

HARVEY M. ROSE ASSOCIATES, LLC

1390 Market Street, Suite 1150 • San Francisco, California 94102
(415) 552-9292 • (415) 252-0461 (FAX) • info@harveyrose.com

public sector management consulting



June 20, 2011

Nick Berardino
Orange County Employees Association
830 North Ross Street
Santa Ana, CA 92701

Dear Mr. Berardino:

Per your request, we have prepared the following summary of our comments regarding the financial status of the City of Costa Mesa and suggestions for budget savings that might be achieved during FY 2011-12 and beyond.

1. The amount of the City's Operating Reserve, established pursuant to Costa Mesa Municipal Code Section 2-205, et seq. can be set at other levels by mere resolution of the City Council. The Municipal Code does not specify an amount that must be reserved nor does it restrict the City Council from establishing additional reserves that would broaden the circumstances for which funds can be used. The \$14.125 million in the Operating Reserve equals 14.4% of the General Fund budget, which is at the high end of reserve levels recommended by the Government Finance Officers Association (between 5% and 15% per year). On a percentage basis, this reserve level is a greater percentage of budgeted expenditures than in the past, as General Fund operating expenses have been reduced over the years. For example, in FY 2008-09, this reserve was 11.49% of the City's operating budget compared with the current 14.4%. By leaving it static, the City has essentially increased its reserve on a percentage of budget basis.
2. The City had designated \$2.9 million of the General Fund balance as a supplement to the reserves held in the Liability Insurance Internal Service Fund (ISF). This designation is unnecessary, since the City generally pays its actual annual costs on a pay-as-you-go basis. Liability Insurance ISF reserves are funded at sufficient levels to ensure solvency through the recession, so this designation is unnecessary.

3. The City has designated \$4.7 million for Compensated Absences, which is a liability booked for the payment of vacation and sick leave balances due to employees upon termination. In FY 2010-11, the financial auditors anticipated that the City would only pay \$1,150,000 for these benefits. Further, Costa Mesa – like other jurisdictions – typically pays for these benefits from salary savings after a position is vacated. Therefore, the full amount of the \$4.7 million can be made available for other purposes and does not need to be reserved. At the very least, \$3.5 million of this designation could be released for other purposes, which is the difference between the \$4,724,270 designated as of June 30, 2011 and the \$1,150,000 estimated to be spent in the financial statements.
4. The City has designated \$1.4 million of General Fund balance for liabilities associated with the payment of OPEB. These funds have not been placed in the OPEB trust and therefore can be expended for any purpose. Although the Unfunded Liability for OPEB benefits is approximately \$35.5 million, the City consistently chooses to fund the benefits on a pay-as-you-go-basis (i.e., pays actual cost of benefits and does not place any funds in reserve), so it does not fund the Annual Required Contribution (ARC) estimated by actuaries.¹ The City should pay the full amount of the ARC each year and eliminate the unfunded liability over time. In FY 2009-10, that would have increased costs by \$743,942, but released General Fund designations of \$664,000.
5. Management’s projection of a \$39.9 million ending General Fund balance for FY 2010-11 is overly conservative. Although the City has had trouble meeting its revenue budget expectations in recent years, it has successfully achieved expenditure savings ranging between 3.2% and 4.5% each year. Revenues in FY 2010-11 are also coming in much higher than expected.
 - Our analysis indicates that in FY 2010-11, prior year General Fund expenditure patterns will continue and that General Fund savings of at least 4.4% will occur. This equates to approximately \$4.2 million.
 - FY 2010-11 General Fund revenue collections have exceeded expectations, since the budget was adopted. The City’s management staff now expect revenues to be approximately \$8.5 million over budget for that year, with which we generally concur.
 - Given these two factors, additional revenue collections, expenditure savings and interfund transfers in FY 2010-11 will result in a positive variance of \$12.0 million over amounts budgeted for the fiscal year. Because the City had assumed that it would need to use General Fund balance of \$9.4 million to balance the FY 2010-11 budget, this results in a net increase in the beginning General Fund balance for FY 2011-12 of \$2.6 million.

¹ Pursuant to the Government Accounting Standards Board (GASB No. 45), the unfunded liability for OPEB benefits can be amortized over a 30-year period, which is consistent with the actuary’s estimate of the annual ARC.

Because the City is now projecting a \$1.6 million operating deficit for FY 2010-11, this surplus represents a positive difference of approximately \$4.2 million. Accordingly, the beginning General Fund balance for FY 2011-12 should be adjusted upwards from \$39.9 million, being assumed in the budget, to \$44.1 million, as shown below.

Category	City	HMR	Difference
Expense Variance	-	4.2	4.2
Revenue Variance	6.8	6.8	-
Transfer Variance	1.0	1.0	-
Total	7.8	12.0	4.2
Budgeted Deficit	9.4	9.4	-
Adjustment	1.6	(2.6)	(4.2)
CAFR Balance	41.5	41.5	-
Beginning 2010-11	39.9	44.1	4.2

6. The City has debt in the form of 1998 Refunding Revenue Bonds, which will be fully paid off in FY 2012-13, saving the General Fund \$1,281,250 per year in budgeted costs. This balance could be paid off from reserves, immediately making current year resources available for funding City operations and avoiding interest expense of approximately \$31,250. In FY 2012-13, the City would no longer have this \$1,281,250 obligation.
7. The City continues to carry unnecessary reserves in its Equipment Replacement Fund and recent suggestions by members of the City Council to increase these reserves is neither realistic nor necessary during a period of financial crisis. Such an action would further degrade services to the public, particularly given the City's history of maintaining substantial balances in that reserve for very little practical purpose. Federal guidelines suggest that such funds hold 60-days working capital and depreciation.² The decision to fund at higher levels is merely local policy.

The following table shows the surpluses that have been carried in the Equipment Replacement Fund for the past five fiscal years, with estimates of working capital and the amounts that could have been released from reserve.

² OMB Circular A-87 Cost Principles for State, Local, and Indian Tribal Governments, states in Attachment C, Section G.4 "Billing rates used to charge Federal awards shall be based on the estimated costs of providing services, including an estimate of the allocable central service costs. A comparison of the revenue generated by each billed service (including total revenues whether or not billed or collected) to the actual allowable costs of the service shall be made at least annually, and an adjustment will be made for the difference between the revenue and the allowable costs." Under this requirement, central service internal service funds are therefore prohibited from charging the federal government an amount which exceeds the actual cost of business (i.e., the federal government will not pay for fund profits).

Equipment Replacement 60-Day Working Capital				
	Ann. Exp. Net Depreciation	60-Day WC Estimate	Actual Surplus	Excess (Deficiency)
FY 2005-06	1,876,094	308,399	7,866,520	7,558,121
FY 2006-07	2,258,506	371,261	7,211,763	6,840,502
FY 2007-08	2,350,030	386,306	7,168,257	6,781,951
FY 2008-09	2,033,614	334,293	8,596,858	8,262,565
FY 2009-10	1,799,099	295,742	6,516,321	6,220,579
5-Year Avg	2,063,469	339,200	7,471,944	7,132,743

This pattern has been consistent for even longer than the period shown in the table, with the fund holding excess funds of \$8.8 million in FY 2003-04 and \$6.4 million in FY 2004-05. Further, in its response to the recent Moody's Investor Services rating report on the City's Certificates of Participation and Lease Revenue Bonds, it was stated that "The city has also noted that \$3.5 million in the Capital Improvement Fund and \$6.5 million in the Equipment Replacement Fund are available to the General Fund if necessary. This remains a credit positive and is reflected in the current rating." Therefore, the City has fully acknowledged the availability of these funds for general government and debt service purposes.

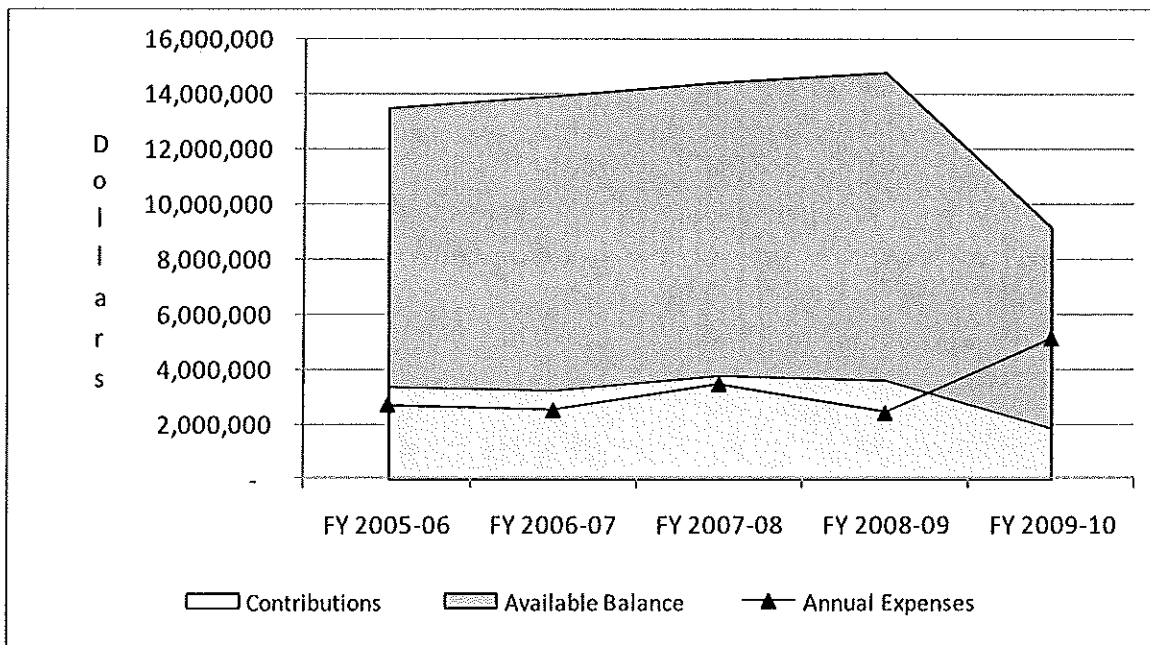
Consistent with comments made by one City Council member, at the very least, the City should use these reserves for their intended purpose. Specifically, the City should use the current reserves to buy-out the Fire Truck Lease-Purchase that it entered into in 2009. That would result in an immediate expenditure of about \$760,000 from the equipment reserves, while providing annual General Fund savings of about \$220,000 in FY 2011-12 through FY 2015-16, when the lease obligation ends.

8. The City drew down balance from the Liability Insurance ISF in FY 2009-10 to pay a large lawsuit settlement. However, in prior years and in FY 2010-11 the City has funded its liabilities on a pay-as-you-go basis (i.e., the City has generally funded actual expenditures and has not added money to build reserves). Nonetheless the City has historically held high reserves in this fund, supplemented by designations of General Fund balance, as discussed previously.

The need to pay out a large settlement in FY 2010-11 caused the reserve balance to decline from about \$11.2 million to \$7.3 million; and, annual expenditures can vary somewhat, due to uncertainty surrounding general liability claims against the City. However, historical patterns indicate that actual expenditures typically range between \$2.5 and \$3.5 million and that contributions generally meet or exceed requirements. Accordingly, current reserve levels are at more than two times the normal expense. Therefore, the City could use the \$2.9 million designated in the General Fund for liability insurance reserves other purposes, while

maintaining the solvency of its self-insurance liability program using ISF resources (see previous discussion).

(See below for Chart illustrating historical patterns for the Liability Insurance ISF).



9. Management has reported concerns about General Fund cash flow difficulties, showing a chart that suggested the cash position of the General Fund had declined to about \$5 million in July 2010. However, this presentation did not present all aspects of cash flow management or the flexibility the City has when it manages its funds. In fact, for general government cash flow purposes, local government can access other funds, provided that the accounting for those funds is maintained (e.g., interfund transfers are recorded and interest earnings on average daily cash balances are appropriately allocated).

Because of the special character of the two ISF funds as being General Fund-like, the interest allocation requirement is not even necessary (i.e., the General Fund in Costa Mesa allocates interest to the Equipment Replacement Fund but then takes back the interest earnings each year, which amounted to \$507,275 in FY 2009-10). Therefore, even when the General Fund cash balance declined to approximately \$5 million in July 2010, it was still able to draw on the cash held by the two ISFs, which was approximately \$14.7 million as of June 30, 2011. This does not even include balances in the Other Capital Projects Fund, which holds General Fund resources and had a balance of approximately \$5.0 million on that same date. Accordingly, the cash position of these four funds in July 2010 was probably much closer to

\$25 million rather than \$5 million, which is not at crisis level for a jurisdiction the size of Costa Mesa.

10. As is well recognized by the City, the unfunded actuarial accrued liability (UAAL) for its CalPERS pension obligations has grown substantially in the past several years. However, the cost of borrowing has also stayed low during the recession, which presents a unique opportunity for the City of Costa Mesa to borrow funds from the private market using Pension Obligation Bonds (POB).

POB financing is used by jurisdictions throughout the country to pay down a portion of their pension system's UAAL. The POB debt is a general obligation of the jurisdiction, which means that it is secured by the jurisdiction's general taxing authority. Unlike other general obligation borrowing, POBs do not need to be authorized by the voters.

At the last valuation, the City had approximately \$108.5 million in UAAL. Whenever a jurisdiction's fund has UAAL, CalPERS treats it as a loan to the jurisdiction, charging an interest rate on the balance at the CalPERS assumed interest rate of return of 7.75%. When market interest rates are advantageous, jurisdictions will often borrow the funds from the private market at lower interest rates than is being charged by CalPERS. Known as arbitrage, the jurisdiction benefits with savings realized by the difference between the amount that would have been paid to CalPERS and the amount that will be paid to the private lender.

Costa Mesa could use POBs to fund its entire UAAL. However, we would not recommend that the City proceed with a borrowing of that size, since CalPERS investment earnings will likely continue to surpass its assumed rate of return and the UAAL will decrease as excess earnings are applied to the City's UAAL balance. However, the City could comfortably borrow amounts from the private market to pay down a portion of the UAAL and realize substantial savings. As an example, we calculated the amount of savings the City would realize by paying off its Side Fund UAAL for the Fire Safety Plan.³ Based on our analysis, which includes an estimate of long-term interest expense based on POB issuances in other Southern California jurisdictions, the City could save approximately \$284,410 per year by borrowing using POBs. Over the 23-year loan amortization period currently employed by CalPERS, this would result in savings of as much as \$6.5 million for the City of Costa Mesa over the term of the borrowing. A summary of this analysis is presented, below.

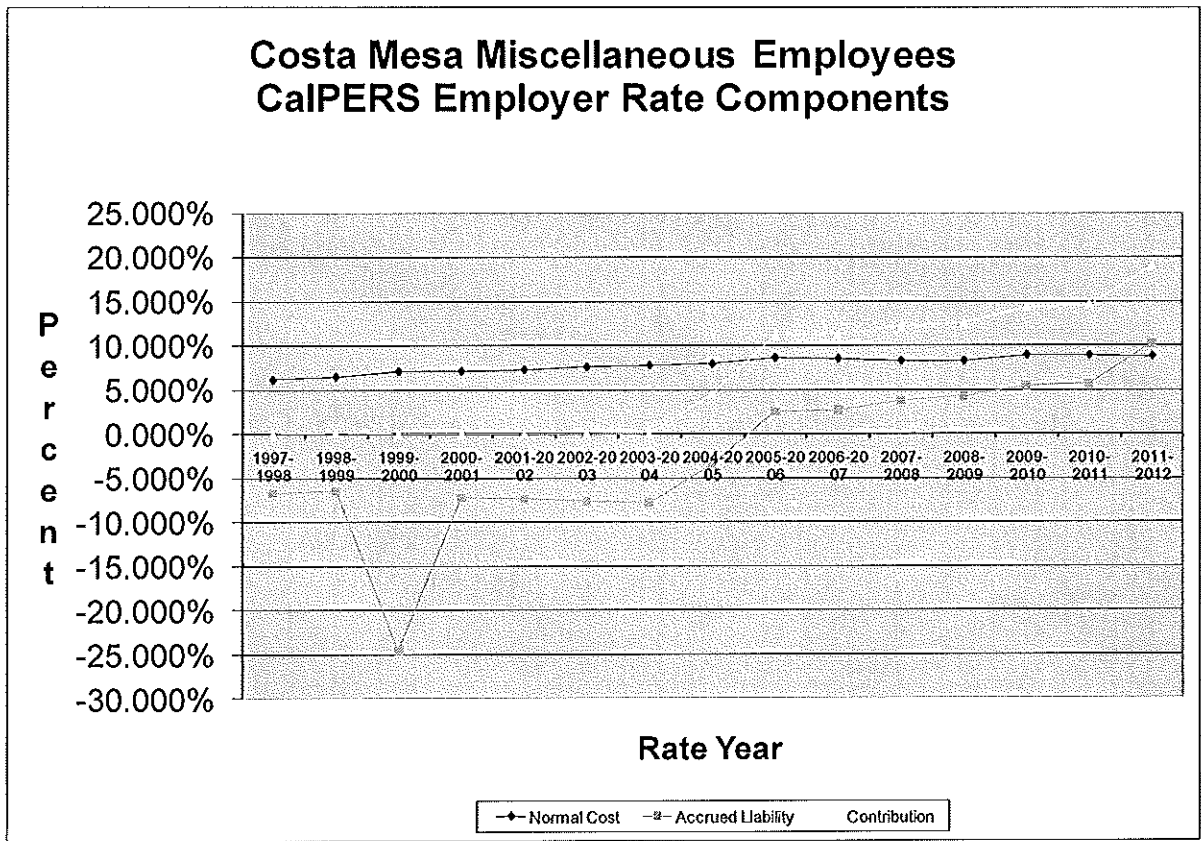
³ Described more fully in our report, plans with 100 employees or less are part of CalPERS risk pool. To adjust for differences between the pooled plan and the individual plans, CalPERS establishes "Side Funds", which hold either additional assets, when the plan has a positive balance; or, UAAL, when the plan has a negative balance. The Costa Mesa Fire Safety Plan is in a risk pool and has a side fund.

Variables	Assumptions			
Side Fund Balance	\$ 21,558,996			
Amortization Years	23			
CalPERS Rate	7.75%			
POB Rate	6.00%			
		CalPERS	POB	Savings
Annual Payment	2,036,693	1,752,283	284,411	
Term	23	23	23	
Total P&I	46,843,948	40,302,498	6,541,450	

11. CalPERS rates will likely continue to be high for the next several years, even with the investment gains that have been realized in the past two years due to actuarial methodologies that smooth asset gains and losses and unfunded liability over long periods. However, reducing employee benefits will have minimal affect in the short term. The cost to the City will be affected more dramatically by CalPERS investment performance, which has historically surpassed its assumed rate of return, had gains exceeding 11% in 2010 and reportedly had year to date gains of over 18% in 2011 (2.3 times the assumed rate of return), prior to the recent stock market slump. The presentation made by the CalPERS actuary, at the direction of the City, therefore overstated future risks to Costa Mesa.

In fact, it is important to recognize that (1) Costa Mesa's normal contribution rate for general employees is modest at approximately 8.82% in FY 2011-12; and, (2) Costa Mesa enjoyed a 0% contribution rate for this plan for six of seven years between 1997-98 and FY 2003-04 (in 1998-99, the City contributed 1.4% due to a actuarial method change). The following chart displays the distribution between the (1) Normal Rate [i.e., what the City would pay each year if there was no investment or gain/loss offset]; (2) the Accrued Liability Rate [i.e., the rate that represents either an additional cost or a credit due to investment returns or gains and losses]; and, (3) the Actual Rate [i.e., what the City actually paid]. It provides some interesting perspective.

(See Chart on next page)



Our full report, which we are presently completing to provide you with additional information supporting these conclusions, will be transmitted to you as soon as possible. In the meantime, we hope this letter summarizing our findings will be of value to your organization.

Sincerely,

Stephen Foti
Principal