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MEMORANDUM

To: Julio A. Guridy, President, Allentown City Council and
Members of Allentown City Council

From: Gerald E. Cross, Executive Director

Date: October 31, 2012

Subject: PEL Interim Report to City Council

Introduction

Pennsylvania's municipalities and Third Class Cities in particular, have increasingly confronted the fiscal reality that the cost of providing fundamental services has been steadily rising while revenues, constrained by legislative restrictions on tax sources and other revenue measures, have at best remained flat. In recent years, unlike many of its peers, the City of Allentown has been able to meet its operational obligations without dramatic tax increases. The City has accomplished this, however, only by utilizing available account balances that are now virtually depleted.

Public Financial Management, Cheiron and EFI Actuaries have each identified concerns that increasing cost of services, flat revenues and the need to meet the City's unfunded pension and other retirement benefit obligations will significantly weaken the City's fiscal condition in the near future. The City, anticipating the fiscal challenges facing it, has initiated a process to examine alternatives to the City's current "pay-as-you-go" pension and other post-employment benefit obligations (OPEB). The City is investigating alternatives that will enable it to meet these challenges in an efficient and effective manner so that the City can continue to provide necessary services without resorting to dramatic tax increases or reductions in services.

The Pennsylvania Economy League—a statewide, regionally based not-for-profit whose mission is to be a force for positive change to make Pennsylvania, and its municipalities, better places to work, live and do business—was asked to review and comment on the reports prepared by PFM. These reports identified the need to address the fiscal issues facing the City and proposed a number of alternative scenarios available to the City to accomplish these goals.

Specifically, PEL was tasked to:

- Review the actuarial assumptions and methods used in calculating the status of the City's three pension funds, addressing long-term sustainability of the pension systems.
- Review the options described in the PFM *Preliminary Analysis of Alternative Solutions to the City's Fiscal Challenge.*
- Review the draft *Preliminary Findings on Impacts to the City's General Fund From Concession/Lease Agreement* and review the alternative provisions suggested through public comment provided to City Council or generated by PEL.
- Meet with PFM and City Council and others as appropriate.

PEL has met with PFM to discuss the *Preliminary Analysis* and the *Draft Concession/Lease Agreement* and is presenting this preliminary statement to Council this evening.

Review of the Pension Obligation

Prior to evaluating proposed solutions to a fiscal "crisis" of any nature, a proper "peer" review must evaluate the methodology and assumptions utilized in the identification and nature and magnitude of the problem or problems outlined in the initial study. PFM recognizes the "annual fiscal imbalance due to rising pension costs" as a critical problem demanding a "long-term solution." PFM calculates current unfunded pension liabilities at approximately $158 million, costing the City approximately $13.2 million annually from the City's operational budget. PFM cautions that these annual payments (MMO) will increase to $25.7 million within the next five years.

PEL Associate, Rick Dreyfuss, has completed an intensive review of the PFM studies as well as additional reports from Cheiron and EFI actuaries. The general conclusions reached by Mr. Dreyfuss with respect to the City's pension obligations are as follows:

- The assumed 8% rate of return on assets and funding periods that exceed the remaining duration of the active members create inherent funding risks that could result in significantly greater pension obligations than those identified in the previous reports.
- Using the 8% assumed rate of return, the current studies estimate the combined pension unfunded liability to be between $154.1 million and $162.6 million. The unfunded liability increases from $223.0 million to $231.5 million when assuming a more conservative 6% rate of return assumption.
- The combined annual municipal contribution ranges from $19 million to $33 million over the period 2013 to 2027, depending upon the asset return assumption and amortization period utilized.
- The separate OPEB unfunded liability is currently $61.4 million and can be expected to significantly increase in the future.
- Cheiron, the City's actuary, has expressed concerns (See page 31 of the 2012 Firemen's Pension Valuation Report) regarding the reasonableness of the current retirement age and service assumptions used to develop plan costs. The current assumptions and methodology likely cause the report to significantly understate the fund's reported unfunded liability and the associated MMO.

On the basis of this review and analysis, PEL generally concurs with the nature and magnitude of the fiscal imbalance dilemma and its relationship to the sizeable unfunded pension liabilities identified in the studies. We also concur with PFM that additional annual obligations created by continuing and growing OPEB costs will exacerbate the City's fiscal imbalance in future operational budgets. At the same time, PEL cautions that PFM employed certain commonly utilized assumptions to reach its pension projections. PFM acknowledges in its report that these assumptions have been criticized as being overly optimistic in the current economic environment. PEL encourages the City to employ the more "conservative" investment return rate and other assumptions consistent with the concerns raised by PFM, Cheiron and PEL. We conclude that the City's current search for a long-term solution to its "fiscal imbalances," and future pension and OPEB obligations is not just prudent, but is a necessity to assure the sustainability of the City's three pension systems and the integrity of the City's operational budgets.

In its *Preliminary Analysis* report, PFM presented an expansive listing and analysis of certain revenue enhancement options available to the City. There are obviously other options by which the City may improve current imbalances. Along with tax increases and increased utility user fees, the City may look to increase miscellaneous fees, fines, and other impositions, as well as improving collection of outstanding tax and other obligations. Service reductions, although not desirable, may also be considered. PEL is prepared to analyze such alternatives along with identifying potential operating efficiencies. However, we recognize that such recommendations will not provide a return of such magnitude to effectively eliminate the necessity for the City to undertake more dramatic measures as proposed by PFM.

Comments on the *Concession/Lease Agreement*

The final leg of our review relates to the draft *Preliminary Findings on Impacts to the City's General Fund from Concession/Lease Agreement.* Given the limited time frame in which PEL has been engaged (contract awarded October 15, 2012), we are not prepared to provide a detailed analysis of this draft. However, it is axiomatic that within the context of concession agreements, "the devil is in the details." Drafting such agreements is an exercise that requires a constant balancing between the need to design a plan to maximize the revenues realized by the City while protecting the public interest in maintaining the operational integrity of the sewer and water systems, and at the same time maintaining user rates that are "reasonable." The concept of privatization is not new. The past twenty years have seen hundreds of municipalities, large and small, employing these arrangements for a host of reasons including improving operating efficiency, increasing professional management and planning, and in monetizing municipal assets.

The results of the numerous permutations of concession agreements are mixed, further emphasizing the importance of carefully drafting and negotiating the agreement. The draft concession agreement contains a host of performance and monitoring provisions intended to protect the ratepayers and assure the delivery of services meeting the City's health and welfare standards. The risks of loss and totality of obligations assigned to the concessionaire in the draft are calculated to result in up-front proceeds of approximately $200 million to the City. It is this amount that is the centerpiece of the transaction. There is, however, no available "standard" that can be used to predict the results of the proposed RFP process.

One might conclude that the uncertainty of the negotiation and drafting process should cause the City to hesitate in its deliberative process. We would suggest to the contrary that the City cannot effectively compare the options presented in the PFM report, or other alternatives suggested by the public, PEL, or others until the City has a firm grasp on the shape of a final "offer." This can only be achieved through the RFP process and the negotiations that will be integral to that process. Only with the "real numbers" and identification of more precise parameters of rights and obligations will the City and its advisors be able to provide a definitive comparison of the City's options to address the fiscal issues for which solutions are being sought.

Observations Relating To Alternative Solutions

We should also note that PFM has indentified potential tax increase scenarios that would, to some degree, improve the City's fiscal imbalance. We caution against reliance on tax increases as a solution to the fiscal imbalance, anticipating that the cost of City services (i.e. primarily salaries and benefits as well as other adverse inflationary costs) will necessitate tax increases even without addressing the unfunded pension and OPEB obligations. Notwithstanding the fiscal gap caused by these pension and OPEB requirements, if the City intends to significantly impact long-term costs, then the total compensation (cash compensation and cost of benefit programs) paid to each current and future employee must be carefully considered in determining an affordable cost to taxpayers that is consistent with the goals of attracting and retaining a qualified workforce and providing efficient and effective municipal services.

PFM has also described an option by which the City would sell the water and sewer systems to a new public Authority. Assuming marketability of Authority-issued bonds at favorable rates to fund the purchase, this option could approximate the magnitude of the concession option. This option may also alleviate public and private concerns about the loss of "public" control of the systems. It may also be a more attractive structure for future expansion of services as a "regional" authority. As with other options, further study is required to more clearly define its potential as a solution to the existing fiscal problem. PEL has been a supporter of regional services throughout Pennsylvania and would recommend that the City further investigate the potential for this option concurrent with the concession RFP process. We suggest that a side-by-side comparison of the concession and new authority options would provide the City with a clearer picture of the costs and benefits of each of these options in fiscal terms and in terms of mitigating public and private concerns regarding the options being considered by the City.

We have not been tasked and are not prepared to make "recommendations" as to which alternatives are "best." Such judgments are properly within the sole province of the Mayor and Council. What we have been asked to do is to review the material prepared by PFM, Cheiron and EFI and to assess and comment on the methodology and the assumptions used in their studies and in their identified solution-set.. Our comments above are intended to demonstrate our comfort with the methodology employed by PFM in its study and the viability of the options identified therein..

Public Concerns

On a final note, PEL is acutely aware of the concerns raised by members of the public as well as the inevitable concerns of employees, ratepayers and those with health and environmental concerns. The fact that all of these concerns cannot be answered with "absolute" clarity at this time is not reflective of any lack of consideration by the City or its consultants. We suggest that these concerns can and should be addressed within the context of the final decision-making process. The draft concession agreement incorporates many of these concerns. Whether a final, negotiated concession "offer" provides the City and other stakeholders with the assurances they desire will only be known when the RFP process has progressed to a point at which such conclusions can be reached in an informed manner.