



CITY OF NEWPORT BEACH

Office of the City Manager

September 23, 2014

The Honorable Glenda Sanders
Presiding Judge of the Superior Court
700 Civic Center Drive West
Santa Ana, CA 92701

RE: "Orange County City Pension Liabilities-Budget – Budget Transparency Critically Needed"

Dear Judge Sanders:

The City of Newport Beach has reviewed the 2013-2014 Orange County Grand Jury Report, "Orange County City Pension Liabilities – Budget Transparency Critically Needed." In response to the Grand Jury's findings and recommendations outlined in said report, the City of Newport Beach offers the following responses:

Finding 1. OC cities have large unfunded pension liabilities both in terms of absolute dollar value and on a per capita basis and as a percentage of city General Fund revenues.

City Response:

The City of Newport Beach agrees with the finding that Orange County cities have large unfunded pension liabilities. The City continues to believe that any use of pension liability on a per capita basis misinforms and is a poor comparative indicator of pension funding progress across cities.

First, we note our appreciation that the Grand Jury points out that the ability-to-pay metric (versus the per capita metric) might be a "potentially better way" of comparing unfunded pension liabilities (page 20).

There are three fundamental problems with the per capita metric. No. 1 – It is nearly impossible to make accurate comparisons across cities. Each city has different operations within its service portfolio and budget. Newport Beach is a full-service city with its own library system, lifeguards, trash service (up until March 2014), water and wastewater system, and municipal police and fire/emergency medical departments. Each of these departments' annual pension expense is reported and approved in the budget. There are cities in the county with as large or larger populations that outsource such services to other public agencies or service providers. One neighboring city does not have a city library system nor a city water and wastewater utility. Another neighboring city has no city fire department, no city water and wastewater department, and no city library. These cities may hire other public agencies with pensioned employees to provide those services to their residents and as a result, pension costs may not be reflected in these cities' budgets. One would have to look at the budget of numerous small special districts, the Orange County Public Library District, the Orange County Sheriff's Department, the Orange County Fire Authority, and more to decipher the true pension liability per capita for each geographic city.

No. 2 – This statistic can misinform about how pension costs are funded, as it does not take into consideration the varied resources used to pay the City's obligations. In Newport Beach, employees pay one of the largest shares of pension costs - nearly \$7.4 million (and growing) is deducted from staff's paychecks every year. This represents 27% of the total pension payment made. Moreover, local pension funding (on top of investment earnings) is also funded from the City's numerous visitors, local employers and their employees. For example, revenues from visitors who use the City's parking lots, buy a car at a local dealership, stay in a hotel room, or eat at restaurants, are used to pay the City costs, including pensions.

No. 3 – Pension liability per capita says nothing about a city's ability to fund the liability. The City of Newport Beach is one of the most financially secure and stable cities in the county and has the financial means to better mitigate the financial risks associated with rising pension costs when compared to other cities (see response to Finding 3 below). This is supported by the published reaffirmation of the City's "AAA" credit rating by Fitch (dated August 1, 2014). It stated the following about Newport Beach:

"Prudent financial management has resulted in a history of positive operations, augmenting the city's very high reserves, despite large planned general fund investment in capital projects. Management has successfully implemented expenditure savings, including major labor concessions and the use of contracted services. The city's total debt burden is low and likely to remain so given limited near-term capital needs. Amortization is average and the city has reduced retiree health care costs, though pension contributions are expected to rise. Carrying costs, including debt service and retiree benefit contributions, remain affordable. Total annual carrying costs, including debt service, pension ARC and OPEB contributions constitute a low 13.9% of governmental fund spending in fiscal 2013. Expenditure controls to date have been moderate, including early retirement incentive plans, increased employee contributions to pension plans, contracting services, and freezing vacant positions. Financial management policies are robust and continue to improve to meet the city's financial needs. They include a contingency reserve equal to 25% of the general fund operating budget, up from 15% at the time of Fitch's last review."

Finding 2. OC cities' unfunded pension liabilities have been increasing on a year over year basis over the past several years as a result of the assumptions that have been changed by CalPERS and OCERS.

City Response:

The City of Newport Beach agrees in part with the finding. "Over the past several years" there has been a significant increase in liabilities, due to actuarial assumption changes and the dramatic fall of the markets in 2008-2009. However, in 2013 and 2014 our unfunded liability fell significantly. Not enough to bring us back to pre-recession levels, of course. We note how important it is to assign a date in time to any unfunded liability value, as the contributing factors (assets and liabilities) can fluctuate dramatically depending on the date used.

Finding 3. There are risks to OC cities of changes to key actuarial assumptions including revisions downward of expected returns on investment and the likely move by pension funds to more realistic mortality assumptions, which would increase unfunded liabilities.

City Response:

The City of Newport Beach agrees with the finding. We are thankful that CalPERS has made some steps in the right direction on rates of return and workforce mortality assumptions.

Finding 4. Locating city budget information on a city web site is not always straightforward and prior year budgets are sometimes not posted by a city.

City Response:

The City of Newport Beach disagrees with the finding in terms of our own data – we cannot speak to the websites of other cities. The City provides access to the most current and prior year budgets going back to FY 1927-28. Budget documents can be accessed from the several menu paths on the City website under the “About (City),” “Finance Department,” “City Government,” and “Residents” web page menus at: www.newportbeachca.gov or can be accessed directly at: www.newportbeachca.gov/budget.

Budgets prior to FY 2008-09 can be found on the same “City Salary and Budget Documents” web page under “Prior Year Budget Documents.”

Finding 5. City budgets posted online project revenues and expenditures for at most one or two years into the future and sometimes do not show prior year data.

City Response:

The City of Newport Beach partially disagrees with the finding in terms of our own data; we cannot speak to the budget documents of other cities. The City does present prior year revenues and expenditures going back four years from the current year adopted budget but deliberately presents and adopts a one-year operating budget. The City prepares many long-range planning documents and projections where long-term planning is prudent and necessary especially for capital replacement and debt management. These tools take various forms from spreadsheets to databases.

Finding 6. City budgets often lack footnotes explaining key assumptions, risks, and unusual changes in budgeted amounts or revenues and expenditures.

City Response:

The City of Newport Beach partially agrees with the finding. We can always do better to explain budgeting practices and assumptions. A discussion of key budget highlights can be found in the Transmittal Letter of the Budget. A discussion of pension risk can be found on pages 148-150 of the Performance Plan.

Finding 7. City budgets sometimes do not provide trend data on the accumulation /drawdown of reserves and lack details on the city’s plan for the size of its reserves or their intended uses.

City Response:

The City of Newport Beach partially disagrees with the finding. The City does provide detail regarding the size of reserves and projects its sources and intended uses for two fiscal years (please see pages 19-24 of the FY 2014-15 Budget Detail document at: www.newportbeachca.gov/budget.) Most analysts seek historical trend data from city

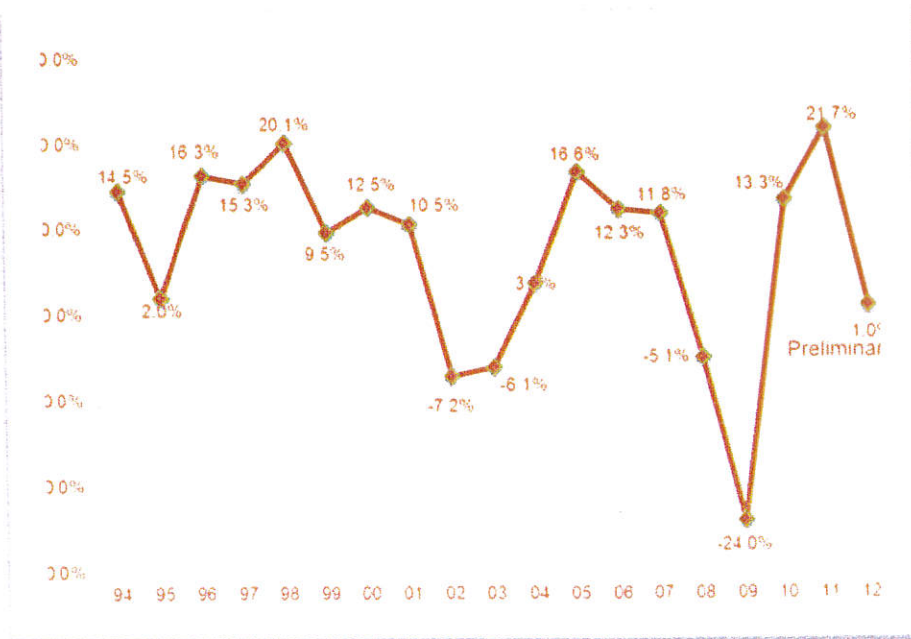
Comprehensive Annual Financial Reports (CAFR) and not the budget. The City also believes that trend data ought to be compiled from the CAFR, which are based on audited actual results and can be obtained at: www.newportbeachca.gov/cafr.

Finding 8. Cities can control most future expenditures by increasing or decreasing budgets for those expenditures as funds are available. However, increases to annual required contributions to their pension systems are imposed externally, change unpredictably, and when they occur, are ramped up over two to five years.

City Response:

The City of Newport Beach agrees with the finding. One of the most impactful actuarial assumptions that affect the City's pension funded status and annual required contribution is the assumed and actual rate of return on the pension assets that are invested in the pension trust. The actual rate of return is largely dependent on financial markets and economic cycles. As a result, the City's pension assets can vary from one actuarial valuation to the next. Even when the City diligently pays CalPERS the Annual Required Contribution (ARC), determined by pension actuaries, the funded status of the plan can change rapidly over a short period of time. As demonstrated in the chart below, CalPERS investment returns decreased 24% in fiscal year 2009 and by fiscal year 2011 had increased 21.7% from the prior year.

CalPERS Investment Returns



While the equities markets are now above the levels in 2007, they still fall short of the where investment balances would have been had they continued to grow 7.5% annually since 2007. Fortunately, the risks are somewhat mitigated by the City's ability to set aside significant resources. During both strong and uncertain economic times, reserve funds provide the City with budgetary options that can help mitigate the need to cut services.

Finding 9. City budgets posted online do not explicitly show the link between planned city pension expenditures and pension system actuarial reports and those reports' annual required contributions. Risks associated with predictions of future annual required pension contributions based on risk assessment data provided by their pension systems and/or based on their own analysis are not discussed.

City Response:

The City of Newport Beach disagrees with the finding with respect to our own documents, website, and discussions. We cannot speak to other cities documents, websites and discussions. City budgets do incorporate the annual required contributions from the latest actuarial reports. We continue to have robust discussions with our pension actuaries, Council, the community, and our Finance Committee about where pension costs are headed, how to lower them, and why. Narrative discussions can be found in the Transmittal Letters of our budget as well as pages 148-150 of the FY 2014-15 Performance Plan (summary budget document) at: www.newportbeachca.gov/budget. The City Manager's newsletter – mailed out to all residences in Newport Beach – also typically discusses pension issues.

Finance Committee review and discussions of our actuarial reports and or subsequent discussions can be found on our website under Finance Committee Agendas at: <http://newportbeachca.gov/index.aspx?page=964> "View Past Meetings" See example, Finance Committee discussions:

- November 18, 2013
- February 23, 2013
- May 7, 2012
- November 7, 2011

Finding 10. Pension costs for New (Post-PEPRA) employees will be substantially lower than for Legacy employees, but only a small percentage of current employees, typically only a few percent of total employees, are New. Substantially reduced pension costs for cities as a result of pension reform will not be realized for one or more decades.

City Response:

The City of Newport Beach agrees with the finding; however, we note our appreciation that PEPRA was enacted into law to assist all Californians in bringing a bit more realism to public employee retirement benefits.

Finding 11. CalPERS Annual Valuation Reports for Miscellaneous and Safety City employees are available to the public online for a very small number of cities.

City Response:

Annual Valuation reports for most or all CalPERS agencies can be obtained directly from the CalPERS website at: <https://www.calpers.ca.gov/index.jsp?bc=/about/forms-pubs/calpers-reports/actuarial-reports/home.xml>

Finding 12. OCERS provides pension plans for OCFA and OCSD employees, but there is no way to trace through publically available sources OCERS unfunded pension liabilities to the city budgets which outsource to OCFA and OCSD for fire and police services.

City Response:

Not applicable.

Recommendation 1. Each city should post its current and at least three most recent prior year budgets on the city's web site, and these budgets should be easily located. Each city's web site should have a search engine and a single search on the word "budget" should immediately link to the current budget. (Finding 1) (Finding 4)

City Response:

The recommendation has been implemented. The City provides access to the most current and prior year budgets going back to FY 1927-28. Budget documents can be accessed from the several menu paths on the City website under the "About (City)," "Finance Department," "City Government," and "Residents" web page menus at: www.newportbeachca.gov or can be accessed directly at: www.newportbeachca.gov/budget.

Budgets prior to FY 2008-09 can be found on the same "City Salary and Budget Documents" web page under "Prior Year Budget Documents" Please see <http://ecms.newportbeachca.gov/Web/Browse.aspx?startid=5743&cnb=FinancialInformation&dbid=0>

The City's website contains a search engine and locates budget documents when the word "budget" is searched.

Recommendation 2. Each city's budget information should contain not only this year/next year budget projections, but should show at least five years of projected revenues and expenditures. Projections should be at the same level of detail and use the same line item structure as information for the current budget. (Finding 1) (Finding 2) (Finding 3) (Finding 5) (Finding 8) (Finding 10)

City Response:

This recommendation will not be implemented at "the same level of detail" as current budgets. The City recognizes that long-term forecasting is an essential part of prudent fiscal planning, especially as it relates to long-term capital replacement and debt management and does so in various internal planning tools. The City also believes long-term forecasts are best managed and are more meaningful at the 30,000-foot-level. The City respectfully disagrees that preparing five year operating budgets at the department/object level would provide informative results and believe this action would be so speculative that it may not accomplish the desired result.

Recommendation 3. Each city's budget should show separate line items for predicted employee and predicted employer contributions for the city pension systems. (Finding 8) (Finding 9)

City Response:

This recommendation has been implemented. The normal cost of pension plans, the employee contribution towards pension plans, the amortized cost of unfunded liability, and the net CalPERS pension cost to the City are segregated in the FY 2014-15 Budget Detail at: www.newporbeachca.gov/budget.

A description of the accounts and explanation of these terms can be reviewed on the unnumbered third page of the FY 2014-15 Budget Detail at: www.newportbeachca.gov/budget.

Recommendation 4. Each city's budget should provide trend data on the accumulation/drawdown of reserves and provide details on the city's policy for the size of its reserves and on the intended uses of such reserves. In particular any discussion of reserves should address possible use of reserves to accelerate amortization of unfunded pension liabilities. (Finding 7)

City Response:

We agree that trend data on reserves, reserve policies, and a regular discussion of strategic uses of reserves deserves strong transparency. We question whether the entire recommendation is best suited for budget documents.

Council Policy F-2, "Reserves" provides staff guidance concerning the size and intended purpose of reserves, directs staff to pay 100% of the Annual Required Contribution (ARC), and contemplates use of reserves when the funded status of the pension plans fall below acceptable actuarial standards (www.newportbeachca.gov/policies).

The City provides detail regarding the size of reserves and projects its sources and intended uses for two fiscal years (please see pages 19-24 of the FY 2014-15 Budget Detail document at: www.newportbeachca.gov/budget). Historical trend data can be culled from Comprehensive Annual Financial Reports (CAFR) which are *audited actual results* and are readily available at: www.newportbeachca.gov/cafr.

Use of reserves to amortize unfunded pension liabilities and other pension mitigation strategies are complex discussions involving consultation with our actuaries and careful financial analysis. We discuss the status of our pension plans, potential risks and opportunities with our Finance Committee in a public and noticed meeting on a regular basis. To us, the Committee and Council discussions, which have tended to occur at least annually and often more so, are ideal mechanisms for decision-making in the public eye.

Recommendation 5. Each city using CalPERS for one or more of its pension plans should identify the names and dates of the CalPERS Annual Valuation Report(s) which call out Annual Required Contributions (ARCs) for these plans and should provide a separate expenditure line item for predicted city catch-up contributions for the city pension systems based on these ARCs. A discussion of the risks associated with these CalPERS projections should also be provided by the city. (Finding 1) (Finding 2) (Finding 8) (Finding 9)

City Response:

This recommendation has been implemented. There is a direct correlation between the budgeted fiscal year and the pension contribution rates for any given fiscal year (The pension contribution rates determine the Annual Required Contribution).

The City does provide a separate expenditure line for the "catch-up" portion of the ARC. This represents the amortization of the Unfunded Actuarial Liability (UAL). A description of the

accounts and explanation of these terms can be reviewed on the unnumbered third page of the FY 2014-15 Budget Detail at: www.newportbeachca.gov/budget.

Narrative discussions of the “risks associated with CalPERS projections” can be found pages 148-150 of the FY 2014-15 Performance Plan at: www.newportbeachca.gov/budget.

Recommendation 6. Each city which outsources fire or police services to OCFA and/or OCSD should require them to provide projections of future costs of service out at least five years into the future and require that these projected costs explicitly show the relationship of projected pension costs including amortization of unfunded liabilities. This level of pension cost information should be provided in budgeted expenditures for outsourced services. A discussion of the risks associated with these projections should also be provided by the agencies and incorporated in the city’s budgets. (Finding 6) (Finding 12)

City Response:

Not applicable to our community. We do, however, appreciate the Grand Jury’s recognition that there can be a less visible pension liability affecting communities that contract for public safety and other services. Including these liabilities in the broader discussion of city-by-city liabilities, while still inadequate for the reasons stated in our response to Finding 1, would at least start to tilt the “per capita” playing field a little closer to level.

Recommendation 7. Each city that has CalPERS as a provider for pensions should include a provision in their agreements with CalPERS that CalPERS will post their Annual Valuation Reports online. (Finding 11)

City Response:

This recommendation has been implemented. The City of Newport Beach’s annual CalPERS Annual Valuation reports can be obtained directly from the CalPERS website at: <https://www.calpers.ca.gov/index.jsp?bc=/about/forms-pubs/calpers-reports/actuarial-reports/browse-results.xml&strCatId=2&q=newport-beach-city>.

If you have any questions about the City’s response to these findings and recommendations, please do not hesitate to ask us.

Sincerely,



Dave Kiff
City Manager