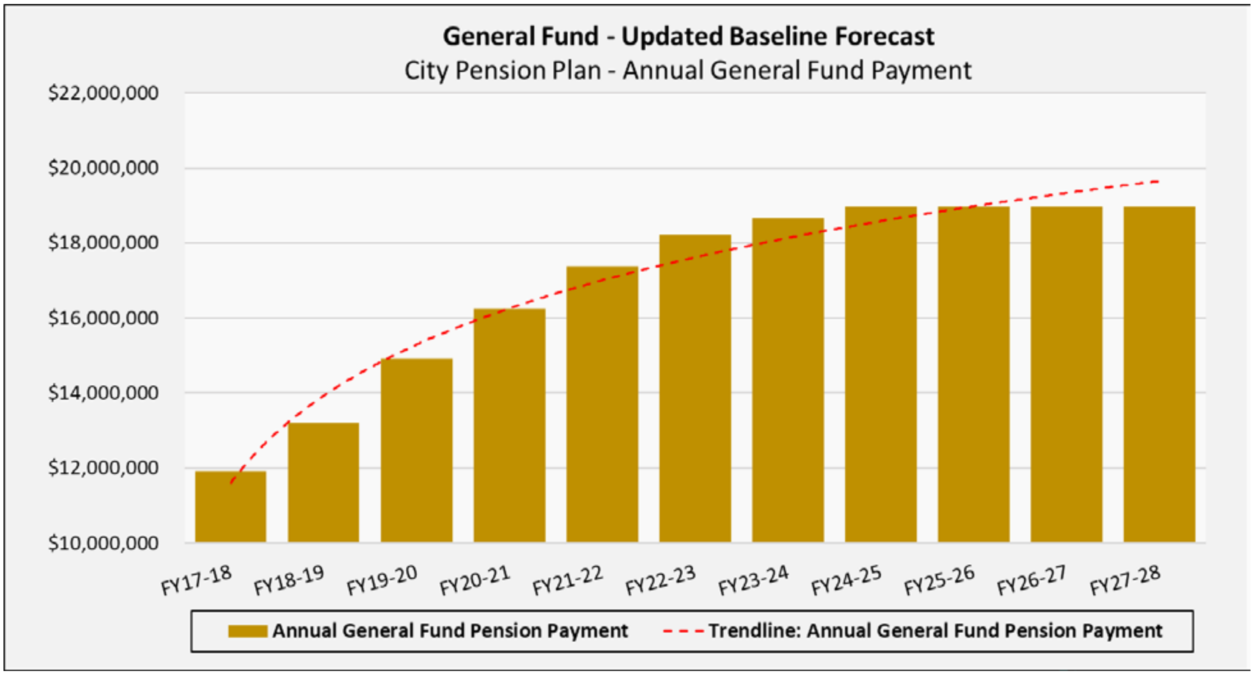
The primary driver of the General Fund's annual operating deficit is the City's structured labor costs: salaries, benefits and pensions. As noted at the beginning of this section, in the last five years, General Fund personnel expenses have grown at an average annual rate of almost 7.5%, far outpacing the growth in other expenses and revenue. The rate of increase for personnel expenses, however, had begun to slow significantly over the past two years and a more moderate rate of personnel cost growth was forecasted to continue in the Initial Baseline Forecast. In the last five months, however, the City has again increased the General Fund personnel costs with new salary increases. The significant effect on the General Fund's growth in personnel costs is demonstrated in the graph below:



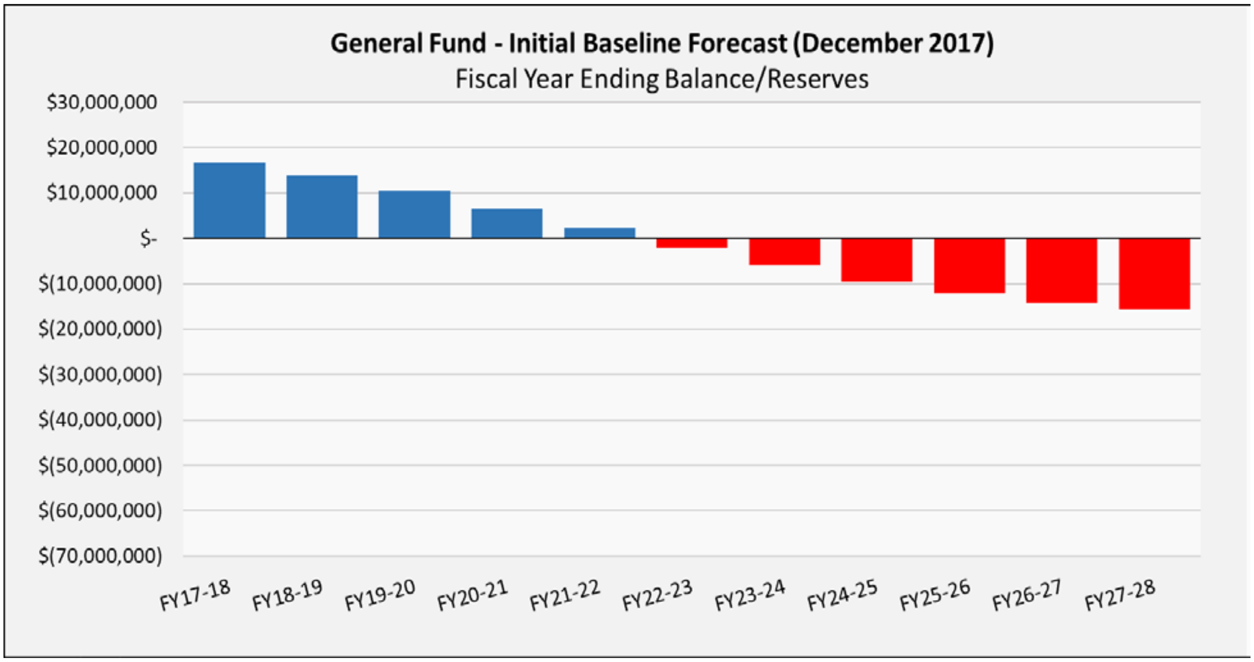
In addition to new salary adjustments, continuing escalation of City pension costs is the other major driver of General Fund personnel costs. Over the next six years, PERS projects the City's annual minimum pension contribution will grow from approximately $13 million to over $18.5 million. This equates to an annual growth rate of 7.8%. In years six through ten of the baseline forecast, the rate of growth for the City's pension contribution slows only because CalPERS has not applied its actuarial assumptions beyond the first six years. More importantly, as discussed in the detail in Section II of this report, the following factors are expected to continue escalating the City's future pension costs:

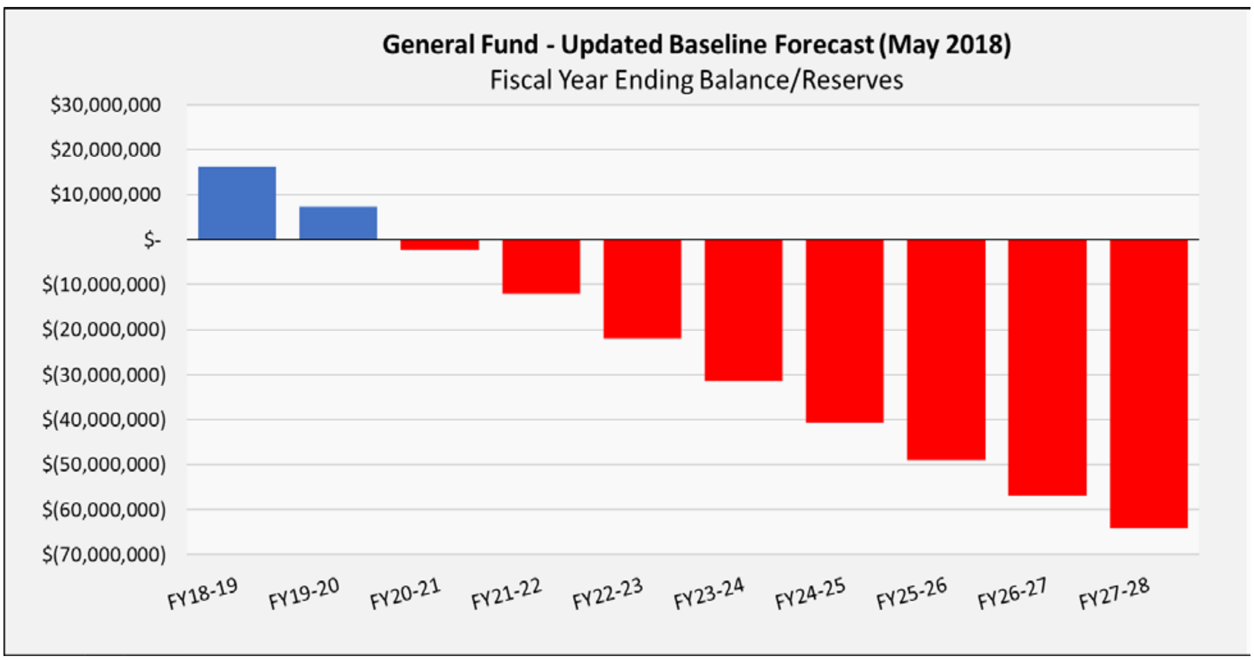
- PERS new shortened amortization period for future investment gains and losses;
- continuing growth in longevity rates for pension beneficiaries; and
- City pension costs associated with recent salary adjustments.

The chart below shows the General Fund's future pension costs as projected by the most recent PERS actuarial report, with a flattening of growth in the out-years of the forecast. Based on the above considerations, UFI strongly believes the City's pension costs will at-least continue along the dotted trendline and may even experience steeper growth if the PERS investment portfolio does not meet the adopted rate of return (currently at 7.38% but dropping to 7.25% this coming fiscal year and then 7% in FY 2019-20).



Finally, there is a very significant issue of the City's short timing to address the $8 to $10 million General Fund budget insolvency. When the Initial Baseline Forecast was presented in December 2017, the City had approximately 4.5 years to address a growing $2.5 to $4 million annual operating deficit. With the new financial data in the Updated Baseline Forecast, the City's drive towards the fiscal cliff of cash insolvency became shorter, steeper and faster. The City now has only approximately 24 months to address an $8 to $10 million annual operating deficit. This is not a slow slide towards a fiscal cliff; it's a downhill run that must be addressed immediately with decisive and significant actions. The charts below show the increased rate at which the City is now projected to burn through its General Fund reserves:





Section IV presents the strategies and recommendations the City needs to immediately evaluate and execute to restore budget solvency to the General Fund.

D. Structural Solvency Findings (good fiscal stability and basic financial sustainability)

Given the City's significant General Fund budget solvency challenge outlined in the previous section, its unsurprising to find the City is likely years away from being able to see significant progress towards structural solvency. As defined by UFI, achieving structural solvency requires the financial capacity to maintain basic municipal service levels and existing infrastructure and capital assets in basic operational condition.

The City's near-term challenge of restoring budget solvency to the General Fund, however, should not prevent the City from concurrently working on improving its structural solvency. The two levels of solvency should not be looked at as a linear process but rather a spectrum for measurement of the City's fiscal and financial health. Actions that address structural solvency in the General Fund will help the City prevent backsliding on budget solvency. The City's primary additional challenges to achieve structural solvency are as follows:

a. **Containing Labor Costs.** Maintaining basic municipal service levels is a human resource challenge. At its core, municipal services are delivered by people. While some enterprise functions are more capital intensive (water, sewer and refuse), services delivered by the General Fund are largely labor-intensive (public safety, public works, community development, parks and recreation, libraries and internal services). Approximately 80% to 85% of the City's General Fund expenditures are for labor costs that support municipal service delivery, of which 66% is for direct labor (city personnel) and 34% is for indirect labor (contracted services such as fire, building and safety and landscape maintenance).

   As such, achieving and maintaining basic levels of municipal service is fundamentally a human resource and labor equation. If the City's labor cost structure is too high and growth of labor expenses continues to outpace revenue growth, then the number of employees must be reduced to maintain solvency thereby diminishing service levels to the community. Conversely, if the City does not periodically adjust labor costs and employee's real wages continually erode under rising living costs, employee morale, recruitment and retention can be severely compromised and the City's capacity to maintain basic service levels is significantly diminished.

   The fact that labor costs dominate General Fund expenditures is expected. However, when labor costs increasingly crowd-out the ability to allocate resources to other critical inputs (facilities, tools, technology, fleet, materials and supplies, etc.), municipal-service levels rapidly deteriorate because employee efficiency and effectiveness is diminished. Employees increasingly spend time on less beneficial tasks, or doing activities in very inefficient ways, to work-around or make-up for the lack of adequate or operational tools, continuing maintenance and deterioration of capital assets, etc. In essence, to avoid making hard personnel choices and minimize current expenses, the City is sub-optimizing expensive labor, implicitly placing higher value on the quantity of its workforce over its productivity and efficiency.

b. **Investing in Capital Assets.** Adequate maintenance of existing infrastructure and capital assets requires disciplined financial planning to enable periodic investments. Performance and continued use of capital assets is essential to providing basic levels of municipal service. Capital assets describes General Fund assets used in municipal service operations and have initial useful lives extending over many years. Capital assets of the General Fund include major government facilities (buildings, community centers, libraries), infrastructure (roads, storm drains, parks) equipment, vehicles, technology, fixtures and other physical assets that enable the city's workforce to deliver municipal services.

Section IV presents the strategies and recommendations the City needs to begin evaluating and implementing over time to begin progress towards helping the General Fund achieve structural solvency.

E. Service Solvency Findings (good financial sustainability)

Similar to achieving structural solvency, given the depth of the City's General Fund budget insolvency and the significant actions required to restore budget solvency, the City is years away from beginning to sustainably meet service solvency. As defined in the previous section, service solvency means achieving and sustaining service-levels desired by the community. Periodic improvements to a municipal service that are reversed or erode when revenues stagnate or decline, is not considered true service solvency. In fact, such actions usually have the opposite long-term effect on service levels. The increased labor costs from temporarily boosting service levels continues after revenues decline or are diverted elsewhere, necessitating deeper cuts to service levels to address the growing operating deficit.

Achieving service solvency is premised on the City implementing the principles of priority-based budgeting, full-cost accounting for municipal services and other long-term cost containment/resource allocation strategies discussed in Section IV. In taking these steps, once the City has achieved budget and structural solvency, these principles and practices will help prevent the City from unexpectedly backsliding while moving towards sustainably improving service levels and capital assets desired by the community, even during periods of economic stagnation or recession.

IV. Fiscal Stabilization and Financial Sustainability Recommendations

This report and its recommendations are heavily focused on actions that can sufficiently impact the City's current General Fund budget insolvency. UFI did not consider it valuable to review the myriad of typical actions that can possibly save the City thousands or even tens of thousands of dollars. It is not that these actions are not worthy or important to be undertaken – they are important and should be done. However, the City does not need a consultant to recommend typical "best practice" actions. There are dozens of resources available that identify how these practices can and should be implemented. Because collectively, these "best practices" will not add-up to the millions in annual savings and revenues required for the City to move the General Fund through its $8 to $10 million budget solvency and towards structural solvency.

It should be no surprise that most of the options and recommendations in this report are not easy to discuss, act upon or implement. They will require policy creation, spending discipline, renewed and aggressive cost-sharing negotiations, and tough prioritizations that will result in decreased support for certain services and programs, and the potential elimination of others for some period of time. Every option and recommendation will require a collective show of political will amongst all stakeholders from City staff and City Council to the public.

A. Recommendations for Budget Solvency

This year the City's General Fund will experience budget insolvency for the first time since it began to climb out from the Great Recession in FY 2012-13. This occurrence may not sound ominous until its understood how fast and deep the City is driving into budget insolvency. The Updated Baseline Forecast shows the General Fund has an annual operating deficit $8 to $10 million over the next ten years. This is not a one-year or short-term dip. The City is facing long-term sustained budget insolvency that will quickly deplete its $16 million in reserves within the next two years.

To restore General Fund budget solvency before the fiscal cliff in FY 2020-21, the City realistically has only three options:

1. Increase base General Fund revenues by $8 to $10 million annually;
2. Reduce General Fund operating expenses by $8 to $10 million annually; or
3. A combination of #1 and #2.

The primary reason the City has only three stark options to restore General Fund budget solvency is because the City has very little time to act with a significant structural deficit to fix. Two fiscal years is simply too little time to achieve $8 to $10 million in savings and/or revenues from other types of changes. In December 2017, when the Initial Baseline Forecast projected the City had four to five years of time, there were perhaps additional options that could be part of the budget solvency fix. Given the two-year time line created by changes in the last five months, those options are off-the-table and can only be considered for how to begin restoring structural and service solvency in the General Fund (discussed in the next section). To restore budget solvency, the City must act immediately on one or more the following options that results in major new base revenues or permanent cost reductions.

1. Revenue Increases of $8 to $10 million

To ensure the City is generating an additional $8 to $10 million annually in General Fund revenue prior to FY 2020-21, there are a limited number of options. Due to the very short-time and high need, the following revenue actions are not recommended as potential budget solvency fixes for the following reasons:

Revenue Options Not Recommended for Addressing the $8-$10 Million Budget Solvency Problem	Reason
General Fund Cost Recovery from Services/Benefits to Other City Funds	City has recently completed updates for the two largest General Fund cost-recovery and reimbursements mechanisms: an administrative cost allocation plan and an enterprise reimbursement model. Legally required changes during these updates resulted in reduced (not increased) revenues to the General Fund.
Update Existing or Adopt New User Fees	City has tended to consistently update its existing user fees for municipal services (e.g., recreation services, development services, permits, etc.). While regular updates should continue, the amount of additional new revenue resulting from these periodic updates is likely in the tens or hundreds of thousands of dollars, not the millions currently needed for budget solvency. Additionally, the City's current range of user fees is broad, and any new user fees that could be legally imposed would add only de minimis revenues to the General Fund.
Economic Development Activities and Projects that Improve the City's Tax Base	This is a long-term revenue augmentation strategy. Any particular project or set of activities is simply unable to quickly translate into a significant increase in the City tax base. Even for large-scale hospitality developments that raise property, sales, utility and transient occupancy taxes, the full tax benefits of these projects are not realized immediately and ultimately still represent only a very small fraction of the existing tax base.
Benefit Assessment District	A benefit assessment district requires that every parcel within the district must be identified as receiving a "special benefit" over and above the benefit the public generally enjoys from use of the revenue. Historically, assessment districts have been used for landscape, medians, parks and lighting. Requires weighted-voter approval. Very few established since laws changed in 1996 to make process difficult and complex. Due to City's relatively small General Fund expenditures for landscape, medians, parks and lighting, revenue generation from an assessment district would be insufficient compared to need and difficulty.

Community-wide Benefit Assessment	This assessment requires that revenues derived from the assessment be used to only fund new levels of service; the funds cannot be used to supplant funding providing current service levels. Thus, funds from this revenue measure could not be used to address the City's budget insolvency.

By necessity, the revenue options that can substantively address the budget solvency problem are new or increased tax measures. Unfortunately, the City is already utilizing most of the local tax measure options at rates similar or higher than surrounding communities. Below is a summary of the City's existing local taxes (excluding state sales tax and local property tax). We have not recommended marginal adjustments to these existing local taxes because either the additional amount of revenue would not be sufficient compared to the City's need, or adjustments would create or exacerbate a tax rate that is significantly higher than surrounding communities:

Existing Local Tax Measures	**City Rate**	**Surrounding Communities**
Utility User Tax (applies to all utilities except sewer and refuse)	9.0%	4.0% to 7.5% with various levels of applicability
Transient Occupancy Tax (hotel guests)	10.0%	9.0% to 11.0%
Real Estate and Documentary Transfer Tax	$2.20 per $1,000 in sale price	most at $0.55 per $1,000 in sales price
Business License Tax	rates and methods vary by business	rates and methods vary by business

Thus, the following are the recommended local tax options the City could use to generate new significant annual General Fund revenues by FY 2020-21 to help solve its budget insolvency:

a. Transaction and Use Tax *($7 to $10 million with majority voter approval)*

The Transactions and Use Tax (TUT) was created by the State of California in 1969, authorizing the adoption of local "transactions and use tax" added to the combined state and local sales and use tax rate. Prior to 2003, the most common TUT measures were for a specific countywide need, most commonly transportation. After the law was amended in 2003, cities and counties began to adopt TUTs for general fund purposes. In fact, over 170 cities and counties in California have adopted a TUT, most of which are for general fund purposes.

Currently, the base statewide sales and use rate is at 7.25 percent ("State Sales Tax"). The State Sales Tax rate includes portions that go to the state general fund, specific state and local programs, and 1% to the cities and counties based on the location of the purchase (often referred to as the Bradley-Burns portion of the State Sales Tax). In practice, the tax application and allocation for most retail sales will not differ between a TUT and the State Sales Tax. The TUT, however, applies to merchandise delivered into the jurisdiction that imposes the TUT. For example, in the case of a sale or lease of a vehicle, vessel, or aircraft, a TUT is charged and allocated based on the location in which the property is registered.

For the City, a TUT would be added to the current 9.5% sales tax applicable throughout Los Angeles County. Currently, fifteen cities in Los Angeles County (mostly in the southern and eastern areas) have adopted a TUT of either ½ or ¾ percent, for a total sales tax rate of 10% to 10.25%. The closest cities in Los Angeles County with an adopted TUT are El Monte and South El Monte. In San Bernardino County, all cities have a total sales tax rate of 7.75%, except Montclair and San Bernardino were the rate is 8% due to an added TUT.

Under current law, the maximum amount the City can adopt for a TUT is ¾ percent, which would create a total sales tax rate in Pomona of 10.25%. At this rate, the City's sales tax consultant provided a very rough estimate that the TUT could potentially generate additional new General Fund revenue of approximately $7 to $10 million annually. The City would need to place a TUT measure on the ballot for approval by the voters at the general election in November 2018, or during 2019 upon unanimous declaration of a fiscal emergency by the City Council and calling of a special election. The TUT measure would need to be approved by a majority of the voters.

b. Parcel Tax ***($3 million per $100 parcel tax with 2/3 voter approval)***

A parcel tax (otherwise known as a property tax override) is a special non-ad valorem (non-value based) tax on parcels of property. The tax is generally based on either a flat per-parcel rate or a variable rate depending on the size, use, or number of units on the parcel. Because a parcel tax is not based on the value of the property, it is considered a "fixed tax." Parcel taxes require two-thirds voter approval and are imposed for any number of purposes, including funding police and fire services, and neighborhood improvement and revitalization. Parcel taxes may be placed on the ballot for voter approval on any date allowed under state law or the City's charter.

The Los Angeles County Assessor's data shows the City has approximately 31,300 taxable parcels. If a flat per-parcel rate of $100 was adopted, the revenue derived would be approximately $3,000,000 after the costs of the County Assessor's administration and distribution (estimated at 3.0%). To ensure continued financial support for municipal services, the City may want to consider a floating rate which keeps pace with Proposition 13 limits and would supplement property tax revenues when Proposition 8 reductions are implemented. To fully address the General Fund's budget insolvency, the per-parcel flat rate would likely need to be $250 to $300 per parcel, unless combined with other revenue measures or cost reduction actions.

c. Extend Utility Users Tax ***($1.1 million with majority voter approval)***

The City currently imposes a 9% tax on all utilities, except refuse and sewer. This option is included because while it is not a new revenue source, extending the existing Utility Users Tax (UUT) to the City's refuse and sewer services would generate additional General Fund revenue. As noted above, the City's UUT rate is significantly above the rate of UUTs in surrounding communities. As such, only an extension of the UUT to City refuse and sewer utilities is recommended rather than a rate increase.

According to financial reports for the City's refuse and sewer enterprise funds, the City receives approximately $8.3 million in charges for refuse services and $4.3 million in charges for sewer services. If the current UUT was extended to the City's refuse and sewer services, the estimated additional revenue to the General Fund would be approximately $1.1 million annually. To fully address the General Fund's budget insolvency, the extension of the UUT would need to be combined with other revenue measures or cost reduction actions.

2. Cost Reductions of $8 to $10 million

This report is not intended to provide a full explication of the process and intricacies of how the City can sustainably reduce $8 to $10 million in General Fund costs. Instead, the report looks to frame the challenge and focus leadership on where it needs to focus in order to realistically help accomplish this difficult task.

Over the past number of years, the City has continued to cut and reduce its non-personnel operational expenditures to very minimal levels. As discussed above, an examination of departmental operational costs reveals the overwhelming largest expense category for the General Fund is labor costs. On average, departments spend 83% of General Fund monies for labor costs, with some departments exceeding 90% such as city administration, finance, police and city clerk. With so little General Fund monies being spent on non-personnel expenses (materials, equipment, facilities, and other capital), the City can realistically only focus on labor cost reduction strategies to address an $8 to $10 million annual operating deficit in the General Fund. The City can no longer expect or pretend that significant savings can be achieved looking elsewhere given the long-term deferred maintenance, repair and replacement of capital resources and other non-personnel inputs.

There are two basic strategies the City can realistically pursue to reduce its labor costs by millions of dollars before the fiscal cliff on the horizon in two years. If the City fails to adopt any of the revenue strategies discussed above, it will almost assuredly need to utilize both cost reduction strategies to achieve $8 to $10 million savings within this period. UFI has not attempted to place cost savings estimates on these strategies as each involves a series of staff recommendations, negotiations and actions that would significantly affect the amount of potential savings.

a. Restructure Delivery Model of One or More General Fund Services

Traditionally, cities have delivered municipal services to their residents and businesses through personnel directly employed by the city. Many older cities have continued to rely on this more traditional service delivery model, including the City of Pomona. While changing the service delivery structure has certain risks and contingencies that tend to limit the amount of savings that can be achieved (especially over the long-term), when facing the alternative of simply cutting current staffing and service levels, this strategy deserves some exploration. Below are two alternative models for delivering municipal services that could potentially be activated to some level within the City's two-year window of opportunity.

- **Consolidate or Regionalize Service Delivery.** By cooperating jointly with other entities to deliver a municipal service to a broader populace or region, there is potential to achieve some savings through efficiencies from scaled-economies of service inputs (both labor and capital), more rational geographic scope and scale for delivering the service, and broader spreading of administrative overhead. The City already participates in several cooperative arrangements for specialized/non-core municipal services such as police helicopter service, insurance, and public transit through its participation in joint powers agencies. More substantively, it participates in a regional fire service through its contract with County Fire Protection District. Extending this type of arrangement to other core municipal services requires staff to investigate whether there is mutual interest from adjacent agencies, and more importantly, whether there are any opportunities to create the aforementioned efficiencies. Some California agencies have found success in the consolidated regional delivery of the following municipal services which the City provides: parks and recreation, human services, code enforcement and library services.

- **Contract with Private Sector.** Since the 1980's, city governments in the United States and California have increasingly turned to the private sector for service delivery in an effort to increase economic efficiencies, reduce transaction costs and achieve overall savings while maintaining service levels. In some cases, the private sector may be better poised to leverage assets compared to local governments, and to be more flexible and responsive to changes in labor demands and costing. On the other hand, cities do not make a profit or pay taxes, and they can typically access capital at lower rates than the private sector. While assessments are mixed of whether greater efficiency and savings has been achieved through private sector contracting, this strategy is worth examination when the alternative is cutting staff and service levels.

  While the private sector provides opportunity to contract for almost all municipal services except public safety, there are some important considerations in evaluating which opportunities (if any) can potentially result in significant and sustained savings.

  - ✓ The City must have a good understanding of the total inputs and costs it incurs to provide the municipal service. This clear understanding is important for evaluating any potential savings and determining whether the City will continue to incur any non-contract costs. For example, the City will likely need some personnel to manage the private sector contractor, and to review the quality and performance of the work. Additionally, unfunded retirement liabilities will remain with the City after contracting but the City's retirement contributions for active employees (the normal costs) will diminish.

- ✓ The City must evaluate whether there is an active and competitive market of private sector providers of the particular municipal service. One of the primary reasons private contracting can help reduce costs while maintaining services levels is because it introduces competition into an otherwise monopolistic system of public service delivery. If, however, the marketplace of potential service providers is non-competitive because there are too few providers, then there is increased risk that initial low prices will simply continue an upward trajectory without the check of competitive market forces.
- ✓ The City must be capable of establishing good performance measurements for the municipal service and holding the private sector contractors accountable to the performance goals. Studies have found that as a municipal service involves more asset specificity and more measurement difficulty, the likelihood that municipalities contract this service out is lower. Performance-based contracts should be used as much as possible to place the emphasis on obtaining the results the City wants achieved, rather than focusing merely on inputs and trying to dictate precisely how the service should be performed.
- ✓ Finally, the City must be realistic on the overall cost savings that can achieved through contracting with the private sector for municipal services. For example, UFI did a high-level analysis of three major General Fund departments -- Neighborhood Services, Development Services and Public Works – to determine the total expenses in these departments that could be subject to savings from contracting with the private sector. In FY 2017-18, the combined budgets of these departments totaled approximately $12.4 million. The following departmental expenses were removed from potential savings because they would continue even if all department services were contracted ("retained costs"): existing contracted services, management required to oversee the contractors, capital costs assigned to the departments and City pension liability and retiree health expenses allocated to the departments. When "retained costs" were removed, the estimated total combined expenses in these three departments that could be subject to savings from contracting was approximately $5 million. If private contractors could perform all the services in these departments for 20% less than the City is currently spending (a significant cost differential), the total savings would be approximately $1 million annually.

b. Seek or Impose Labor Cost Concessions

Although this strategy is burdened with significant procedural requirements, legal limitations and potential pitfalls, it is important to evaluate whether certain existing labor cost components can be reduced through renegotiation and agreement with labor groups, or potentially through unilateral action by the City if necessary. Like all municipalities, the City attempts to provide a competitive package of salary and benefits to its employees. To attract and retain employees, it is important that City compensation levels are competitive in the labor-market. But the total cost of employee compensation must also be examined within the context of both what the City can sustainably afford currently and prospectively, and the broader total available labor market in both the public and private sectors.

There are a number of components that make-up an employee's total compensation and some components are protected as vested rights from being reduced or eliminated without an off-setting benefit (e.g., City pension plan, accrued vacation or leave, and other "contractual" terms and conditions). Nonetheless, the City should consult with expert legal and labor counsel as to options it may have within the next two years for potentially reducing the cost of the current total compensation it provides to employees. In the absence of such cost reductions or increased tax burdens on citizens (discussed above), the City may be left with the least-favored recommendation discussed in the next section.

c. Permanently Reduce General Fund Staffing and Municipal Service Levels.

In the hierarchy of cost reduction strategies, this recommendation is clearly at the bottom because of its high impact to both the community (which has already suffered under service insolvency for many years) and the affected city employees. If the $8 to $10 million budget insolvency cannot be resolved through some combination of the cost reduction and revenue strategies discussed above, the City will be left with only the strategy of permanently reducing staffing and municipal services to close the remaining gap.

It is beyond scope of this report to make specific recommendations on the staffing and service cuts that would be required to achieve savings of $8 to $ 10 million annually prior to FY 2020-21. The various options and permutations require careful evaluation by city staff, with input from elected leadership and the community, that balances various factors such as feasibility, timing, impacts to residents and businesses, and estimated savings. Below, however, are several recommendations and considerations to assist in this process:

- **Start Evaluating this Option Now.** If this option may be used as a last-resort by the City to solve its General Fund budget insolvency problem, the City should immediately begin evaluating and making a contingency plan of employee and service reductions even though its pursuing other preferred options. Not only is the process for identifying and assessing cuts potentially lengthy, by the time other options/recommendations are evaluated and attempted, there will likely be insufficient time to evaluate and successfully implement the cuts before the City arrives at the point of cash insolvency.
- **Priority-Based Budgeting.** To assist in evaluating potential impacts and savings from various staffing and service reductions, the City should consider moving to priority-based budgeting. Priority-based budgeting and its benefits are discussed in more detail in the next section. While full adoption of priority-based budgeting may not be achievable before the City needs to finalize its plan of cuts, the process of moving towards this goal

will help the City formulate a more thoughtful and sustainable plan of cuts, as well as a roadmap for eventually restoring service levels.

- **Scope of Required Cuts.** While the amount of cost reductions and/or new revenues obtained through other strategies will determine the extent to which staff and service reductions are required, it is important to understand from the outset the scope of cuts required to obtain significant cost reductions. Here are some estimated savings that help contextualize the impacts of aggregating $8 to $10 million in annual savings through staff and service reductions:
  - ✓ $2.7 million – close all General Fund supported programs, services and facilities within the Neighborhood Services Department;
  - ✓ $2.0 million – eliminate all General Fund monies for parks and community facilities, requiring closure of most parks and community facilities without maintenance or upkeep;
  - ✓ $1.3 to $2.2 million – close Fire Station (require renegotiation with LA County Fire District);
  - ✓ $1.0 to $1.2 million – eliminate Gang Suppression and Major Crimes Unit;
  - ✓ $1,000,000 – eliminate all Library services and close facilities;
  - ✓ $700,000 – eliminate all Code Enforcement activities; and
  - ✓ $500,000 – reduced demand for Internal Service Departments (IT, vehicle maintenance and administration) from staff and municipal service cuts.

B. Recommendations for Structural and Service Solvency

Structural solvency is the City's financial capacity to maintain basic levels of municipal service and to adequately fund existing infrastructure to ensure basic operational condition. Service solvency builds upon this structural stability of adequate service-levels and operational assets. Service solvency moves the City towards augmenting the services and assets most valued by the community and ensuring these improvements can be sustained. As discussed in the findings section of this report, the biggest challenges to the City obtaining structural and service solvency are:

- Balancing projected continued growth in labor costs with maintaining and augmenting the services most valued by the community;
- Dedicating sufficient funds to keeping existing infrastructure and assets operational and eventually augmenting those facilities desired by the community; and
- Developing sufficient operational reserves and capital capacity so improvements to services and facilities can be maintained and sustained through periods of economic and revenue stagnation and recession.

At its core, achieving structural and service solvency requires the City to develop and adhere to strong financial and budgeting policies and principals designed to optimize services that best meet the communities needs and priorities. Below are the recommendations that if implemented will facilitate the City achieving structural solvency and progressing towards service solvency.

1. **Implement Strong Core Financial Policies**

Progress towards structural solvency is difficult if not impossible if the City is continually struggling to maintain General Fund budget solvency. The following core financial policies are important so that once the City has restored budget solvency to the General Fund, it continues to follow practices and procedures in budgeting and decision-making that prevent unwanted "backsliding" during periods of economic stagnation or recession.

- **Reserve Policy.** Most cities maintain multiple funds based on different revenue sources and requirements. Because there are risks (both known and unknown), it is important that reserve levels in all funds be maintained as a hedge against such risks. Without proper reserves, there can be major disruptions in services when unforeseen financial demands emerge that require immediate diversion of resources. For the General Fund, different types of reserves should be maintained, including an economic uncertainty reserve (sometimes called a contingency) to provide a cushion for unexpectedly low revenues in any given year and for other emergency needs that arise. To establish appropriate levels and allocations of reserves, the City may consider engaging the GFOA's Research and Consulting Center which has been working with local governments in the area of risk-based reserve analysis since 2008.
- **Use of One-Time Resources.** Periodically, the General Fund is the beneficiary of one-time resources from revenue spikes, budget savings, sale of surplus equipment and/or property or other similar nonrecurring event. It is recommended the City adopt a policy to prevent the use of one-time resources for current or new ongoing operating expenses, and instead dedicate one-time resources to building reserves, retiring debt early, prepaying long-term liabilities, capital expenditures that do not increase operating costs or other nonrecurring expenditures.
- **Continually Update Fees and Cost Recoveries.** While the City has recently updated its administrative cost allocation plan and cost recovery methodologies for the General Fund, it is important the City adopt a policy that ensures future updates occur at regular intervals. This policy should include all fees (including development impact fees) and where appropriate ensure the use of appropriate inflationary indexes and variables to prevent under-collecting and subsidy between updates. As a general rule, if appropriate indexes and variables are used, the time period between updates should not be greater than three to five years.
- **Multi-Year Financial Forecasting.** To ensure current budget decisions consider future financial implications, the City's long-term financial forecast should be utilized by city staff

and City Council as a continual decision-making tool. Any new or major changes to services or programs, or any budget revisions, should include an analysis of the impact on the forecast out-years. If a revision creates a negative impact on the forecast, a funding plan should be developed and approved to offset the impact. The baseline forecast should be updated semi-annually to reflect changes in revenues and unexpected changes in expenditures. The forecast should be presented to the City Council for discussion and to provide information to the public.

2. Move to Priority-Based Budgeting

In periods of fiscal constraint or revenue decline, the traditional budget process typically continues funding the same services it funded last year, albeit at the same or reduced level (e.g. across-the-board budget cuts). Similarly, during periods of revenue growth or receipt of one-time revenues, traditional budgeting allocates increased funding to various departments, often to “restore” previous across-the-board cuts. The result is a continuing see-saw of municipal finance expansion and contraction, disconnected from why the municipal services exist, the full cost of the services, and consequently, what relative value the services provide to the community.

The underlying goal of priority-based budgeting is simple: to help a city invest its available resources to best meet the community’s stated objectives. To achieve this goal, priority-based budgeting provides elected officials with better and more relevant data for informed decision-making, meaningfully engages citizens in the budgeting process, and avoids the pitfalls of basing the "new" budget on revisions to the "old" budget. This holistic approach to municipal finance helps the community identify and enhance the services it most values. The principles associated with priority-based budgeting are as follows:

- **Prioritize Services Based on Community Priorities.** Priority-based budgeting starts with identifying core community needs and priorities, and then evaluates the relative benefit/value each municipal service (rather than entire departments) provides towards meeting the community needs and priorities.
- **Spend Within the City’s Means.** Priority-based budgeting begins with total revenue available to the city, rather than last year’s expenditures, as the basis for decision-making. It focuses on ensuring funding decisions are based on the true cost of providing a service.
- **Do the Important Things Well; Cut Back on the Rest.** In identifying the services most valued by the community, priority-based budgeting emphasizes continued strong funding for those services, while reducing service levels or potentially eliminating lower-value services.
- **Transparency of Community Priorities and Accountability for Service Results.** By basing budget decisions on well-defined community priorities, city spending decisions are less open to interpretation. By focusing city services on how well they advance community priorities, accountability for results is easier to ascertain and support.

The above principles were adapted from materials and information provided by the Center for Priority Based Budgeting and the Government Finance Officers Association (GFOA), both of which can provide the City strong guidance, steps and practices for moving to priority-based budgeting.

3. Adopt Labor Cost Containment Strategies

With between 80% to 85% of current General Fund expenditures going to labor costs, any improvement and sustainment of increased municipal service levels will by necessity involve additional costs that are primarily related to personnel. Moving the City towards structural and service solvency requires very careful attention and dedication to labor cost containment strategies.

- **Total Compensation Approach to Labor Costing.** Negotiations for any increase or change to employee compensation should utilize "total compensation" bargaining concepts that examine and include all components of compensation, including "salary equivalent" compensation. These compensation components include: base salaries, step increases, special pay, vacation and leave allowances and cash-out policies, health benefits, employer pension contributions, and built-in cost adjustments. The City should also evaluate and consider how to "monetize" the value of non-economic improvements to employee working conditions as part of the total compensation approach. Potential changes to any form of compensation should be first modeled through the Baseline Financial Forecast to ascertain affordability to the municipality, within the context of expected revenues. Particular attention should be given to fully-costing any proposed adjustments to compensation that are pensionable (salaries, special pay, etc.), and priority should be given to adjustments or improvements to components of compensation that are not pensionable.
- **Modernize Salary Step Adjustments.** Traditional public agency salary schedules with an average of five or six steps within each employment classification range were developed before the onset of widespread collective bargaining. These steps were intended to provide an opportunity to reward employees annually for their performance and for the growth of their experience and productivity as they become more effective on the job. The increases are often known as merit increases, but many are implemented automatically. Consequently, it only takes three and a half to four years for the employee to get to the top step. During this period the employee is typically awarded a step increase, and if available, cost of living adjustments negotiated by their bargaining group. Because of this practice, new employees often receive significant pay increases raises in just the first few years of their employment with the City. A 10 to 15 step range for management and non-management employees would reduce the City's costs and could spread the opportunity for performance increases over six to nine years rather than the current three and a half to four years. Such a change in the salary schedule would need

to be negotiated with each of the City's bargaining units and would be considered by both sides as part of the total compensation package during negotiations.

- **Pension Cost Containment.** There are two primary components of the City's annual pension contribution payment: (1) the "normal cost" which is the amount required for proper funding of the retirement benefit provided to current employees, and (2) the "unfunded actuarial liability" (UAL) cost which is the amount required to ensure the City's pension plan can pay all obligations to all retirees when due. The normal cost portion of the City's pension contribution is a function of the City's current payroll and the terms of its pension plan. The more employees and higher salaries paid, the greater the City's normal cost. Thus, while working to stabilize and improve services, the City can control its normal cost by optimizing its employee's productivity, and more importantly, adhering to the total compensation principles discussed above, including minimizing pensionable components of compensation for current employees and ensuring pension plan terms are included as part of the City's total compensation approach (especially for new employees).

  For the UAL component of the City's contribution, the City has less control because actuarial assumptions largely drive the UAL (see discussion in Section II of this report). To help cost-contain its UAL, however, the City has several options it should evaluate and consider. First, as discussed in Section II, every time the City's pension plan experiences a loss in value, the City's payment to restore the value (and fiduciary soundness of the plan) is spread over a period of time – called an "amortization period." Amortization of the loss helps the City avoid dramatic swings in its annual pension contribution. But this stability comes with a long-term cost. Just like a home mortgage, the total cost of a 15-year mortgage is always significantly less expensive than a 30-year mortgage because of the time value of money. Similarly, if the City is able to pay for an amortized loss in its pension plan more quickly, it will save significant overall costs. This "prepayment" of the pension UAL is often a good use of one-time revenues and/or could be part of an overall reserve policy (both discussed above). More importantly, prepayment of the pension UAL should be considered a component to "total compensation" for employees, as helps to secure the future integrity of the employees' retirement benefit.

4. Develop and Maintain Comprehensive Asset Management Program

Structural and service solvency require a growing commitment to ensure adequate funding is dedicated to keep existing infrastructure and assets operational, while also implementing appropriate long-term financial plans for the full replacement and improvement of the capital assets identified as most valued by the community. While the City currently annually updates a Five-Year Capital Improvement Plan (CIP), this document is focused on the funding and construction status of capital construction projects across all funds in the city. Missing from the City's current CIP process is a regular holistic (citywide) capital needs assessment and costing, and prioritization of capital investments in alignment with community identified objectives and values.

To this end, the City should annually prepare a Citywide Capital Asset Management Report for presentation and consideration by the City Council prior to the annual budget and CIP discussions. The report would provide a "city-as-a-whole" perspective for capital assets and would include the physical assets of all services and programs that rely on capital assets for service delivery. The report would provide an accounting of the number, condition and replacement-value of existing capital assets, and an assessment of current service levels supported by the capital assets, and the costs of unmet needs. The report would also identify the amount of funding needed on an annual basis to keep the capital assets from deteriorating or becoming non-operational, and the annual funding gap over current service levels needed to bring assets up to a sustainable level of maintenance, repair and replacement.

The timing and delivery of this report will enable the City Council to consider how to address the identified capital funding needs when adopting the annual General Fund budget. This Citywide Capital Asset Management Report is especially integral to implementing a priority-based budgeting process discussed above, because it allows funding for community-valued services and assets to be optimized.

V. Conclusion

In order to achieve fiscal stability and financial sustainability for the General Fund, the City will need to take bold, decisive action to implement changes. The required actions and changes, especially those required to restore General Fund budget solvency, must be commenced immediately. The City has less than two years to correct the General Fund's budget insolvency before the General Fund faces a fiscal cliff and potential cash insolvency. The recommendations in this report will assist the City in realigning General Fund annual revenues with annual expenditures to restore budget solvency and to establish a basic level of fiscal stability. Moving the City beyond basic fiscal stability toward long-term financial sustainability and economic resiliency, however, will require a shared culture of partnership and commitment to engagement, transparency and fiscal discipline among the City Council, staff and community.