November 5, 2015

TO: Programs and Administration Committee
Planning and Organization Committee/Recycling Board

FROM: Gary Wolff, Executive Director
Wendy Sommer, Deputy Executive Director

SUBJECT: Pension Liability Payoff and a Related Schedule Proposal

BACKGROUND:

Our Agency, like most in the State, has a pension liability balance. This balance is often referred to as an unfunded liability, but it is actually being paid off within our core budget as part of our annual payments to PERS. According to the actuary at CalPERS (PERS) that handles our account, entities in a risk pool such as ours were not allowed to pay off any unfunded pension liability prior to fiscal year 2015-2016 (FY15-16), other than a side pension fund we paid off in 2011 (created in 2003 when we joined a pool).

Government Accounting Standards Board (GASB) Rule 68 now requires that public agencies include this part of our pension liability in their audited financials, beginning with the just completed fiscal year (FY14/15). The preliminary net position of the Agency (assets minus liabilities) as of June 30, 2015, after accounting for this liability, is about $47 million, so our balance sheet is still strong.

In prior years the liability being created as employees earn more service credit each year, and the previously accrued unfunded pension liability, have been rolled into a single payment expressed as a percentage of payroll. FY15-16 is the first year in which PERS has separated the "normal" payment for liability being created in that year from the payment for previously accrued, but not yet fully funded, liability. In addition, the normal pension payment is still listed as a percentage of payroll (10.1% in FY15-16), but the accrued unfunded pension liability is now paid as a lump sum each year. The lump sum payment in FY15-16 is about $209,000. PERS has projected lump sum payments for FY16-17 through FY20-21 as about $244,000, $281,000, $320,000, $361,000, and $370,000 respectively. These payments include interest at 7.5%, the assumed rate of growth of the PERS investment portfolio.

The size of the previously accrued unfunded pension liability varies from year to year primarily because the investment portfolio return varies. PERS smoothes the impact of each year's variation by recognizing 1/5 of it in the year it occurs and each of the next four years; nonetheless, the impact of year to year market fluctuations can be large. For example, our accrued pension liability as of 6/30/13 was about $4.8 million but was only about $3.5 million as of 6/30/14. $3.5 million is the lowest amount reported in the last four years; $4.9 million is the highest. This variation occurs even if the portfolio earns 7.5% on average.

In addition, if the long-term rate of return of the portfolio is higher or lower than 7.5%, our accrued unfunded liability will be lower or higher. For example, the $3.5 million liability as of 6/30/14 would be about $6.2 million if the long-term future average annual rate of return is only 6.5%; and only about $1.2 million if the future average annual rate of return is 8.5%.

Over the 20 years ending June 30, 2015, the preliminary reported PERS portfolio return has been 7.76% per year. The preliminary reported return in FY14/15 was only 2.4%, but the preliminary reported portfolio returns in the three and five year periods ending June 30, 1015 were 10.9% and 10.7%, respectively.

"PAYING DOWN" VERSUS "PAYING OFF" THE LIABILITY

These factors make it difficult to entirely "payoff" pension liability. Paying down the liability reduces the interest payments on it, but might not pay it off entirely if the average long-term rate of return on the PERS portfolio falls by even one percentage point per year. And if we pay in "too much" because the portfolio does better than expected, we cannot get the excess back again or use it to reduce our normal annual (percent of payroll) payment. That is exactly what has happened (so far) with our OPEB trust account, which is super-funded by about $400,000 as of 6/30/14, due to strong recent portfolio gains.

However, paying down the previously accrued pension liability by $3.5 million would save us more than 7% per year on $3.5 million (at present) because we earn less than 0.5% per year on our funds held in the County investment pool or in LAIF (the Local Agency Investment Fund). This action would also reduce our annual future payments to PERS by $200,000 to $300,000 per year. (Because they use a '5-year ramping up' formula for the unfunded liability payments, the savings will vary by year.) Paying down by that amount will likely not be “too much” given that $3.5 million is the smallest liability reported by PERS to us in recent years.

DISCUSSION OF OPTIONS TO REDUCE ("PAY DOWN") THE PREVIOUSLY ACCRUED PENSION LIABILITY

Staff committed during the budget process in April and May that we would develop a proposal for partially or fully paying down the previously accrued pension liability, in November or December, 2015. The *first option* is the simplest. We can very likely pay down the liability by up to $3.5 million without impairing our reserves or our ability to sustain the core budget for the next three fiscal years (that is, through 6/30/18). The conservation easement we recently agreed to sell will likely bring in $2.9 million by September 2016. And the fiscal reserves held by the two Boards can reasonably be reduced by at least $0.7 million.

The fiscal reserves were created in 2010 and were sized so that there was a 97.5% chance -- based on statistical models of landfilled tons subject to our fees -- that the reserve would not be needed in the 18 months following the start of each fiscal year. Since any fee action affecting member agency solid waste rates, adopted during a budget process in the spring, cannot take effect any sooner than the following January 1st, under the Joint Powers Agreement (except in an emergency, for which a special procedure exists), 18 months of fiscal reserve allows the agency to not need to consider budget cuts during a budget year unless revenues fall far, far below projections.

We have reviewed the fiscal reserve size every year and reported in the last few years that it may be larger than necessary. However, given the slow speed and fragility of the economic recovery we've held off on taking any action. Resizing to account for the newest data, the end of import mitigation fees from San Francisco around the end of this calendar year, and our practice in the last two fee actions of implementing them the following July 1st rather than the following January 1st, indicates that the reserve could be reduced to $2.1 million from $2.8 million. Sizing the reserve to fund two years of revenue shortfalls rather than 1.5 years provides a margin of safety beyond the 97.5% statistical criteria.

A ***second option*** is to repurpose a part of our other designated reserves, such as the two organics processing development reserves, which together have a balance of about $7.1 million. (We also have some contractual reserves, but the funds in them are committed by contract to specified purposes, and cannot be re-allocated unless they are unspent when the contract to which they are committed expires.)

This option may be feasible since there are at least two composting facilities being developed in-County with private funds, and the anaerobic digestion facilities at EBMUD are being expanded. Our reserve funds do not seem to be necessary to directly fund these facilities. On the other hand, it would be premature to commit funds from this reserve to paying down the pension liability. We recommend a project in FY16/17 that reviews progress under the strategic plan, with a primary focus on organics diversion and any infrastructure needed to support that (not just composting facilities), followed by reconsideration of using some of this reserve to pay down the pension liability in the Spring of 2018. This recommendation is placed in an overall schedule in the next section of this memo.

A ***third option*** is to use some of our account balances. Account balances are revenues received, but not yet authorized for spending or transferred into a reserve. Some account balances, however, are restricted to specified uses and cannot be spent directly to paydown the pension liability. For example, the household hazardous waste account balance must be used to support the countywide household hazardous waste program, and the revolving loan fund balance is restricted to making loans (unless the Recycling Board was to discontinue the loan program).

The core budget scenario presented in April 2015 along with the budget proposal showed that our account balances, if not used for pension paydown (option 3), are likely adequate to support a deficit budget at about the current level ($11.4 million), plus 2.5% each fiscal year, through at least the end of FY18/19 (three more fiscal years). We've updated that scenario to account for actual revenue and spending in FY14-15, landfill tonnage data since the budget was prepared, the adoption of AB901, and other factors, and it shows essentially the same result. (See Figures 1 and 2).

Although one could use the conservation easement payment and reduced fiscal reserve balance to extend the date by which a fee action or spending cut will be needed to balance the core budget, doing so would allow the deficit to continue to grow. Approving a deficit budget for two or even three years may be reasonable, but operating with a growing deficit for more than three years seems unreasonable.

There are *other options* for paying down the pension liability, but they involve "last-resort" types of decisions that do not seem necessary, such as: 4) selling assets (e.g., our land in eastern Alameda County), 5) borrowing at a lower interest rate than we pay PERS (e.g., use our line of credit on 1537 Webster Street), 6) reduce total compensation to staff by either increasing the staff salary contributions to PERS or reducing one or more benefits, or 7) raise fees.

Option 4 is not feasible unless we are sure we will not need reserve landfill capacity in the future, which we cannot be sure of at present.

Option 5 is inferior to other feasible options because the rate we would pay for a loan is significantly higher than the rate we can earn on funds in hand. This means it is far less expensive to pay down the liability from funds on hand, if feasible, than to pay down the liability by borrowing.

Option 6 seems to contain some inherent inequities, and would experience a reduced funding base over the time period that would be required to substantially paydown the pension liability (20-30 years). To see the equity concern, consider two employees with the same salary that are required to contribute the same additional amount to paydown the liability (e.g., 1% of salary), but if one has been employed here for 20 years versus another for 5 years, the one employed longer should, in concept, contribute more to solve the problem. And the one employed longer, on average, will be here fewer years in the future helping to pay down the liability, when, in concept, they should contribute more to the paydown. Furthermore, because employees hired after the statewide pension reform act adopted two years ago have contributed nothing to the ‘legacy liability’, they should pay nothing toward eliminating it. And retirees cannot be forced to contribute. So the salary base for this solution option will decline over time as people retire and new employees cannot reasonably be asked to pay into the solution.

Finally, *Option 7* -- a fee increase to pay for unfunded liabilities rather than a new or continued service -- seems inappropriate to staff, unless absolutely necessary, which it is not.

RECOMMENDED PAY DOWN AMOUNT AND SCHEDULE

The first option, with the second option as a 'back-up plan', seems preferable at this time. If that is not palatable to the Board, staff needs feedback on whether paying down the liability is important enough to pursue other options. We recommend that paydown of the liability occur in two steps. First, $0.6 million would be sent to PERS following approval of the mid-year budget, using most of the $0.7 million funds transferred from the fiscal reserve to a new 'pension liability' reserve. Second, another $2.9 million (or less if funds are not available in the new 'pension liability' reserve) would be sent to PERS after Golden Hills LLC (the windfarm developer on our east county property) pays us for a conservation easement. They will likely pay us by early September 2016, because the price per acre increases by $500 per acre in early September 2016. They have recently said that they intend to purchase the maximum conservation easement from us approved by the Resource Agencies.

A PROPOSED SCHEDULE THROUGH FY16/17 RELATED TO PENSION PAY DOWN

Figure 3 presents a proposed schedule, through FY16/17 (that is, until about June 30, 2017), that is related to pension pay down. All of the issues touched on in the schedule are related because they involve spending – or planning to spend -- funds that the Boards could choose to spend on pension pay down, the core budget, or one-time items usually funded from reserves.

Approving this schedule would not be the same as approving any item in it. The schedule items are 'directions to staff,' not final decisions. Final decisions will be made later, per the schedule.

1. December 2015. In the mid-year budget proposal, reduce the WMA fiscal reserve by $0.7 million and create a pension liability reserve initially funded by that amount. Authorize paying PERS $0.6 million immediately from that reserve. Also, move the $1 million in the East Bay MUD commercial food waste digester project reserve into the organic processing development reserve, in order to consolidate all funds available for future organics processing development. (The EBMUD project is already fully funded, so this reserve is no longer needed. Spending to support commercial organics diversion in Oakland and other member agencies using the EBMUD facility can be considered via the study described in item 5, below.)

2. February 2016 committee meetings. Discuss criteria for spending part of the organic processing reserve in FY16/17, prior to full evaluation in FY16/17 (see number 5 below). This discussion and partial use of the reserve in FY16/17 is critically important given the percentage of our garbage that is organics suitable for anaerobic digestion, composting, or other resource recovery techniques. The State of California has prioritized such efforts, including possibly substantial funding, so we should be ready to take advantage of opportunities by partnering with the state or others, at minimum.

3. March 2016. Discuss inspector employment assessment by an outside expert with the P&A Committee, in preparation for the April budget proposal.

4. April 2016. Propose core budget no greater than $11.7 million (current core plus 2.5% inflation). If staff believes more funds are needed, clearly propose the incremental spend and the incremental projects or activities that would be funded by the incremental spend. Also, present the updated core revenue, core spending, and core account balances scenario through mid 2020.

5. April 2016. Include in the budget proposal a project to review progress under the strategic plan and possible adjustments to it, with a focus on how best to spend or reallocate the organic processing reserve. The results of the project will be available no later than the April 2017 budget presentation. This project should also consider whether further pension pay downs would be appropriate based on revised estimates of the financial need for our reserves

6. June or July 2016. Start full compensation and classification study (that is, issue the Request for Proposals for external review). The results will be available no later than the March 2017 P&A Committee meeting and sooner if substantial discussion of them seems necessary.

7. September 2016. Pay PERS up to $2.9 million, after receiving payment for a conservation easement from Golden Hills LLC.

8. April 2017. Propose a core budget no greater than $11.8 million (current core plus 2.5% inflation for two years, less $200,000 per year of savings due to pension pay down). If staff believes more funds are needed, clearly propose the incremental spend and the incremental projects or activities that would be funded by the incremental spend. Also, present the updated core revenue, core spending, and core account balances scenario through mid 2020.

9. April 2017. Based on the scenario update in schedule item 8, either propose a fee action or budget cuts effective in FY19/20 or sooner (that is, effective July 1, 2019 or sooner), or defer that discussion to a specific later date if the scenario update indicates that neither higher fees nor budget cuts is estimated to be necessary to fund the core budget in FY19/20.

RECOMMENDATION

Staff recommends that the P&A and P&O Committees recommend that the WMA direct staff at its November 18, 2015 meeting to follow the schedule presented above, which is intended as a decision making framework based on currently available information; and recommend that the WMA approve the proposed changes to reserves, and payment to PERS, when the mid-year budget revisions are brought before them on December 16, 2015. A recommendation from the P&O to this effect will be understood by staff as direction by the Recycling Board with respect to preparation of its part of the combined agency budget proposals for FY16/17 and FY17/18. Should future modifications to the schedule and associated actions be needed, they will be discussed with the Board.

Attachments: Figure 1: Financial Scenario with Growing Core Budget

Figure 2: Financial Scenario with Core Budget that Peaks in FY17/18

Figure 3: Proposed Pension Pay Down Schedule Through FY16/17

Figure 1: Financial Scenario with Growing Core Budget

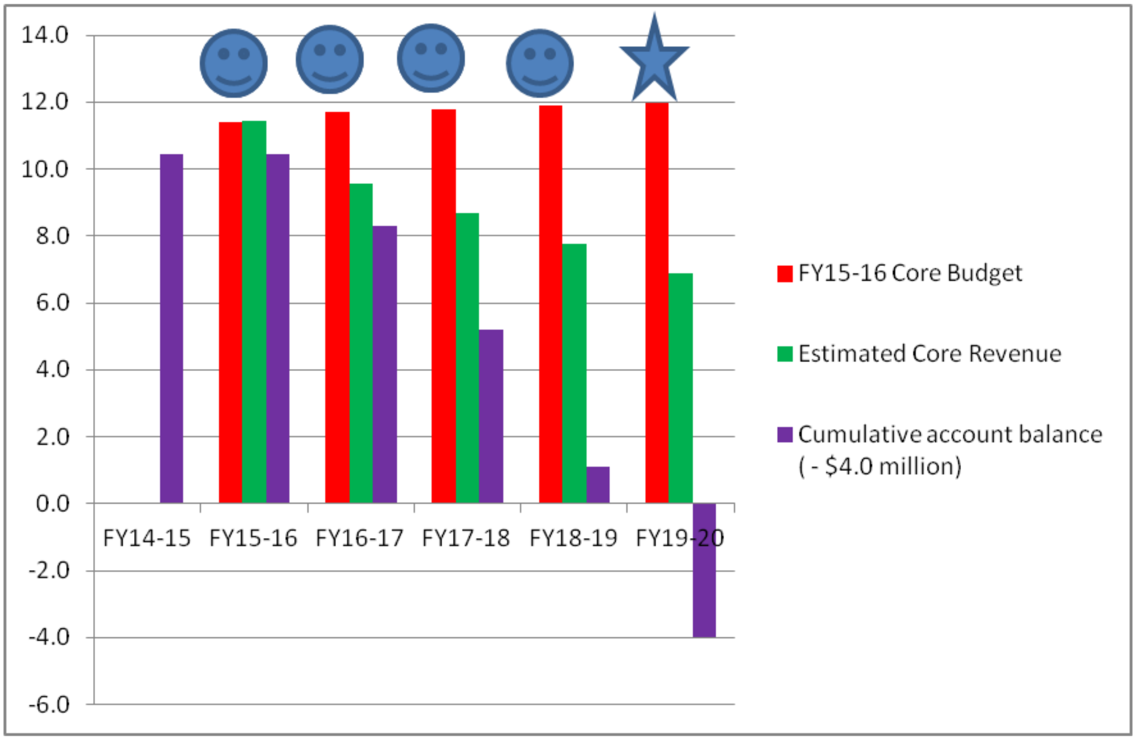

Figure 2: Financial Scenario with Core Budget that Peaks in FY17/18

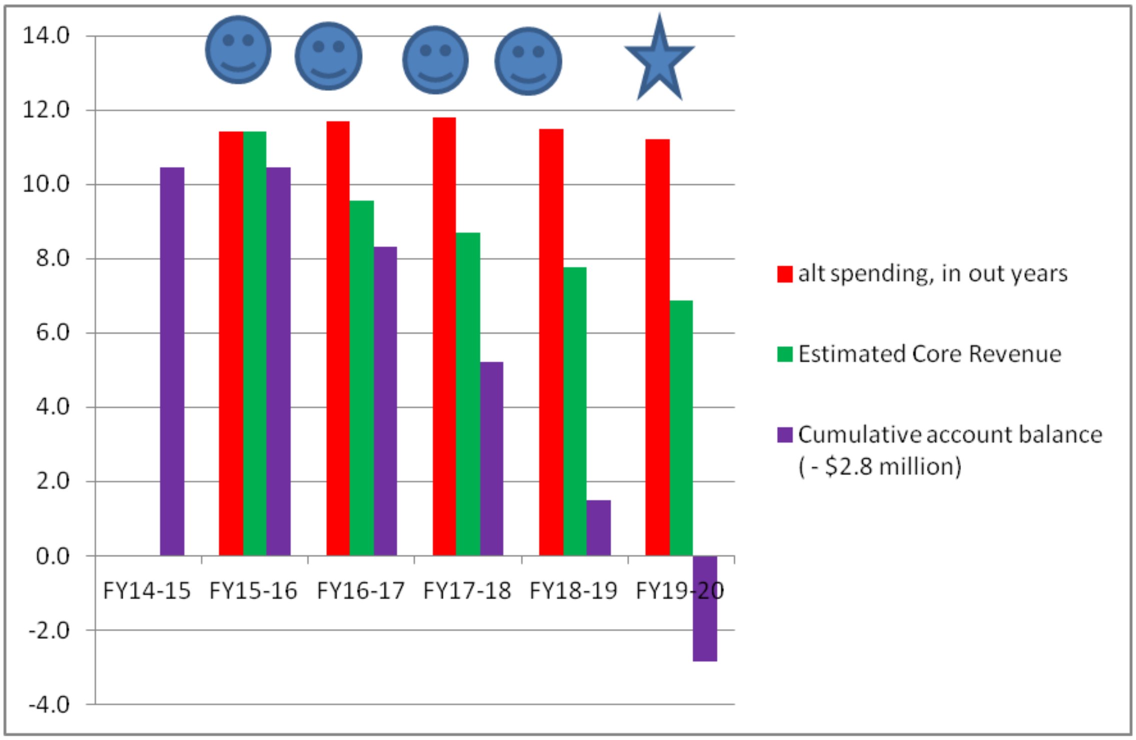

Figure 3: Proposed Pension Pay Down Schedule Through FY16/17