CITY OF TEMECULA
AGENDA REPORT

TO: City Manager/City Council

FROM: Jennifer Hennessy, Director of Finance

DATE: November 29, 2022

SUBJECT: Receive Presentation on the City's Fiscal Strategy Update (At the Request of Subcommittee Members Mayor Rahn and Council Member Edwards)

PREPARED BY: Jennifer Hennessy, Director of Finance
Ward Komers, Assistant Director of Finance

RECOMMENDATION: That the City Council receive the presentation on the City's Fiscal Strategy Update and discuss the conceptual strategy related to the paydown of the City's debt and unfunded liabilities.

BACKGROUND: The City of Temecula has a long-standing history of solid financial responsibility and managing the City's resources in a prudent, fiscally conservative manner. Over the past decade, several measures have been implemented to strengthen the City's fiscal position, create ongoing budgetary savings and leverage outside grant opportunities to enhance the City's infrastructure and quality of life for its residents.

The attached Appendix A provides an infographic depicting the budgetary and economic growth the City of Temecula has experienced, as a result of prudent fiscal management. Most notably, the General Fund/Measure S Budget has grown by nearly 125%, General Fund Reserve levels have doubled, Capital investment has increased over 80% and Asset Management Funds have quadrupled in the past 10 years, while staffing levels have increased by a conservative 25%.

<u>10-Year History of Fiscal Strategies</u>

- Established Fiscal Policies
    - Define eligible uses for General Fund Reserves and increase from 20% to 25% of Operating Expenditures
    - Define uses for General Fund Unassigned Fund Balance
    - Appropriation guidelines for Measure S revenue
    - Contingency Plan in the event of unfavorable economic impacts
    - Establish, and fund, Asset Management/Replacement Funds
    - Pension Rate Stabilization Policy
    - Investment Policy (results of which are provided in further detail below)

- Balanced budgets with reserves fully funded
    - Revenues continually exceed expenditures (actuals & projected)
    - Fund Balance exceeds 25% of Operating Expenditures
- Executed cost-sharing agreements
    - TVUSD – shares 50% of School Resource Officers (~$440k/year)
    - Riverside County – shares 50% of Fire Station 95 staffing (~$800k/year)
    - Riverside County Flood Control – contributes annually for homeless encampment clean-up efforts ($75k/per year)
- Leveraged grant-funding
    - 70% of Capital Improvement Program funding over past 10 years has come from outside City-funded sources, through grants and outside contributions ($955M)
- Completed strategic acquisitions
    - Streetlight acquisition and LED retrofit ($750k/year)
    - SMER Solar Power Purchase Agreement (future savings of $40k/year)
- Refinanced debt to create taxpayer savings
    - CFD Bonds – average homeowner savings per parcel of $260/year
    - Tax Allocation Bonds – ongoing savings of $60k/year
    - Civic Center Loan – ongoing savings of $32k/year
- Established, and funded, future asset replacements
    - Fleet, Facilities, Technology, Support Services, Street Maintenance, Fire Facility Acquisition Funds – increase of $12.4M in 10 years
- Mitigated rising CalPERS pension costs
    - Established Internal Revenue Code Section 115 Irrevocable Pension Trust to be used to pay CalPERS pension costs. Current Trust balance of $16M
    - Prepaid annual CalPERS Employer Contribution ($93k/year)
- Ensured competitive wages and benefits
    - Conduct periodic compensation surveys to ensure competitive wages, and include cost-of-living-adjustment in labor agreements to keep pace with inflation

Through the various measures and strategies implemented over the past decade, a significant amount of budgetary savings has been achieved, averaging nearly $2.2 million per year, and are summarized in Appendix B. Through a decade of intentionality, the City has created excess budgetary reserves that can be used to strategically pay down ongoing debt obligations, which will further increase annual resources to invest in the City's infrastructure, programs and services to meet the diverse needs of the community.

Debt/Liability Paydown Strategy

In response to the City's history of fiscal strategies, at the Fiscal Year 2022-23 Budget Workshop in May 2022, the City Council discussed the concept of paying down the City's debt and unfunded liabilities. Staff committed to develop a strategy and return to the City Council for further discussion. Staff has worked collaboratively with the Council's Strategic Fiscal Ad Hoc Subcommittee (Mayor Rahn and Council Member Edwards) to develop a comprehensive

Debt/Liability Paydown Strategy. The strategy presented below reflects the payoff of all debt and unfunded liabilities within 7 years, given the City's current fiscal position. As the economy changes, the paydown strategy may be revisited and modified to ensure the City remains in strong fiscal position while addressing its outstanding debt.

- *City Debt -* The City currently has only two debt issuances in the form of private placement loans on the Civic Center and the Margarita Recreation Center (MRC). The Civic Center loan has an outstanding balance of $12,774,000, with annual debt service of approximately $1.6 million. The loan matures on 12/1/31. The MRC loan has an outstanding balance of $5,077,617, with annual debt service of approximately $556,000, and the loan matures on 9/1/33. Staff has worked with the bank to negotiate an early payoff in December 2022, which would save over $3.2 million in total interest payments over the remaining life of the loans. Paying these loans off in full will generate an additional $2.1 million per year in available funding which may be utilized to expedite the paydown of the City's pension liability.

- *City Pension Liability -* The City's pension program is funded through CalPERS, and has an unfunded liability of $46,364,142, as of 6/30/20. The annual payment required for the unfunded liability ranges between $4-5 million and is scheduled to be paid off in 25 years. The unfunded liability consists of 29 separate "amortization bases," which reflect historical gains and losses from CalPERS' actuarial projections. Each year, CalPERS revalues the City's pension plan and determines the annual contribution necessary to fund the plan and paydown a portion of the unfunded liability. Each new amortization base is spread over a 30-year time horizon for gains and a 20-year time horizon for losses, per CalPERS policy. CalPERS allows agencies to make "Additional Discretionary Payments" (ADPs) to reduce the unfunded liability quicker by paying it off earlier and save interest costs (similar to paying off a mortgage early). With the excess Fund Balance and through the establishment of the Pension Trust, the City has built up adequate reserves to fund ADPs and reduce the City's unfunded liabilities, saving between $905k in Year 2 up to $5.6M in Year 8, plus millions of dollars in accrued interest.

- *City Other Post-Employment Benefits (OPEB) Liability -* The City established an OPEB Trust in 2008 with the California Employers' Retiree Benefit Trust (CERBT), a division of CalPERS. The Trust was established primarily to fund the cost of the retiree health benefit afforded to eligible City employees hired prior to 6/30/05 with 12 or more years of service. Additionally, the OPEB Trust pays for the annual service fees for CalPERS Health and the ongoing implied subsidy, required by the Governmental Accounting Standards Board (GASB). Effective June 30, 2022, the Total OPEB Liability is $20.6M, with total Trust balance of $16.6M, leaving an unfunded liability of $4.0M. However, the investment losses experienced during Fiscal Year 20-21-22 are not reflected in these amounts. Once the losses are reflected, the estimated unfunded liability is $5,361,000 as of 6/30/22. The annual contribution to the OPEB Trust is approximately $645,000.

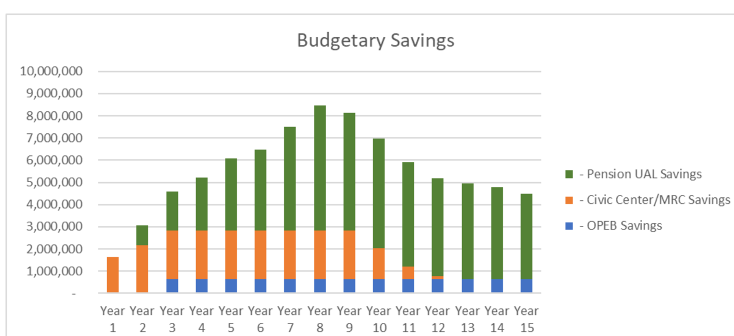
Staff has developed a conceptual Debt/Liability Paydown Strategy, whereby the available fund balance within the General Fund is combined with the resources in the Pension Trust to pay off the City's outstanding debt and unfunded liabilities. The current amount outstanding is $69.5 million. With the Debt/Liability Paydown Strategy, all outstanding amounts would be paid off in 7 years by FY2028-29, without utilizing General Fund Reserves.

Debt/Liability Summary				
	Amount Outstanding	FY2022-23 Operating Cost	Status Quo Payoff Date	Years Until Payoff
OPEB (UAL)	5,361,000	645,000	FY2042-43	21
Civic Center	12,774,000	1,603,835	FY2031-32	10
MRC	5,077,617	555,808	FY2033-34	12
Pension (UAL)	46,364,142	4,460,315	FY2046-47	25
Total	69,576,759	7,264,958		

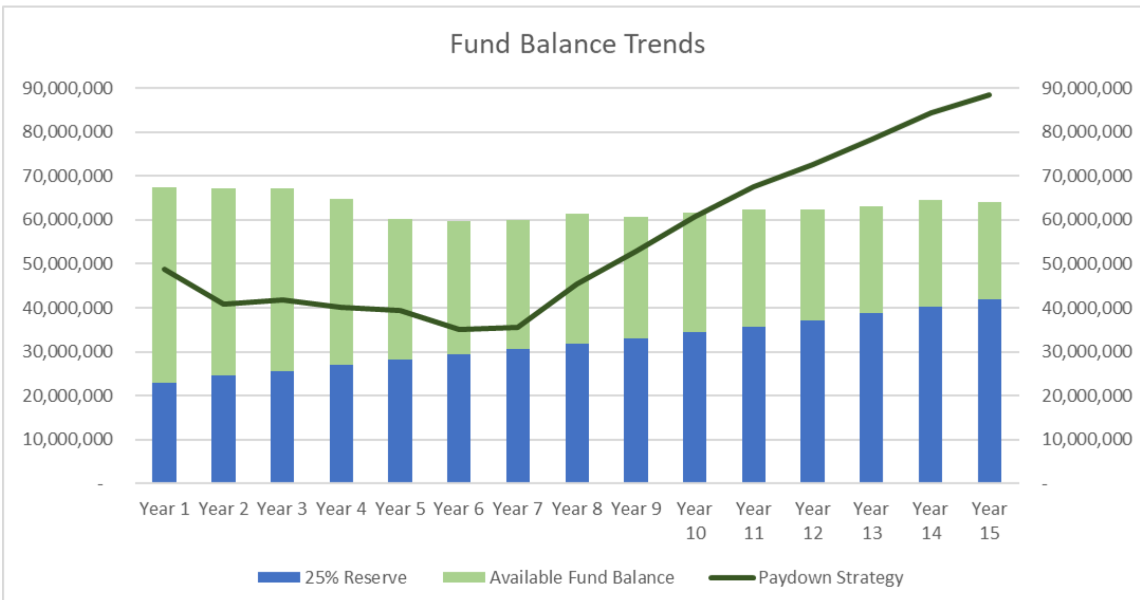
Below is a table illustrating the cash flow by fiscal year assumed in the Debt/Liability Paydown Strategy, and the corresponding budgetary savings created by paying off the debt.

		Funding Sources		Payoff Schedule				Annual
Year #	Fiscal Year	Pension Trust	Available Fund Balance	OPEB Liability	Pension Liability	Civic Center Loan	MRC Loan	Budgetary Savings
1	2022-23	5,000,000	20,278,594		7,248,977	12,952,000	5,077,617	(1,620,001)
2	2023-24	5,000,000	10,982,828	5,361,000	10,538,003			(3,069,564)
3	2024-25	5,000,000	3,223,220		8,234,950			(4,585,647)
4	2025-26	2,000,000	5,498,008		6,819,012			(5,224,588)
5	2026-27		2,680,009		2,178,158			(6,067,321)
6	2027-28		10,788,263		10,204,668			(6,487,782)
7	2028-29		8,330,579		7,430,035			(7,519,736)
8	2029-30							(8,471,321)
9	2030-31							(8,137,447)
10	2031-32							(6,966,787)
		17,000,000	61,781,501	5,361,000	52,653,803	12,952,000	5,077,617	(58,150,194)

As the debt and unfunded liabilities are paid off, the annual debt service is reduced, creating ongoing annual budgetary savings, which can be used to further accelerate the paydown of outstanding liabilities. For example, paying off the Civic Center and MRC debt creates $2.1 million in budgetary savings, which when applied to the outstanding pension liability, pays the debt down more quickly. Moreover, and perhaps most significant, is that once the debt has been paid off, the budgetary savings can be reallocated to meet the needs of the community. The chart below illustrates the annual savings generated by this plan. The budgetary savings peaks in Year 8 at $8.4 million, then tapers off as the existing Civic Center and MRC loans mature in Years 10 and 12, respectively. The savings generated by removing the OPEB and Pension unfunded liability payments is ongoing.



To develop the Debt/Liability Paydown Strategy, a 15-year Financial Model was created for the General Fund. In the following chart, the columns show the Available Fund Balance (green) and 25% Reserves (blue). The green line in the chart illustrates the impact on the Available Fund Balance after implementing the Paydown Strategy. The first six years of the plan utilizes the majority of the Available Fund Balance to pay off the outstanding debt/liabilities. Beyond Year 7, all debts are paid off, the Available Fund Balance is restored and escalates at a much faster rate because of the reduction in annual debt service payments. By Year 15, an additional $26 million in Available Fund Balance would be generated, all while the 25% Reserves stay fully funded throughout the implementation of the Paydown Strategy. The additional Fund Balance would be available to fund one-time projects outlined in the updated Quality of Life Master Plan.



As with any financial projection, the assumptions built into the projection will be evaluated each year and the projections will be updated based on any changing conditions. The potential negative impacts to this plan include the state of the economy, pending recession, or declines in revenue. If the investment returns at CalPERS do not meet expectations, the unfunded liability amount increases. If we experience a decline in revenue or the investment returns in our Pension Trust decline, our ability to fund the debt/liability paydown decreases. For these reasons, it will be critical to monitor the Debt/Liability Paydown Strategy and update the plan accordingly as conditions change.

If the Council approves of this conceptual plan, staff will bring a recommendation to Council to execute the Civic Center and MRC loan payoff at the December 13, 2022 meeting, as well as a Resolution to utilize the Pension Trust and the necessary budget adjustments to paydown the unfunded liabilities outlined in the plan for Fiscal Year 2022-23. Additionally, a revised Budget Policy will be presented to memorialize the Debt/Liability Paydown Strategy, including key milestone dates of when the plan would be revalued and updated to reflect the state of the economy and the City's available funds.

City's Investment Program Update

At its June 14, 2022 meeting, the City Council adopted a revised investment policy. This policy reflected revised allowable investments and incorporated best practices as recommended by the California Municipal Treasurers Association (CMTA) and the California Debt and Investment Advisory Commission (CDIAC). Importantly, the investment policy affirmed the three primary goals of the investment program:

1. *Safety of principal* - achieved by ensuring that losses are avoided, whether from securities default, broker-dealer default, or erosion of market value. This is accomplished by selecting highly rated, investment grade securities and by structuring the portfolio such that securities do not need to be sold at a loss.

2. *Liquidity* - achieved by maintaining sufficient cash balances to cover operating expenditures and is segmented in the City's "liquidity portfolio."

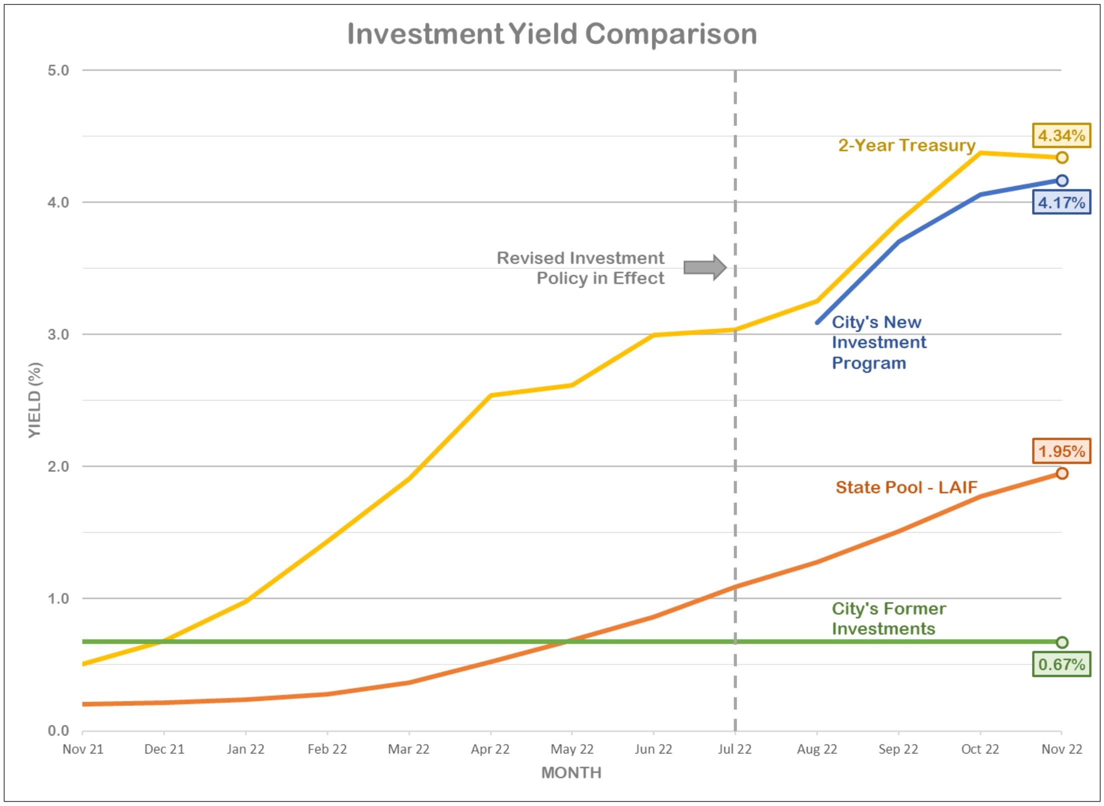
3. *Return on investment* - achieved by purchasing securities that align with the current market-average rate of return and is segmented in the City's "long-term portfolio."

Together, the liquidity portfolio and the long-term portfolio create the total portfolio for the City.

As of June 30, 2022, the City's total portfolio had a market value of approximately $153.7 million. The liquidity portfolio had a market value of more than $135 million, which was invested in the State's Local Agency Investment Fund (LAIF). The LAIF program offers local agencies the opportunity to participate in a major investment portfolio using the expertise of the State Treasurer's Office professional investment staff. Currently LAIF has more than 2,300 participating agencies and $28.6 billion under management. While investments held by LAIF are safe and liquid, investment returns are comparatively low. In addition to the liquidity portfolio, the City's long-term portfolio had a market value of $18.7 million, invested in U.S. agency obligations, including bonds issued by the Federal Farm Credit Bank and the Federal Home Loan Mortgage Corporation.

With the change in the interest rate environment, Finance staff re-evaluated and established the risk and return objectives for the investment program. The first part of the evaluation was to determine the appropriate size of the City's "liquidity portfolio." As previously discussed, a liquidity portfolio includes cash and other highly liquid investments that are readily available to cover operating expenditures. Accordingly, a cash flow analysis was performed to estimate the City's liquidity needs. This analysis found that the City's cash flow is seasonal, with the greatest cash needs occurring between June and December of each year. In addition, the analysis found that roughly 88% of the current portfolio was liquid.

After Council approved the revised Investment Policy in July 2022, Finance staff implemented the strategy in August by systematically withdrawing funds from LAIF and investing them in higher yielding instruments. Using the 2-year U.S. Treasury yield as a benchmark, investments were made in eligible diversified sectors including corporate bonds, US Agencies, US Treasuries, and Supranationals. As of November 2022, the total portfolio has achieved a balance of 65% liquid ($101.4 million) and 35% long-term ($54.8 million). The weighted average yield of the new investments in the long-term portfolio ($30.6 million) has risen to 4.17% (as illustrated by the blue line in the chart below), more than double the current LAIF yield of 1.95%.



In dollar terms, the difference in yield results in an additional $56,000 in interest earnings per month to the City. Under current market conditions, and when the investment program is fully implemented, it is estimated that the new investment program will return an additional $93,000 per month to the City in interest earnings.

FISCAL IMPACT: No fiscal impact at this time.

ATTACHMENTS: Appendix A – Temecula 10-Year Comparisons
Appendix B – Summary of Strategic Fiscal Measures