Review and Report on Proposals to Fund the City's Future Pension Obligations

PENNSYLVANIA ECONOMY LEAGUE

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City of Allentown

April 2013

This summary report is based upon the review of financial materials prepared by Public Financial Management and the City's actuary, Cheiron, as well as PEL observations. The statistical data are available from public sources and are not repeated herein.

Pennsylvania Economy League

- Over 75-year-old independent, nonprofit, public policy research and development organization with offices throughout the state.

- Working with Pennsylvania's public and private sectors, PEL provides independent research and analysis on emerging issues to stimulate public and private action to make Pennsylvania a better place to live, work, and do business.

- A regionally based statewide organization, PEL's goal is to create a knowledgeable corporate and civic community that will help ensure the economic competitiveness of the Commonwealth and its regions.

Scope of Work

- Review and report observations regarding the financial options identified by Public Financial Management (PFM) for dealing with the unfunded liability of the city's pension systems inclusive of the water/sewer concession lease agreement, creation of a city water/sewer authority, issuance of pension obligation bonds, and a pay-as-you-go plan.
- Analyze impacts of each option identified by PFM on the City's General Fund and identify impact on residents, property owners, and rate payers.
- Review current collective bargaining contracts and any Memoranda of Understanding and comment on options to control pension cost increases under existing labor agreements or memoranda.
- Report on the results of the review.

Observation On Unfunded Pension Liability

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For our review, the following assumptions were used:

- Unfunded pension liability is between $164 and $168 million (Cheiron estimates). For purpose of our review, we used $166 million.
  - The unfunded pension liability estimate is based upon an 8% interest and return rate and a 20 year amortization. (As provided in the PFM and Cheiron projections).
  - We note that a 7% interest and return rate may be a more realistic projection. A 7% rate of return would require between $199 and $206 million to cover the unfunded pension liability.

Observation On Unfunded Pension Liability

For our review, the following assumptions were used:

- City will use proceeds from lease/concession or sale primarily to eliminate the unfunded pension liability.
- Any additional proceeds remaining after paying the unfunded pension liability under the option chosen will be used by the City to defease the existing water/sewer debt ($30.5 million).
- Proceeds of the transaction in excess of those used above will be applied toward $10 million in necessary capital improvements identified by the City and as potential funding for other post employment benefits (OPEB) liabilities or other desired uses.

Lease Concession Option
(Lehigh County Authority)

- City will receive $220 million upon closing.
- The $220 million will be sufficient to eliminate the City's unfunded pension liability at the 8% return.
- It is anticipated that the LCA proceeds in excess of unfunded pension liabilities will be sufficient to pay the water/sewer debt and necessary capital improvements ($40.5 million).
- The estimated remaining proceeds of $13.5 million would be available for current OPEB liability or other desired uses.

City Authority Option

- Estimated proceeds from borrowing of $228 million.
- Eliminates unfunded pension liability at the 8% return rate.
- Pays existing water/sewer debt and necessary capital improvements.
- Covers cost of issuance and related costs. (approx. $20 million)
- No excess funds available for OPEB or other desired uses without additional borrowing.
- New debt service will be borne by rate payers of system.

City Authority Option

- Estimated operating deficit of City Authority would be almost $10 million to be paid by immediate rate increases.
- The City Authority option assumes taxable bond financing.
- Taxable financing adds $4 million annually to debt service which requires revenue increases of approximately 12%, or 25% on the metered user base.
  - Based on PEL review, overall metered user rates would be increased by at least 50% to cover operating deficit.

Pension Obligation Bond Option

- Assumed borrowing of $166 million plus costs of issuance (approximately $4 million) to cover unfunded liability at 8% rate of return.
- Provides for a uniform annual payment at assumed 8% rate of return.
- No additional funds for OPEB or other desired uses.
- No proceeds available for necessary capital improvement.
- No impact on water/sewer funds.

Pay As You Go Option

- City revenues, primarily through large increases in the real estate millage and earned income tax rates, will be necessary to pay the minimum annual pension obligation.
- No excess funds will be available for OPEB or other desired uses without additional tax revenues.
- No proceeds available for necessary water/sewer capital improvement without higher user rates.
- No impact on water/sewer funds.

Controlling Pension Cost Increases

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- Our observation regarding future pension obligations requires that the City avoids repeating the mistakes of the past. This includes paying benefits in excess of those authorized by law and further burdening the City with increased pension costs.

- Contributions by employees should continue at the maximum amount authorized by law (currently 5%).

General Observations

It should be noted that, if the water/sewer system remains as a part of the City, the costs of the underfunded pension and OPEB liabilities, payment of existing bonded indebtedness related to the water/sewer systems and increased costs of future operations will be paid through any combination of real estate millage, earned income tax and utility rates. PEL has run various sets of numbers but recognizes that the different levels and subjects of taxation and rates are infinite and variable. For this reason, while we presented a few possible scenarios, our engagement did not include these financial calculations or analysis. Suffice it to say that user rates impact lower income and larger families as well as non-residential users more acutely than wealthier property owners with small families. Elderly property owners, despite popular notions to the contrary, would be spared some of the rate increases because of smaller family size and reduced water utilization.

General Observations

We observe that even though the current "crisis" was not caused by City residents or this Council or Mayor, the fact is that the City has the unfunded liability and cannot avoid its repayment. Nor can the City avoid repayment of other bonded indebtedness on the sewer/water system. In addition, the City will need to address its OPEB obligations along with finding a way to fund approximately $10 million in "necessary" improvements.

General Observations

PEL was asked to respond to the question; “Which of the options can achieve the goals of the needs identified above?”

While we do not make any recommendations, we do note that the Pension Obligation Bond option fails to meet several of the identified needs and is merely a partial band-aid. The Lease/Concession Option, City Authority Option and "Pay-As-You-Go" Options can all achieve the goals. The differences in their utility as a solution to the issues revolve on the costs of start-up, interest rate on funded obligations, and impacts on residents, property owners and rate-payers. We hope that the information we have related will assist the Council and Mayor in adopting a plan to address its financial needs.

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