

Agenda Report Reviewed by:

City Manager: 

CITY OF SEBASTOPOL
CITY COUNCIL
AGEND ITEM

Meeting Date: May 16, 2023
To: Honorable Mayor and City Councilmembers
From: Ana Kwong – Administrative Services Director
Subject: Fiscal Sustainability Study
Recommendation: That the City Council Receive the Report from NHA of Fiscal Sustainability Study
Funding: Currently Budgeted: Yes No N/A
General Fund Cost: N/A | Water Fund Cost: N/A | Sewer Fund Cost: N/A

Account Code/Costs authorized in City Approved Budget (if applicable) AK (verified by Administrative Services Department)

INTRODUCTION:

The item tonight is to present to the City Council and community a presentation from NHA on Fiscal Sustainability Study.

BACKGROUND:

The City of Sebastopol (City) hired NHA Advisors, LLC (NHA) to help evaluate the City’s current financial position, including to identify current and future financial challenges and discuss potential strategies to address these financial challenges. Over the last five years, the City has maintained unassigned reserves above its minimum target (15% - 20% of annual operating expenditures); however, these reserves have been bolstered by one-time funds that are not expected to recur in the future. As a result of one-time funds likely disappearing and operating expenditures projected to outpace operating revenues in the future, the City’s \$0.9 million structural deficit in FY 2022-23 is projected to widen to \$2.6 million in FY 2023-24 and increase up to \$3.0 million in FY 2028-29. Unassigned reserves are projected to be depleted in FY 2024-25 based on the City’s current General Fund forecast. The Fiscal Sustainability Report (Attachment A) includes detailed information related to various revenue enhancements, as well as cost management strategies (specifically to address rapidly rising pension costs) that the City can consider in an effort to address the structural deficit and enhance long-term financial sustainability and resiliency.

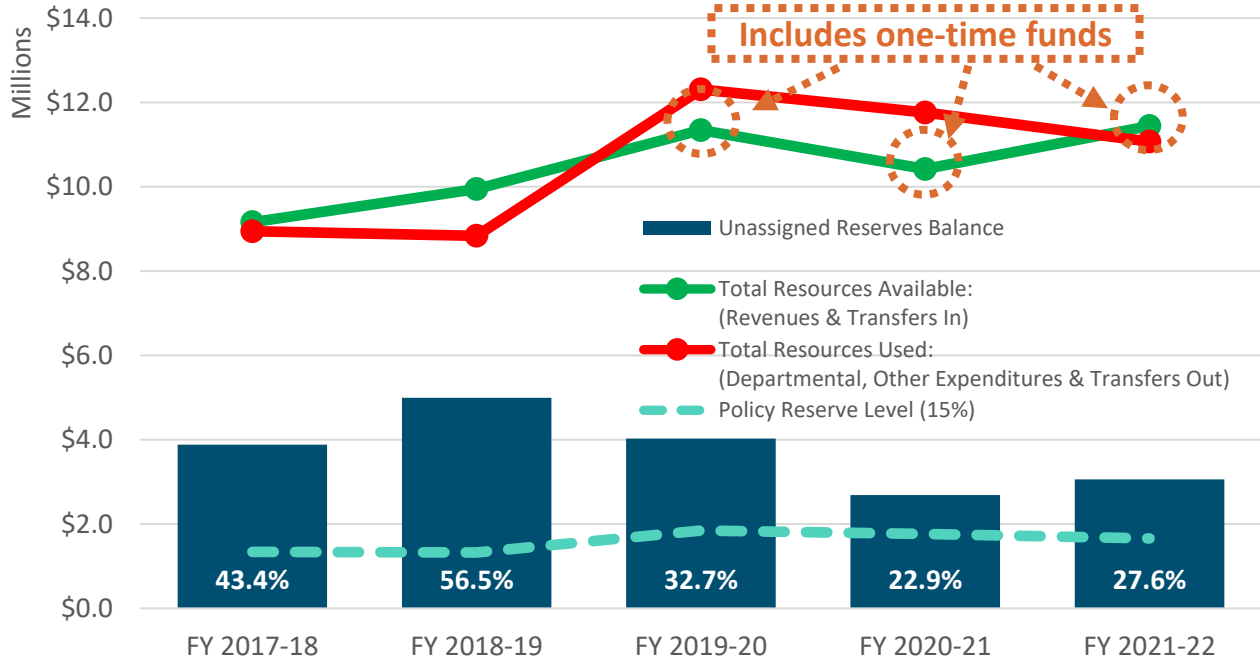
NHA met with the City’s Budget Committee in Fall 2022 to discuss the scope, objectives, and timing for delivery of the Fiscal Sustainability Report. City staff and NHA collaborated to review and analyze the City’s financial data, including the City’s General Fund forecast model, FY 2021-22 audited financial statements, FY 2022-23 budget (adopted and amended), and draft FY 2023-24 budget prior to any proposed reductions. A first draft of the Fiscal Sustainability Report was presented to the Budget Committee in a public meeting on April 5, 2023. Following this Budget Committee meeting, NHA revised the Fiscal Sustainability Report to reflect adjustments to the City’s FY 2022-23 budget and draft FY 2023-24 budget, as well as comments from the Budget Committee and City staff.

DISCUSSION:

5-Year General Fund History: The City’s unassigned reserves have been decreasing over the past few years due to a structural deficit. The City’s unassigned reserve balance decreased 39% from FYE 2019 (\$5.0 million) to FYE 2022 (\$3.1 million), despite receiving approximately \$3.0 million in one-time funds during this same period. The City does not expect to receive these one-time funds in the future. Without one-time funds over the past few years, there would

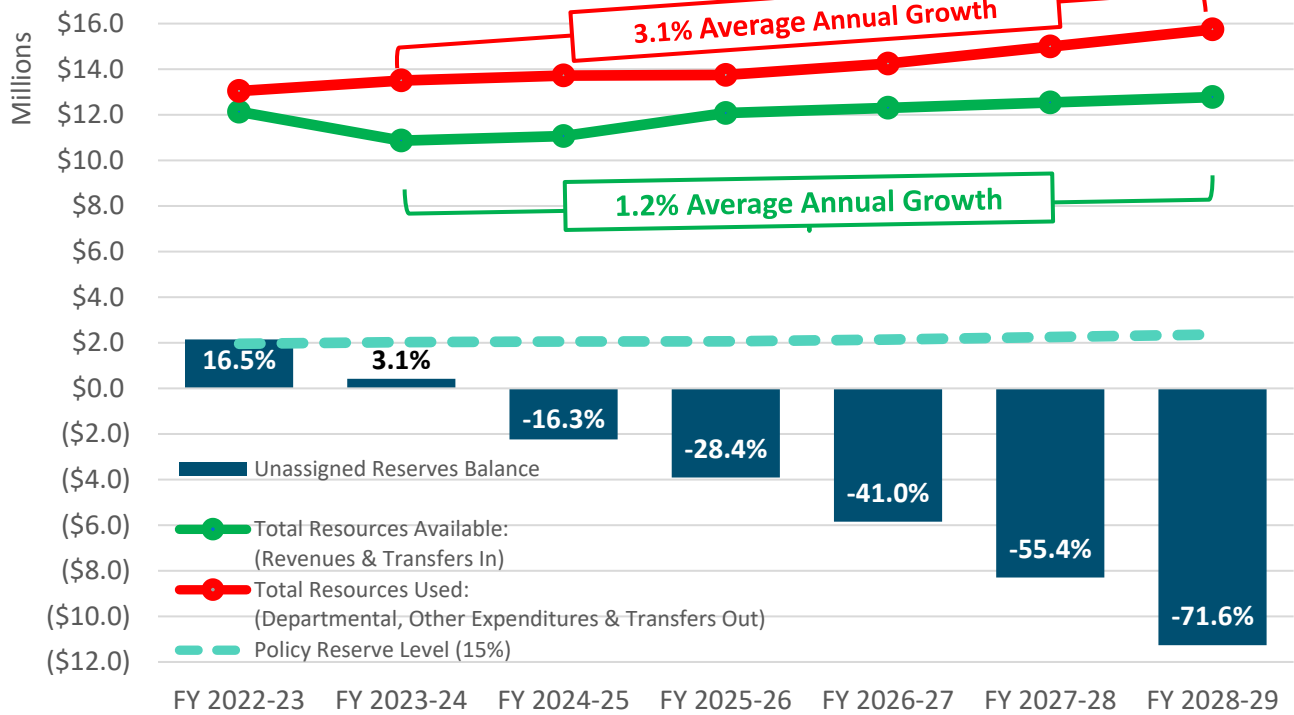
have been a significant risk that the City’s unassigned reserves would become depleted. The following chart provides a graphical depiction of revenue, expenditures, and unassigned reserve levels over the past five years.

General Fund Revenues, Expenditures, and Unassigned Fund Balance
FY 2017-18 through FY 2021-22

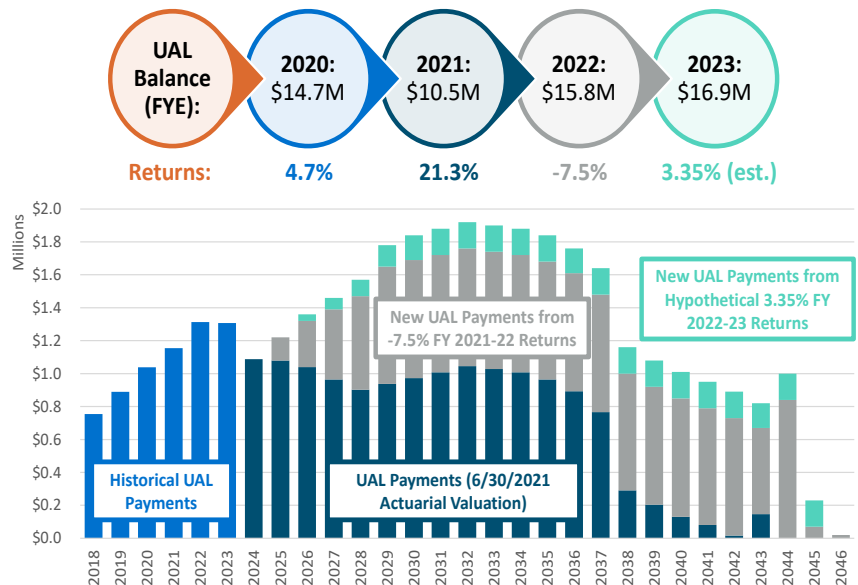


General Fund Forecast: Based on the City’s General Fund forecast (visually depicted at the top of the next slide), which was recently revised to reflect an adjusted FY 2022-23 budget and the draft FY 2023-24 budget, the City’s structural deficit is projected to widen from \$0.9 million in FY 2022-23 to \$2.6 million in FY 2023-24, and up to \$3.0 million in FY 2028-29. These projected deficits would cause reserves to be depleted in FY 2024-25. As the Fiscal Sustainability Report shows in Section 2, the City would need approximately an additional \$2 million to \$3 million annually to maintain the minimum unassigned reserves target of 15% of annual operating expenditures. Details on the key revenue and expense growth assumptions used in the forecast can be found in Section 2 of the Fiscal Sustainability Report.

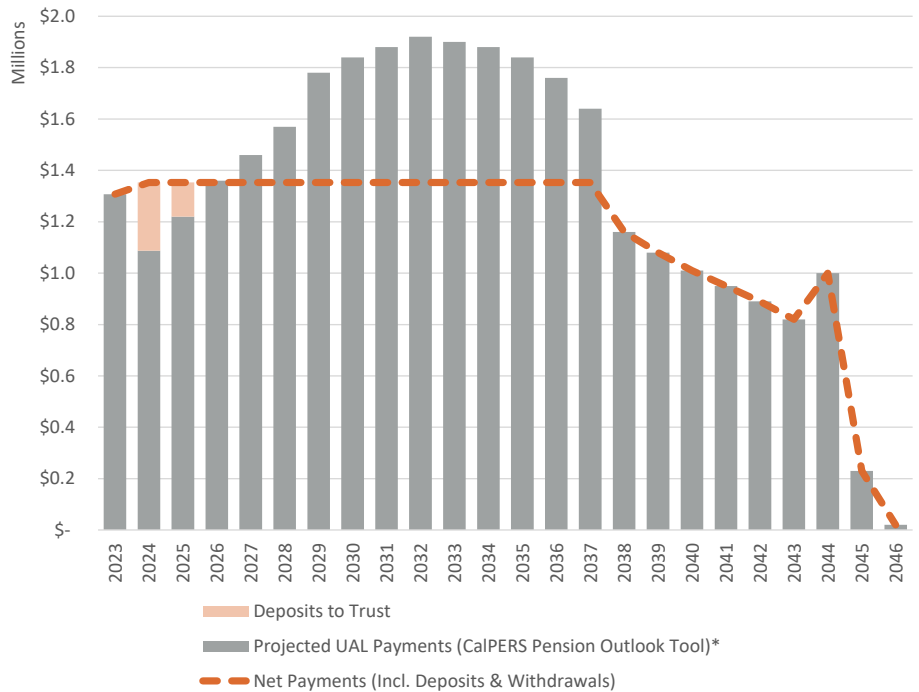
General Fund Revenues, Expenditures, and Unassigned Fund Balance FY 2022-23 through FY 2028-29



CalPERS Pension Costs: One of the fastest growing expenses and largest debts of the City is the City’s CalPERS Unfunded Accrued Liability (UAL). A UAL occurs when the current pension plan assets are not projected to be sufficient to pay total pension costs in future years. The City’s UAL is not repaid all at once but amortized over time with the City paying down a portion each year (principal and 6.80% interest). The City’s UAL balance nearly doubled from \$7.9 million at FYE 2014 to \$14.7 million at FYE 2020 and is currently estimated to increase to \$16.9 million at FYE 2023, due to CalPERS’s investments underperforming and other CalPERS assumptions changing over the years. As a result of recent underperformance, the City’s UAL payments are projected to peak at \$1.9 million in FY 2031-32, which is nearly 50% higher than the \$1.3 million UAL payment paid by the City in FY 2022-23, and 155% higher than what was paid on this debt just five years ago. The recent fluctuations in the UAL debt and corresponding payments to amortize the debt can be seen in the chart to the right.



The City has taken prudent efforts to get ahead of rising pension costs, including setting aside funds in a pension reserve, which has a current balance of approximately \$2.8 million. One of the recommendations in the Fiscal Sustainability Report is to transfer these funds to a Section 115 Trust, which would ensure the funds can only be used for pension expenses. The Section 115 Trust also enables the City to invest the funds in a variety of investment vehicles, which would potentially earn more in interest compared to the restricted investments allowed in General Fund reserves. In addition to the benefit of increased investment potential, the Section 115 Trust can be used to “smooth out” higher UAL payments in the future by withdrawing funds from the Section 115 Trust to supplement payments from the General Fund. This stability will help enhance budget predictability and future financial resiliency and it’s one of the most common strategies being used by other cities in the state.



*Assumes FY 2021-22 returns of -7.5%, FY 2022-23 returns of 3.35%, and 6.80% returns from FY 2023-24 onward.

Setting up a Section 115 Trust can take one to three months and consists of (i) evaluating Section 115 Trust providers, (ii) selecting the provider and working with its investment advisor to determine the preferred investment portfolio, (iii) adopting the necessary documentation at a City Council meeting, and (iv) establishing and funding the Section 115 Trust.

Capital Improvement Project Funding: The City’s latest Capital Improvement Program (CIP) in its draft FY 2023-24 Budget identifies \$30.8 million of capital expenditures for FY 2022-23 through FY 2027-28. About \$27.3 million of the capital expenditures already have funding sources, leaving only \$3.5 million unfunded. Note that this CIP does not include larger potential facility projects such as a fire station, library, City hall, or other larger facility. Capital funding options, including cash, various debt options, and grants are discussed in more detail in Section 3c of the Fiscal Sustainability Report. Given the current structural deficit, any larger capital projects would likely need to be funded from new revenue measures as opposed to being paid from current General Fund revenues.

	FY 2022-23	FY 2023-24	FY 2024-25	FY 2025-26	FY 2026-27	FY 2027-28	Total
Project Category Expenditures							
Bikes, Pedestrians & Safety	\$48,500	\$1,601,000	\$3,411,000	\$9,801,000	\$0	\$0	\$14,861,500
Transition Plan ADA Projects	\$35,000	\$338,500	\$0	\$0	\$0	\$0	\$373,500
Housing Projects	\$0	\$10,500	\$402,000	\$0	\$0	\$0	\$412,500
Parks Projects	\$256,500	\$779,000	\$445,000	\$0	\$0	\$0	\$1,480,500
Paving Projects	\$472,400	\$1,470,000	\$2,577,500	\$1,255,000	\$0	\$0	\$5,774,900
Sewer/Wastewater Projects	\$79,000	\$1,730,500	\$581,500	\$0	\$0	\$0	\$2,391,000
Stormwater Projects	\$52,000	\$202,000	\$1,366,500	\$400,000	\$0	\$0	\$2,020,500
Water Projects	\$392,000	\$635,000	\$808,500	\$1,642,000	\$0	\$0	\$3,477,500
Arts Projects	\$6,500	\$50,500	\$0	\$0	\$0	\$0	\$57,000
Total	\$1,341,900	\$6,817,000	\$9,592,000	\$13,098,000	\$0	\$0	\$30,848,900
Unfunded	\$0	\$205,500	\$1,686,500	\$1,655,000	\$0	\$0	\$3,547,000

Future Considerations: Over the years, the City has been diligent about implementing various studies to help make policy and financial decisions (staffing study, fire department study, fee study, utility rate study, etc.). Despite these efforts, and given the structural deficit faced by the City, the City must evaluate additional strategies to close the funding gap through revenue enhancements and/or cost containment strategies.

Voluntary Taxes	Studies	Actions for the Future
☐	☐	☐
<input checked="" type="checkbox"/> Transaction and Use Tax	<input checked="" type="checkbox"/> Fire Department Feasibility Study (Completed 2023)	<input type="checkbox"/> Potential Sales Tax Increase
<input checked="" type="checkbox"/> Business/Franchise Tax	<input checked="" type="checkbox"/> City-Wide Staffing Study (Completed 2023)	<input type="checkbox"/> Potential Utility User Tax Increase
<input checked="" type="checkbox"/> Transient Occupancy Tax	<input checked="" type="checkbox"/> Fee Study (Completed 2020)	<input type="checkbox"/> Potential Transient Occupancy Tax Increase
<input checked="" type="checkbox"/> Utility Users Tax	<input checked="" type="checkbox"/> Utility Rate Study (Currently in progress; previously completed in 2019)	<input type="checkbox"/> Potential Parcel Tax (June 2024)?*
	<input checked="" type="checkbox"/> Fiscal Sustainability Assessment (in progress)	<input type="checkbox"/> Cost Allocation Study (Most recently completed in 2000)
		<input type="checkbox"/> Cannabis Tax Feasibility Study

**Use of tax revenues to be determined*

Several revenue enhancement opportunities are discussed in the Fiscal Sustainability Report, including the following:

- **Sales & Use Tax Increase**
 - City has capacity for 1% in new taxes (this capacity is shared with potential tax increases the County may implement)
 - Every ¼ cent increase could generate an additional \$700,000 per year
 - The City currently has the second highest sales & use tax rate in Sonoma County (9.25%), behind Cotati and Petaluma (9.50%)

- **Utility Users Tax (UUT) Increase**
 - There was strong support (83.4% voted yes) for the City’s Measure N in November 2022, which maintained the City’s 3.75% UUT and removed the tax’s sunset clause
 - Santa Rosa has a UUT of 5.00%
 - Increasing the City’s UUT from 3.75% to 5.00% could generate an additional \$230,000 per year

- **Transient Occupancy Tax (TOT) Increase**
 - The City has the second highest TOT in Sonoma County (12%), behind Healdsburg (14%)
 - Increasing the City’s TOT from 12% to 14% could generate an additional \$80,000 per year

- **Potential Parcel Tax (June 2024)**
 - A parcel tax is a special tax on a parcel/unit of real property
 - Parcel taxes may be imposed for any municipal purpose
 - Parcel taxes require two-thirds voter approval

- **Local Cannabis Tax**
 - Five Sonoma County cities have a cannabis tax

- Annual tax revenue varies from \$150,000 for Sonoma up to \$1.8 million for Santa Rosa

While the City can evaluate some or all these revenue measures, a hypothetical example of how the City can use these revenues measure to close a \$2.5 million (approximate) funding gap is included in Section 4 of the attached Fiscal Sustainability Report. This hypothetical example includes a sales & use tax increase of 0.50%, a UUT increase of 1.25%, a TOT increase of 2.00%, and a parcel tax that generates \$790,000 per year.

Final Takeaways: Without action or significant growth in revenues, the City’s projected structural financial deficit will reduce and potentially eliminate its unassigned General Fund reserves in the next few years. The City can take action using cost containment strategies and revenue enhancements. Transferring the City’s existing pension reserves to a Section 115 Trust is a cost containment strategy that could help enhance budget predictability and future financial resiliency, as well as generate net savings during the projected peak UAL payments in the next several years. Revenue enhancements, such as an increase to the City’s sales & use tax or a new parcel tax can add relatively large amounts of additional annual revenue.

PUBLIC COMMENT:

The City Council anticipates receiving public comment from interested parties following the publication and distribution of this staff report. Such comments will be provided to the City Council as supplemental materials at the meeting. In addition, public comments may be offered during the public hearing.

GOALS:

Goal 1: Maintain the long term financial stability and sustainability of the City of Sebastopol and Operate City government in a fiscally responsible and responsive manner

1.1.1 Create City Policy to Maintain Operating Reserves and Create Emergency Reserves which complies with the City’s Strategic Plan, provides for optimal staffing levels, minimizes service level reductions, and develops a plan for the General Fund to obtain long-term financial stability

Goal 2: Maintain, Improve and Invest in the City’s infrastructure (Water, Sewer, Streets, Circulation, Park, Storm Drains and Public Facilities).

ENVIRONMENTAL REVIEW

Not applicable for this item.

PUBLIC NOTICE:

This item was noticed in accordance with the Ralph M. Brown Act and was available for public viewing and review at least 72 hours prior to the scheduled meeting date.

FISCAL IMPACT:

None by receipt of this report, but impact if any of these strategies are executed in the future would require outside consultant for ballot measures support, polling research and/or survey, and guidance on ballot measure strategies.

RECOMMENDATION:

That the City Council receive this report and provides guidance on next steps to pursue and evaluate. It is also requested that City Council provide direction for staff to begin the process of setting up a Section 115 Trust to address rising pension costs. While there isn’t any formal approval sought tonight for the 115 Trust, direction to continue moving forward with this strategy will enable staff and its team to continue evaluating the best provider and strategy for this trust, and present those findings to Council at a later date.

ATTACHMENTS:

Fiscal Sustainability Report (presentation). Pages with “star” has been identified to be key slides which consultant will focus their presentation on.

CITY OF SEBASTOPOL

FISCAL SUSTAINABILITY DISCUSSION



NHA | ADVISORS
Financial & Policy Strategies.
Delivered.

MAY 16, 2023



Project Objectives

- ▶ Assess current fiscal condition of City
 - ▶ Understand key aspects of financial forecast
 - ▶ Bonding options/feasibility for new projects
- ▶ Identify potential financial challenges and risks
 - ▶ Rising pension costs
 - ▶ Inflation, labor, capital needs
 - ▶ Legislative changes
- ▶ Discuss potential strategies to improve financial position
 - ▶ Pension cost management
 - ▶ Revenue enhancements



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5. Final Takeaways





Executive Summary

- ▶ City has maintained minimum unassigned reserve targets over last 5 years
 - ▶ Over 22% of annual budget; unassigned reserve target of 15%-20%
 - ▶ Reserves have been bolstered by one-time revenues (not recurring sustainable revenues)
- ▶ \$0.9M FY 2022-23 structural deficit projected to widen to \$2.6M in FY 2023-24, increasing to \$3.0M by FY 2028-29
 - ▶ Unassigned reserves will be depleted by FY 2024-25 (based on the City's current forecast)
- ▶ City can consider revenue enhancement and/or cost management strategies to balance budget and enhance resiliency to future economic shocks
 - ▶ Pension Cost Management: Section 115 Trust to mitigate pension costs increases/volatility
 - ▶ Revenue enhancement considerations: Sales Tax, TOT, UUT, Cannabis Tax, Parcel Tax
 - ▶ Voter approved bonding options for capital: General Obligation, Parcel Tax





1. KEY ASPECTS OF FISCAL SUSTAINABILITY

NHA's Fiscal Sustainability Criteria



Delivery of Essential Services

Are City's essential service levels at risk if there is an economic downturn or other "Black Swan" events (i.e., COVID, natural disaster)?



Financial Health

Economic environment; Reserve levels (At/above policy levels created through comprehensive evaluation of areas of specific risk); Revenue and expense historical trends and projections; Budgetary performance; Budgetary flexibility; Debt burden; Policies & practices



Capital Funding

Pay-as-you-go vs. Debt; Reserve levels; Bonding Capacity; Are critical assets being maintained to prevent potential catastrophic events and/or essential service disruptions?



Resiliency

Sustainability under financial and/or operational duress; 5-10-year forecasting; How would the City fare assuming a near-term recession or a catastrophic event?



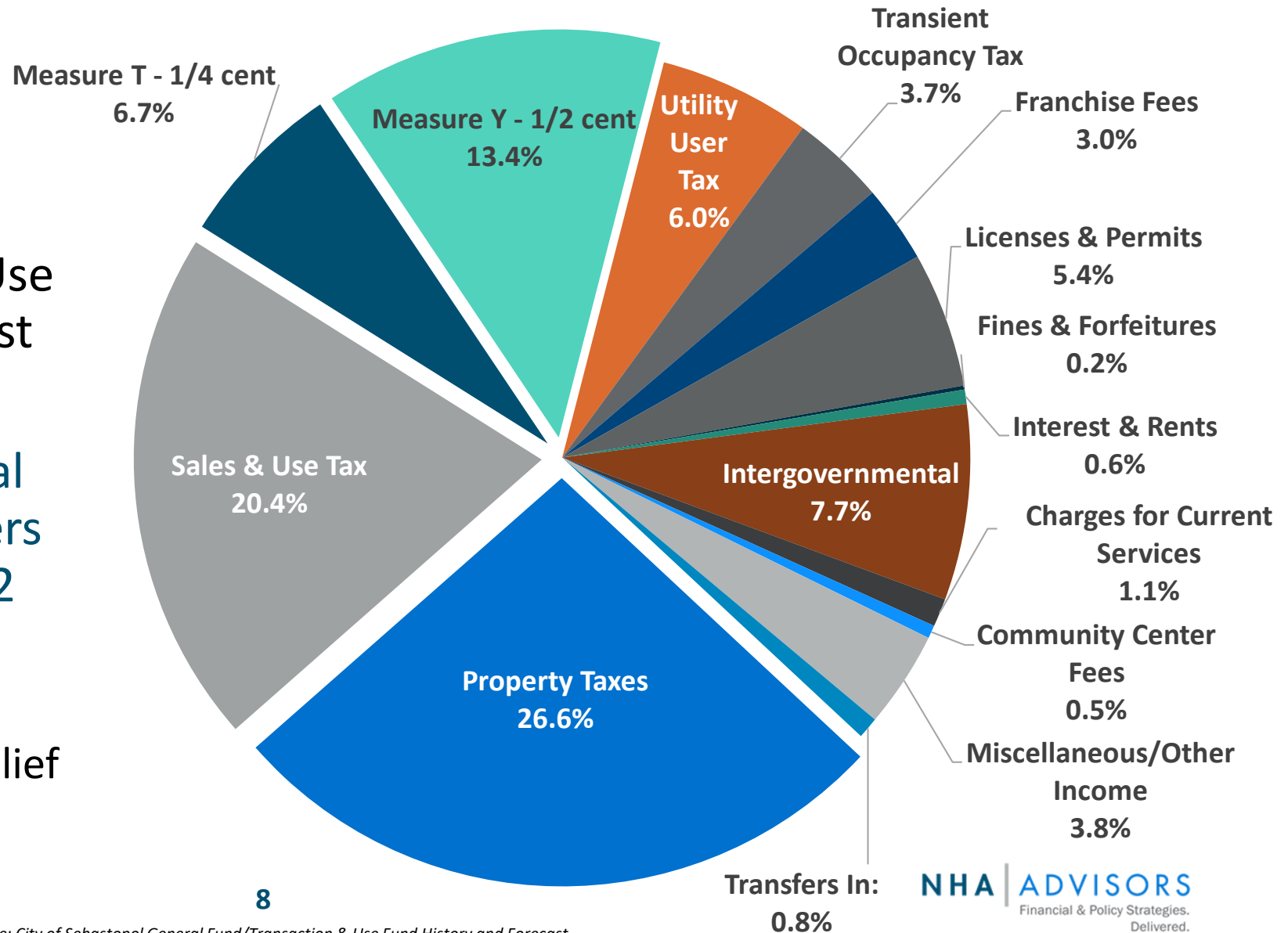


2. FINANCIAL SNAPSHOT

2022-23 General Fund Budget Revenues

▶ \$12.1M Total Budget

- ▶ \$9.3M (77%) derived from taxes
 - ▶ Property Tax and Sales/Use Taxes are the City's largest revenue categories
- ▶ \$0.7M (6%) increase in total revenues (including transfers in) compared to FY 2021-22
 - ▶ Notable increase to Intergovernmental revenue, due to one-time Covid-19 relief funds in FY 2022-23

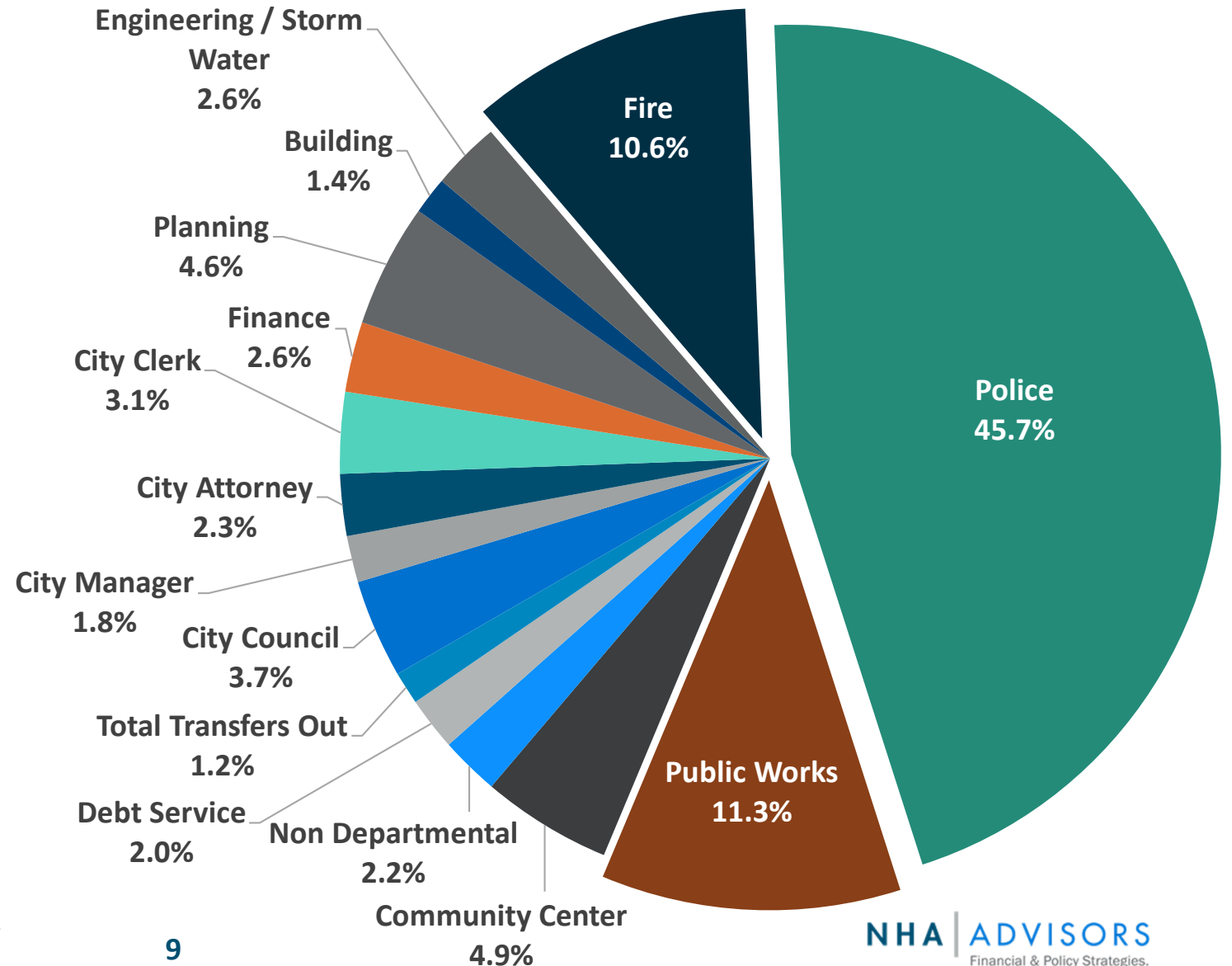


Source: City of Sebastopol General Fund/Transaction & Use Fund History and Forecast

NHA | ADVISORS
Financial & Policy Strategies.
Delivered.

2022-23 General Fund Budget Expenditures

- ▶ \$13.0M Expenditures
 - ▶ \$7.3M (56%) Public Safety
- ▶ \$2.0M (18%) increase in total expenditures (including transfers out) compared to FY 2021-22
 - ▶ Notable increases in public safety and public works expenditures



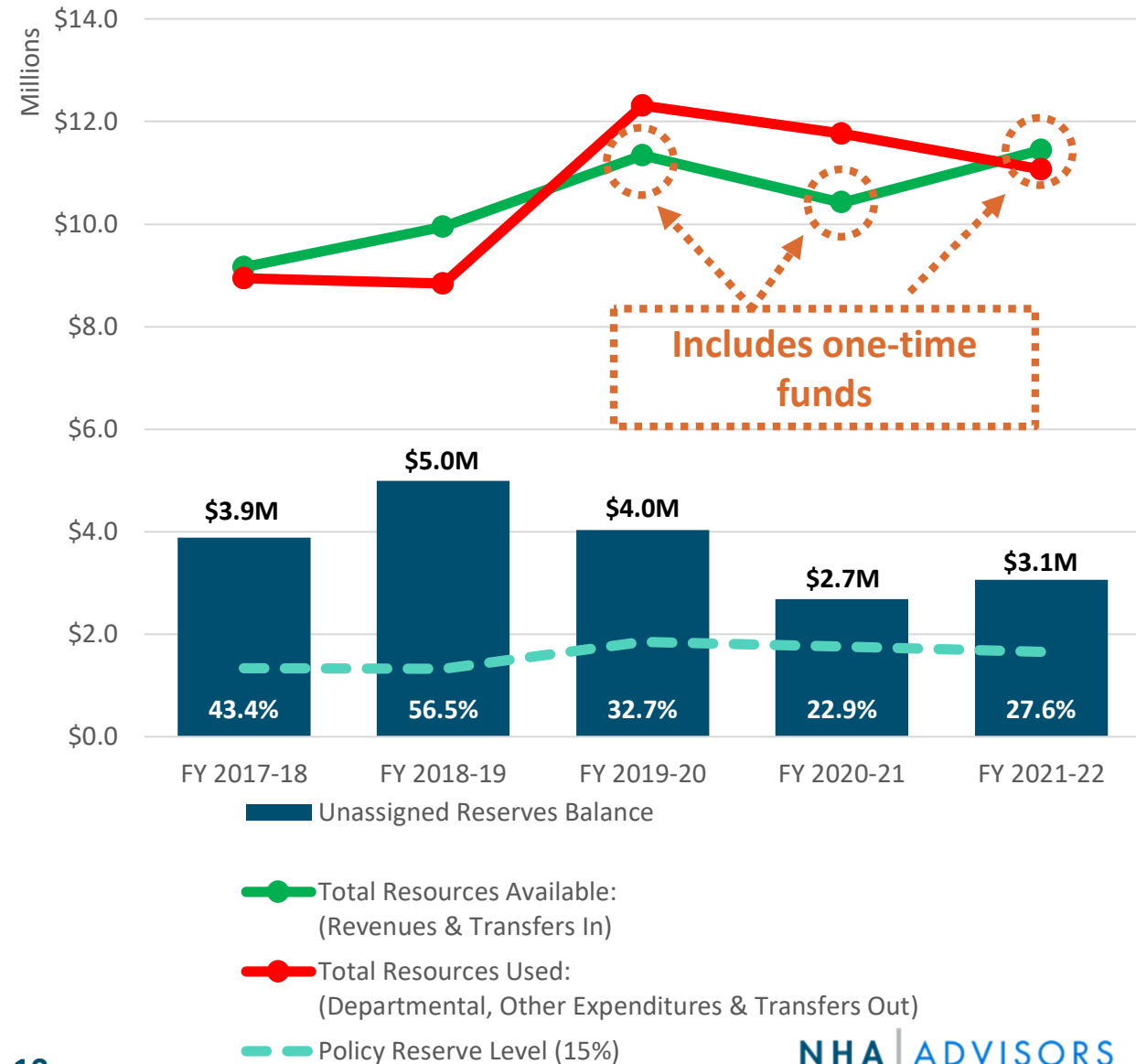
Source: City of Sebastopol General Fund/Transaction & Use Fund History and Forecast

General Fund Revenues, Expenses, & Fund Balance

5-Year History



- ▶ City has been operating with a structural deficit for several years
- ▶ Unassigned reserves have decreased by 39% (from \$5.0M to \$3.1M) over last three years, despite \$3.0M in one-time funds
 - ▶ **Without one-time funds, reserves would have been depleted**
- ▶ One-time funds:
 - ▶ \$900K of one-time ARPA funds FY 2021-22
 - ▶ City also received one-time funds FY 2019-20 (\$1.6M; State flood-related money + insurance reimbursement) and FY 2020-21 (\$0.5M; County homeless initiatives + CARES Act)

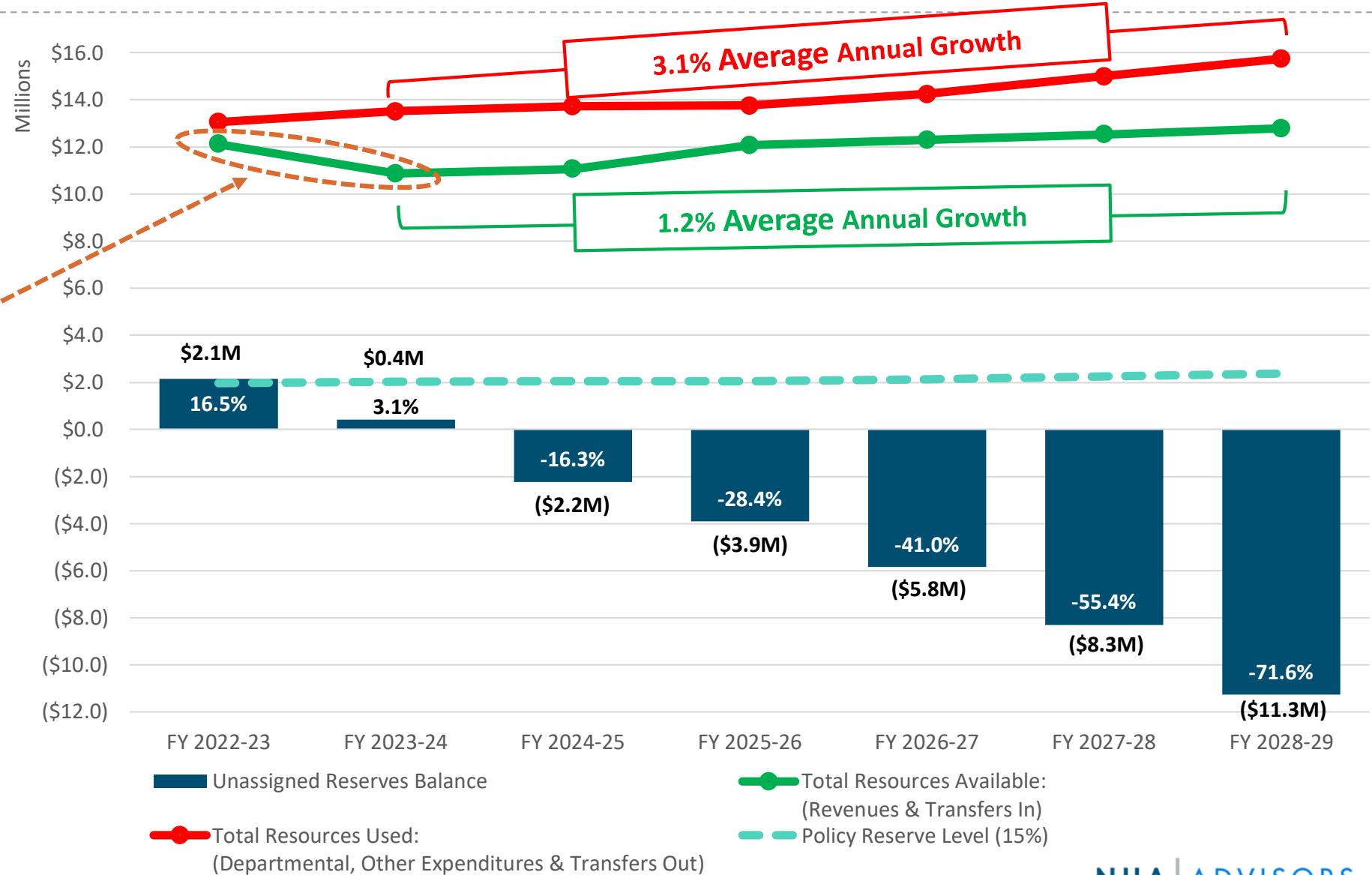


General Fund Budget + Projection



Resources Used projected to exceed Resources Available

- ▶ FY 2022-23 budget deficit and projected FY 2023-24 deficit decrease reserve levels to 3.1% by FYE 2024
- ▶ Revenue decrease for FY 2023-24 due to one-time funds (ARPA + donation) in FY 2022-23
- ▶ Projected deficits impact unassigned reserve balance → **(\$11.3M)** by FYE 2029



General Fund Budget + Projection

Key Forecast Assumptions

- ▶ Forecasted revenues & expenses are based off the FY 2023-24 proposed budget data
- ▶ Projected deficits exaggerated by inflationary expenditure assumptions compared to conservative revenue growth rates

Annual Growth Rate (2025 - 2029)

Revenues:

Property Tax	2.00%
Sales & Use Tax	2.00%
Measure T - 1/4 cent	2.00%
Measure Y - 1/2 cent	2.00%
Utility User Tax	1.50%

Expenses:

Salaries	3.00%
CalPERS Rates	7.70% - 25.70% (depending on plan)
Health Insurance	5.00% - 12.00% (depending on provider)
Materials & Supplies	5.00%

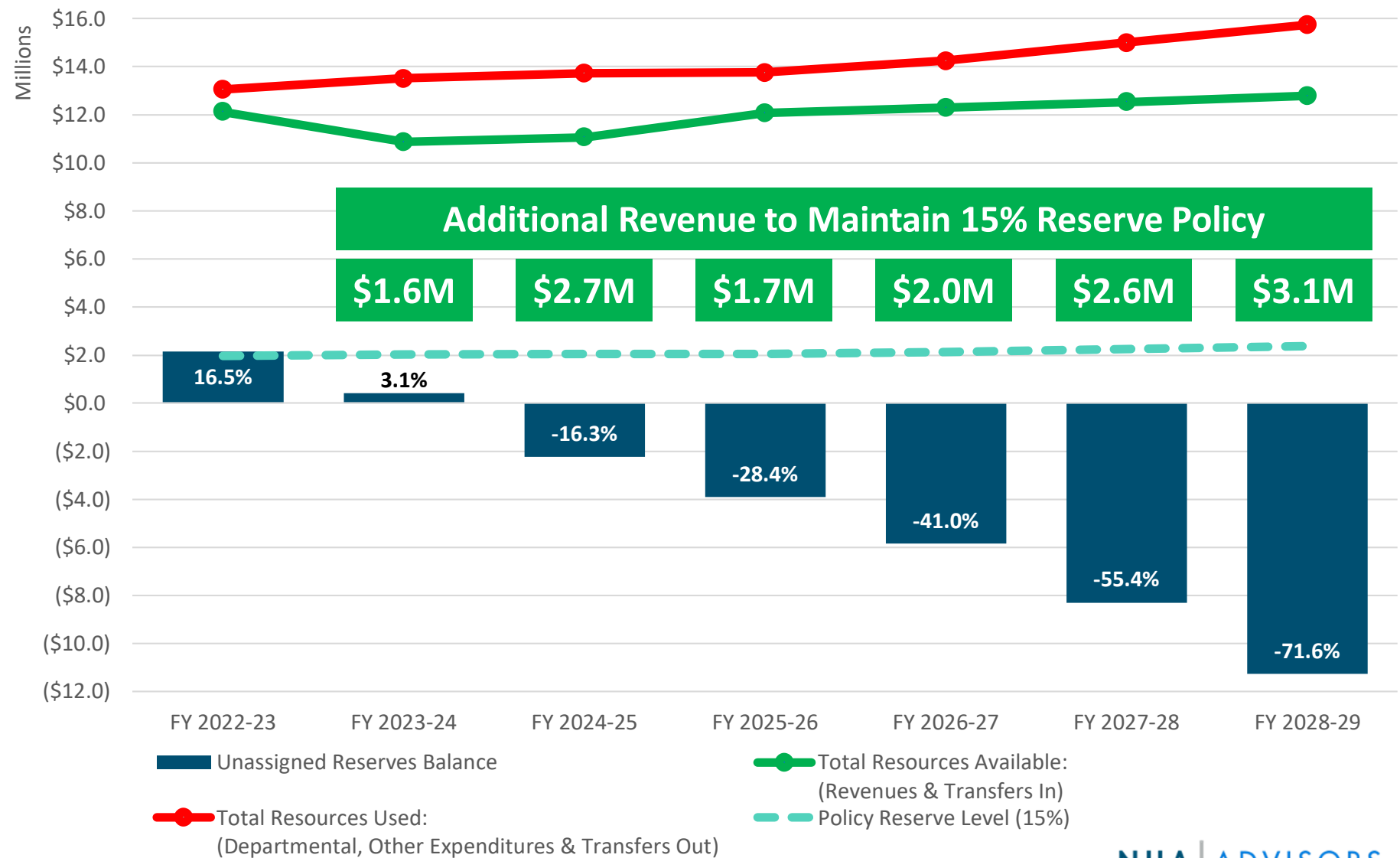




General Fund Budget + Projection

Additional Revenue and/or Cost Containment Required to Maintain Reserves

- ▶ New Revenue of **\$3.1M** required by FY 2028-29 to maintain 15% reserve target
- ▶ Strong Property Tax and Sales Tax Revenue Growth (5% annually) would generate **\$1.4M/year** by FY 2028-29



Credit Rating Scorecard

Estimated “AA” Category GO Rating Using S&P Scorecard

Strengths:

- ▶ **Economy:** Median Household Income 127% of national
- ▶ **Liquidity:** \$11.2M in governmental cash/investments
- ▶ **Budgetary Flexibility***:** \$8.1M in General Fund balance (74% of General Fund expenditures)
- ▶ **Debt & Contingent Liabilities:** Low debt burden

Weaknesses:

- ▶ **Budgetary Performance***:** Negative net result in General Fund and total governmental funds
- ▶ **Pension Liability**

*** Denotes potential area of credit concern – structural deficit (budgetary performance) could lead to weakening reserve levels (budgetary flexibility)

S&P's Local Government GO Criteria (Issuer Credit Rating)

Key Rating Factors	Weight	Score
Institutional Framework	10%	2.00
Economy	30%	1.50
Management	20%	3.00
Financial Measures		
Liquidity	10%	1.00
Budgetary Performance	10%	3.00
Budgetary Flexibility	10%	1.00
Debt & Contingent Liabilities	10%	1.00
Estimated Score		1.85

Indicative Rating Outcomes

Estimated Score	Indicative Rating
1.00-1.64	AAA
1.65-1.94	AA+
1.95-2.34	AA
2.35-2.84	AA-
2.85-3.24	A+
3.25-3.64	A
3.65-3.94	A-



Source: City of Sebastopol 2022 ACFR

City's Debt Profile

Low Debt Burden; CalPERS UAL Debt is Largest Debt on Balance Sheet

Debt	Outstanding Principal*	Final Maturity (FYE)	Source of Repayment	Annual Debt Service as % of FY 2022-23 General Fund Budget
<u>Governmental Activities</u>				
Special Assessment Bonds (<i>Improvements to Woodstone Center</i>)	\$35,000	2023	Assessments	N/A
Capital Lease Agreement (<i>Clean Renewable Energy Projects</i>)	\$292,767	2025	General Fund	0.75%
Lease Financing Agreements (<i>Purchase of a Mobile Home Park</i>)	\$308,102	2028	General Fund	0.50%
2021 Refunding Lease (<i>Refunds 2006 Financing Used for Various Projects, Including a Sewer Force Main, Skate Park, Water Booster Pump, Solar Panels, and more</i>)	\$338,264	2026	General Fund	0.66%
2022 Finance Purchase Agreement (<i>Energy Efficiency and Conservation Equipment and Improvements</i>)**	\$1,126,307	2037	General Fund	0.66%
Total	\$2,100,440	--		
<u>Business-Type Activities</u>				
2021 Refunding Loan (<i>Refunds 2015 Financing Used for Removal of Arsenic from Water Well Seven and its Treatment System</i>)	\$955,734	2035	Water Fund	N/A
2021 Refunding Lease (<i>Refunds 2006 Financing Used for Various Projects, Including a Sewer Force Main, Skate Park, Water Booster Pump, Solar Panels, and more</i>)	\$487,375	2026	Water/ Wastewater	N/A
2022 Finance Purchase Agreement (<i>Energy Efficiency and Conservation Equipment and Improvements</i>)**	\$3,812,582	2037	Water/ Wastewater	N/A
Total	\$5,255,691	--		
<u>CalPERS Pension Liability</u>				
Unfunded Accrued Liability ("UAL" – More Detail in Section 3A of Presentation)	\$15,770,000	2046	General Fund/ Water/Wastewater	8% - 10% (FY 2022-23)



*As of 6/30/2022

** Energy conservation debt offset by energy savings

Source: City of Sebastopol 2022 ACFR

Very Comprehensive City Policies & Practices

New Pension Funding Policy Could be Considered

Annual Operating Budget Policy

- Maintain multi-year financial forecast

Capital Improvement Program

- Maintain 5-year capital improvement program

Revenue Policies

- Maintain diversified and stable revenue base

Expenditure Policies

- Expenditures are to be budgeted and controlled to not exceed estimated revenues

Cash Management/ Investment Policy

- Investments will prioritize safety, liquidity, and return on investment, in that order

Debt Management Policy

- City should plan and use debt in a manner that sustains financing payments at manageable levels

Fund Balance Policies

- Unassigned General Fund balance of 15-20% of annual operating expenditures
- Maintain CalPERS Retirement & OPEB Reserve

Financial Reporting Policy

- City's accounting and financial reports are to be maintained in conformance with GAAP

Security & Risk Practices

- Having faced a cyber/fraud incident in 2021, the City has recently implemented protective measures recommended by Kroll, a leading risk consultant.

Pension Funding Policy

- Recommended; outlines long-term strategy for managing and stabilizing rising pension costs

This policy is a recommendation and has not yet been approved by the City



Source: City of Sebastopol FY 2022-23 Budget



3. HEADWINDS FOR CITY'S FINANCIAL HEALTH

Headwinds for City's Financial Health



Labor

- **CalPERS Costs:** Poor CalPERS investment performance is projected to increase the City's UAL by 50% or more
- **Staffing:** Additional annual costs as new positions are added. Inflationary pressures and salary increases



Capital Project Funding

- Limited bonding capacity projected in the General Fund and Enterprise Funds
- Due to weakened General Fund reserve levels, it is currently not feasible to use reserves to pay for various capital projects, especially large ones



Economy

- Current recessionary pressures
- Sales Tax revenue, which makes up almost 40% of the City's governmental activities revenue, can be volatile under recessionary pressures
- TOT revenue could also be affected



Legislative/Political

- Local or statewide legislation that impacts the City's ability to raise revenues
- California Business Roundtable Initiative (November 2024 Ballot)
- City's UUT would need to be readopted in compliance with the Initiative, if it passed





3A. HEADWINDS FOR CITY'S FINANCIAL HEALTH: RISING PENSION COSTS

Background - Retirement Plans

- ▶ 2 CalPERS plans
 - ▶ Miscellaneous: 100 covered members
 - ▶ Safety (Police & Fire): 61 covered members

- ▶ PEPR (2013) helpful to manage long-term pension costs for new employees

- ▶ 99% of UAL is attributable to Classic employees

MISCELLANEOUS PLANS			
Benefit Group	# of Actives	% of Actives	Benefit Formula
Miscellaneous	18	64.3%	2.0% @ 55
PEPRA Miscellaneous	10	35.7%	2.0% @ 62
Total Active Members	28	100.0%	-
Total Covered Members	100	-	-

SAFETY PLANS			
Benefit Group	# of Actives	% of Actives	Benefit Formula
Safety Fire	1	7.1%	3.0% @ 50
Safety Police	7	50.0%	3.0% @ 50
PEPRA Safety Fire	1	7.1%	2.7% @ 57
PEPRA Safety Police	5	35.7%	2.7% @ 57
Total Active Members	14	100%	-
Total Covered Members	61	-	-

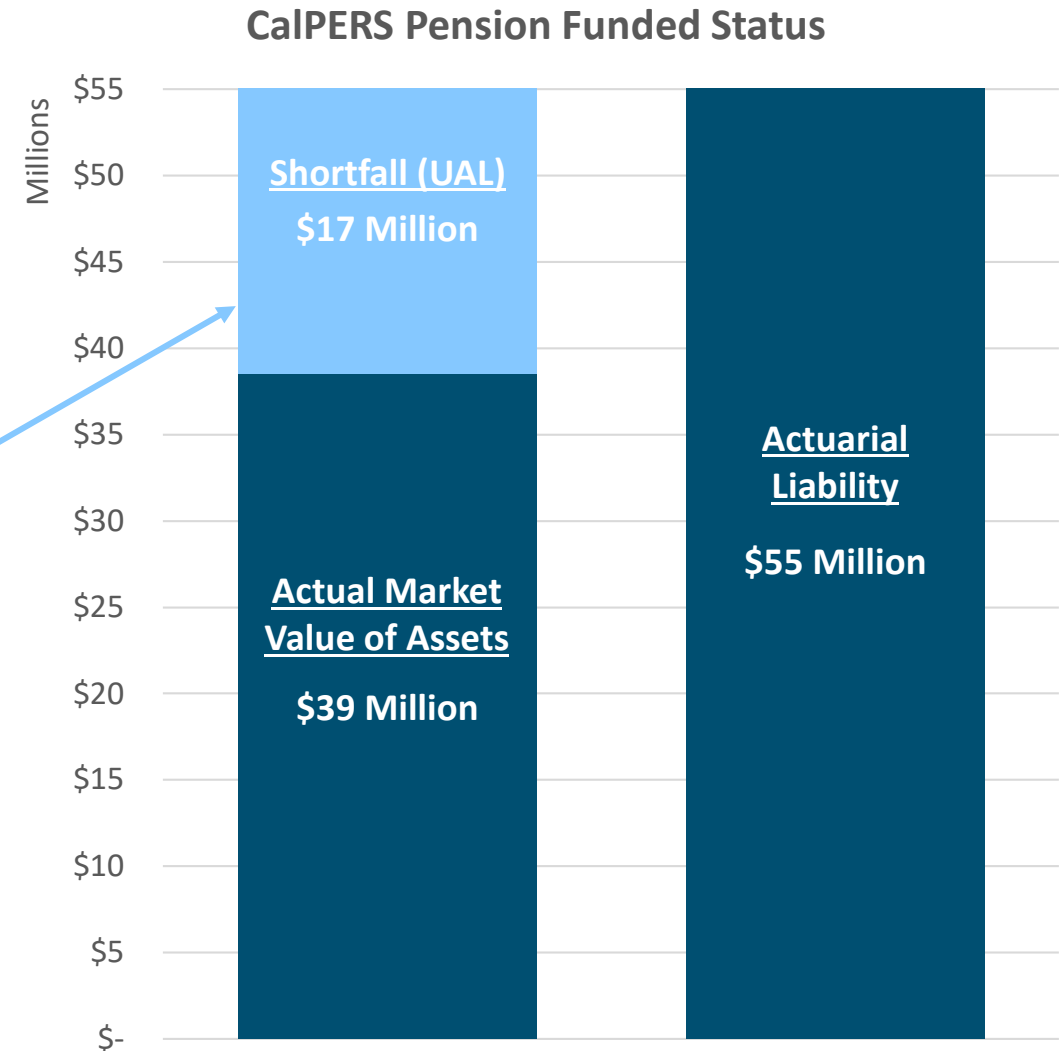


Source: City of Sebastopol CalPERS Actuarial Valuation Reports (June 30, 2021)

Background on How CalPERS Works

Two Payments Made to CalPERS Annually

- ▶ **(1) Normal Cost (“NC”)** = Annual cost for current employees
- ▶ **(2) Unfunded Accrued Liability (“UAL”)**: Annual payment to amortize the “debt” to CalPERS
 - ▶ CalPERS actuaries calculate how much the City is required to have in its account with them to pay out benefits to City’s retirees over the next 30-40 years (Actuarial Liability)
 - ▶ CalPERS annually calculates the Market Value of City’s assets held on account with them; Most public agencies have *less assets than required* to meet Actuarial Liability
 - ▶ This shortfall (i.e., the “UAL”) is not repaid all at once but amortized over time with the City paying down a portion each year (principal and interest)
 - CalPERS uses a “discount (i.e., interest) rate” of 6.80%
 - CalPERS annually adjusts this repayment schedule by adding a new “base” (i.e., layer) which adds to (in bad investment years) or lowers (good investment years) the overall repayment schedule
 - Over the past 20 years, the addition of these “layers,” along with other CalPERS assumption changes, has created a very irregular repayment shape for most CalPERS public agencies



Note: The numbers reported in this chart assume FY 2021-22 returns of -7.5%, FY 2022-23 returns of 3.35%, and 6.80% returns from FY 2023-24 onward. Due to rounding, amounts may not add up exactly.



Historical PERS Returns

5-Year: 6.7%
10-Year: 7.7%
20-Year: 6.9%
30-Year: 7.7%

Why CalPERS Costs have Trended Higher

Then (late 1990s)...

- ▶ Robust investment returns (10%+)
 - ▶ Retirement plans were “Super-Funded” through the late 1990s
 - ▶ Earnings on funds were more than adequate to cover retirement costs
- ▶ Super-funded status induced widespread retirement benefits enhancements....

Now ...

- ▶ Sluggish returns outlook (<7%)
- ▶ Assumptions have changed/changing
 - ▶ Discount Rate: 8.25% → 7.00% → 6.80%
 - ▶ Inflation rate (prices going up)
 - ▶ Mortality rates (people living longer)
 - ▶ Actuarial Valuation → Market Valuation
 - ▶ Shorter (20 year) amortization
- ▶ UAL payments have grown rapidly from past changes, remain exposed to the effects from future poor investment returns and assumption changes

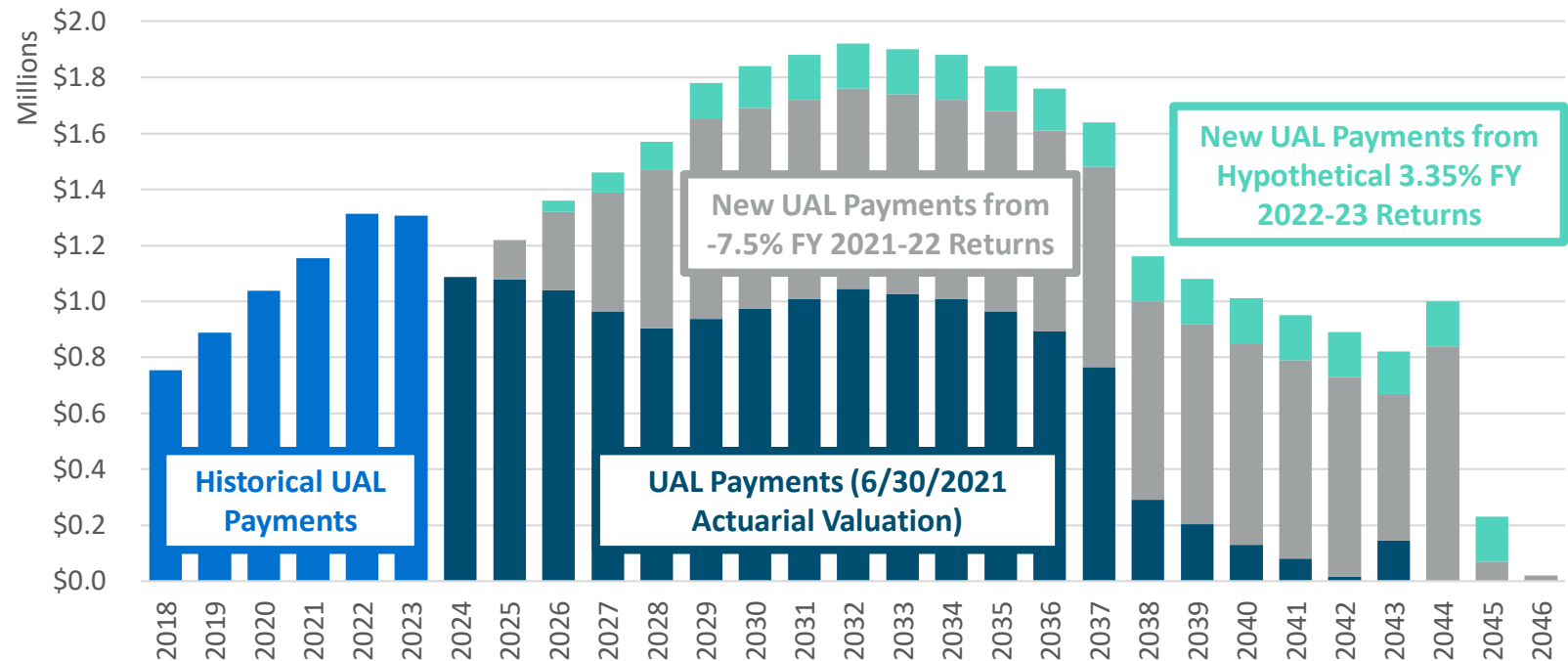
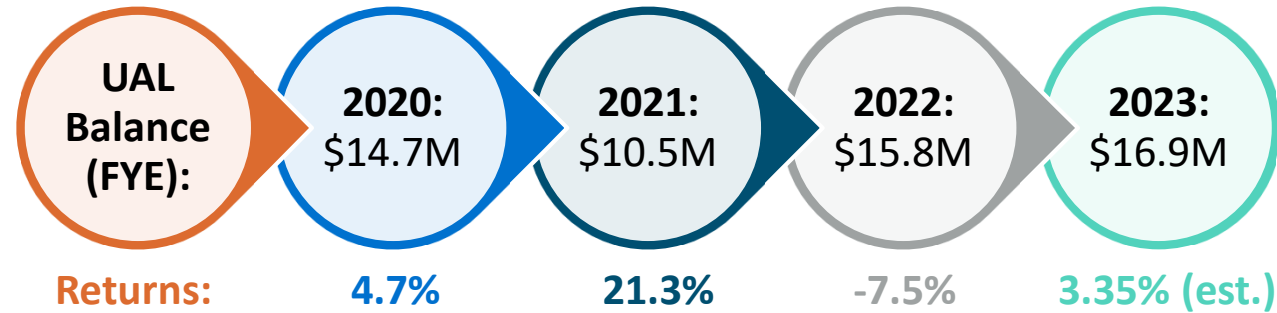


Historical and Projected UAL Payment Schedule



Current Estimated Pension Debt Approaching \$20 Million

- ▶ The City's UAL balance had nearly doubled from \$7.9M in FYE 2014 to \$14.7M in FYE 2020
- ▶ The City's UAL balance as of FYE 2021 is \$4.2M lower than FYE 2020 but is expected to increase \$5.3M in the next CalPERS valuation
- ▶ The City's UAL balance could increase another \$1.1M if CalPERS earns 3.35% in FY 2022-23 (CalPERS' investment returns as of end of March)
- ▶ City's \$0.8M UAL payment in 2018 has increased to \$1.3M in 2023. Projected payments peak at nearly \$1.9M in 2032.
- ▶ Rapidly increasing impact to City's budget
- ▶ Note that the UAL will fluctuate annually moving forward based on future CalPERS investment returns & assumption changes



Source: CalPERS Pension Outlook Tool. Assumes FY 2021-22 returns of -7.5%, FY 2022-23 returns of 3.35%, and 6.80% returns from FY 2023-24 onward.

UAL Cost-Containment Strategies – Not Mutually Exclusive

(1) Prepay UAL early in Fiscal Year (\approx 3.3% discount)



(2) Negotiate Cost Sharing With Employees

- Require employees to pay their share; new employees already governed by lower cost/benefit PEPRAs plans
- Negotiated cost sharing of the City's share

(3) Fresh Start Amortization offered by CalPERS

- Pros: Smooths payment, shortens repayment period; reduces overall interest paid from shorter amortization period
- Cons: New structure "locked-in" + increased annual payments in near term; still amortized at discount rate

Currently not recommended

(4) Use Cash Reserves to Pay Extra (two options)

- Section 115 Trust - Separate trust solely dedicated to pension/OPEB
- ADP – Reduce UAL through direct lump sum payment to CalPERS
 - Choose optimal amortization bases to pay off



(5) Restructure All or Portion of Remaining UAL

- Restructure portion of UAL at lower bond interest rate and "smooth out" payments for enhanced budget predictability, near and mid-term potential savings, and preservation of cash for other critical projects

Currently not recommended;
Continue to Monitor



Use Cash Reserves: Section 115 Trust

- ▶ **What is it?** Dedicated (restricted to pension/OPEB) account managed by 3rd party
- ▶ **Pros:**
 - ▶ Potential for increased investment returns vs. current General Fund reserves
 - ▶ General Fund investments restricted by Government Code (limits types of instruments and maturities)
 - ▶ **Flexibility – more investment options than CalPERS and the City can decide when and how to use**
 - ▶ Longer-Term: Trust funds can grow over time and pay off full UAL in the future
 - ▶ Shorter-Term: Apply during challenging budget years or to **“smooth”** payment spikes in UAL and/or Normal Cost
 - ▶ Diversify asset management away from CalPERS
 - ▶ Potential shock absorber for volatility from CalPERS investment performance & assumption changes
- ▶ **Cons:**
 - ▶ Market risk (dependent on type of investment portfolio)
- ▶ Note: The Trust will show up as an asset on the City’s financial statements, but will not technically offset UAL until funds are transferred to CalPERS



Use Cash Reserves: ADP

- ▶ **What is it?** City makes Additional Discretionary Payment (“ADP”) directly to CalPERS and designates which amortization base(s) / layer(s) shall be paid off
 - ▶ CalPERS will eliminate payments associated with the portion of the UAL paid off, essentially giving the City credit at the discount/interest rate (currently 6.8%)
- ▶ **Pros:**
 - ▶ Reduced future payments
 - ▶ Reduced UAL / higher CalPERS funding ratio
 - ▶ Broader, less restrictive CalPERS investment portfolio has potential for higher returns
- ▶ **Cons:**
 - ▶ Re-investment and market timing risk with ADP funds
 - ▶ No options for other investment portfolios like there is with a Section 115 Trust



Section 115 Trust vs. CalPERS ADP Comparison

OPTION	Section 115 Trust	CalPERS ADP
Reduced UAL & UAL Payments with CalPERS	No	Yes
Reduced Pension Liability in ACFR	No (but the Trust will show up as an asset on the City's financial statements)	Yes
Control of Investment Strategy	Yes	No
Funds Managed By	Trust Administrator	CalPERS
Flexibility in Uses	Yes (annual pension or OPEB expense, ADP, OPEB, etc.)	No
Savings	Varies; Depends on when City utilizes funds to pay liabilities	Immediate; Length of time varies based on which amortization component is paid off (City's amortization bases currently range from 1 - 27 years)
Enhanced Budgetary Flexibility	Yes	Limited
How Many Agencies in CA Have Used?	Hundreds of CA agencies maintain Section 115 Trusts	Historically, hundreds of ADPs made by CA agencies annually

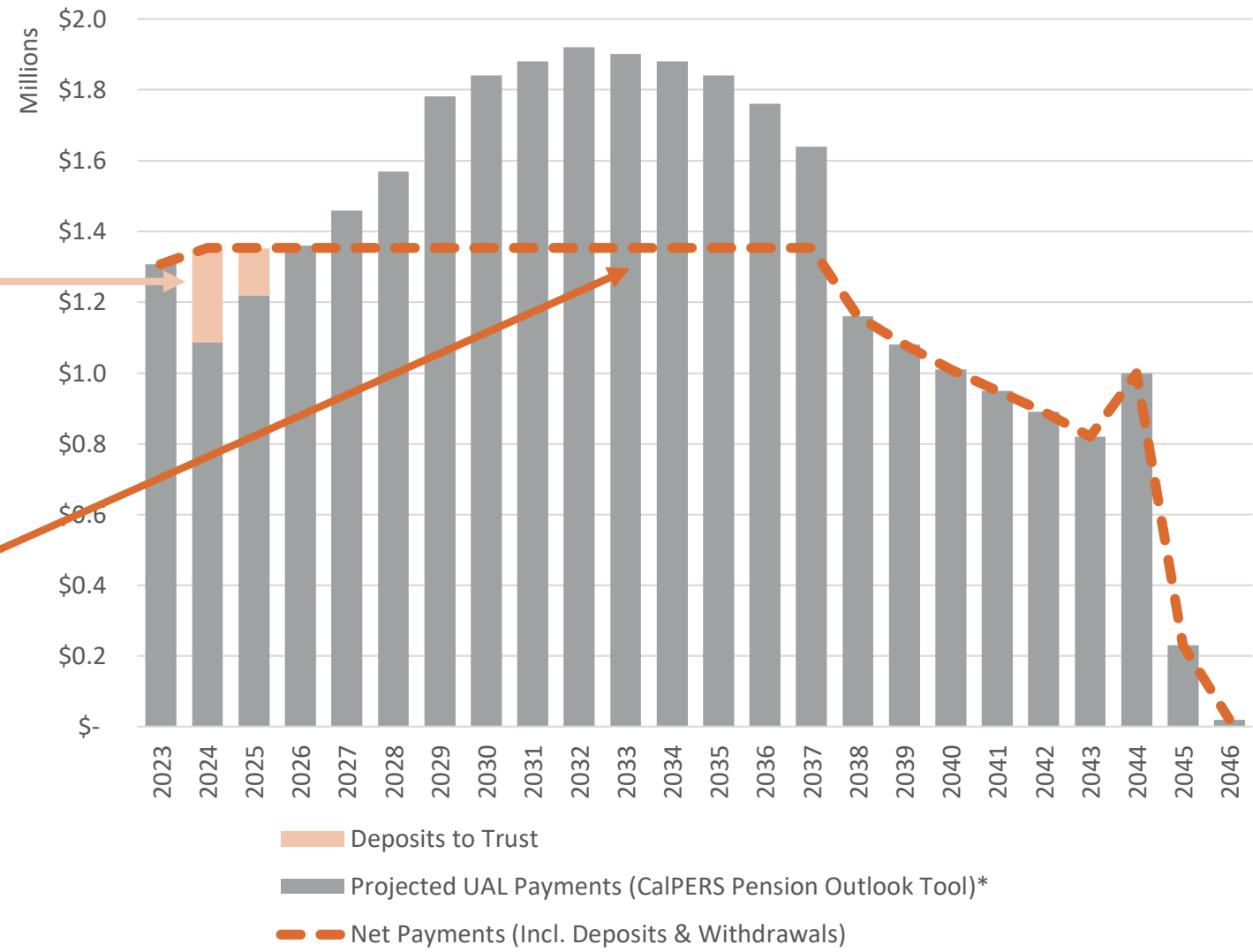




Considerations for Managing New 6.80% UAL Debt

Apply Section 115 Trust Assets to Smooth Out Peak UAL Payments

- ▶ Assumes City's existing pension reserve of \$2.8M is **transferred to a Section 115 Trust**
 - ▶ A main benefit of moving funds to a Section 115 Trust is the increased potential for interest earnings vs. current General Fund investments (especially in today's inflationary environment)
- ▶ Assumes an additional total of \$0.4M is deposited in 2024 - 2025
- ▶ Assumes a 4.50% long-term investment returns rate**
- ▶ Funds could be withdrawn from the Section 115 Trust during higher payment years to stabilize net impact to the General Fund
 - ▶ Smooth annual payments at \$1.4M
 - ▶ Projected to generate \$1.4M of savings, net of existing pension reserves and additional deposits
- ▶ Budgetary savings during elevated UAL payments in years 2027 – 2037 will help protect the City's General Fund deficit from widening



**This long-term investment returns rate is not fixed/guaranteed

*Assumes FY 2021-22 returns of -7.5%, FY 2022-23 returns of 3.35%, and 6.80% returns from FY 2023-24 onward.

Section 115 Trust

Overview of Steps to Select the Provider and Establish the Trust

Establishment of the Trust can be completed in 30 – 90 days

Evaluate potential
Section 115 Trust
Providers

Select Provider and
work with its
Investment Advisor to
determine preferred
investment portfolio

Formal City Council
adoption of necessary
documentation

Trust established and
funded by City (if
desired at that time)





3B. HEADWINDS FOR CITY'S FINANCIAL HEALTH: STAFFING

Summary of City-Wide Staffing Study

- ▶ In the fall of 2021, the City engaged Regional Government Services (RGS) to conduct a City-wide staffing study
 - ▶ Study completed in September 2022
- ▶ City has approved a couple of the staffing changes recommended by RGS
- ▶ City staffing is a long-term solution that will continue to be discussed and evaluated
- ▶ **Additional annual staffing costs estimated by the study are not factored into the City's forecast**



Source: RGS City-Wide Staffing Study (2022)



3c. HEADWINDS FOR CITY'S FINANCIAL HEALTH: CAPITAL IMPROVEMENT PROJECT FUNDING

Overview of City's Capital Improvement Plan (CIP)

- ▶ \$30.8M of CIP expenditures for FY 2022-23 through FY 2027-28
 - ▶ Expenditures concentrated in bikes, pedestrians & safety projects and paving projects
 - ▶ Does not include larger potential facility projects such as a fire station, library, City hall, etc.

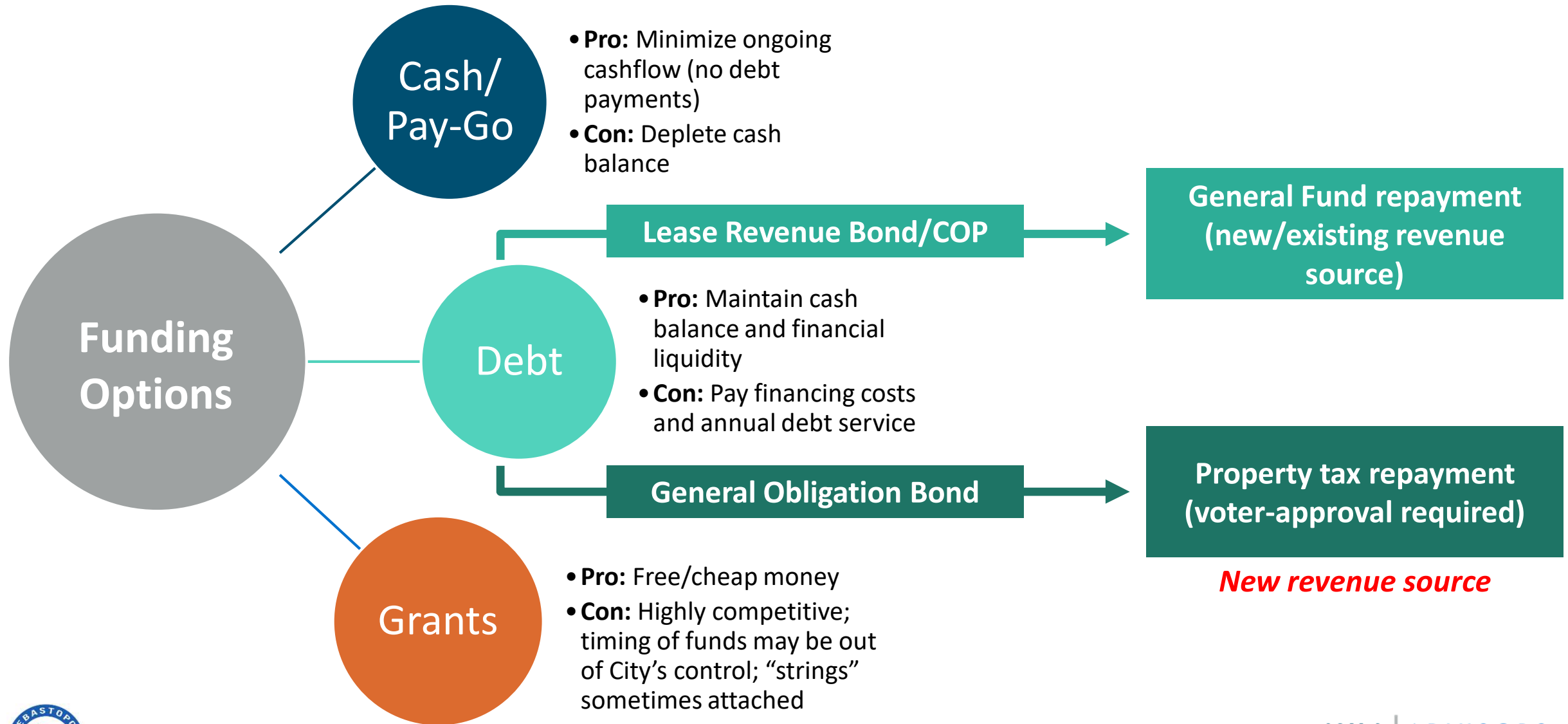
	FY 2022-23	FY 2023-24	FY 2024-25	FY 2025-26	FY 2026-27	FY 2027-28	Total
Project Category Expenditures							
Bikes, Pedestrians & Safety	\$48,500	\$1,601,000	\$3,411,000	\$9,801,000	\$0	\$0	\$14,861,500
Transition Plan ADA Projects	\$35,000	\$338,500	\$0	\$0	\$0	\$0	\$373,500
Housing Projects	\$0	\$10,500	\$402,000	\$0	\$0	\$0	\$412,500
Parks Projects	\$256,500	\$779,000	\$445,000	\$0	\$0	\$0	\$1,480,500
Paving Projects	\$472,400	\$1,470,000	\$2,577,500	\$1,255,000	\$0	\$0	\$5,774,900
Sewer/Wastewater Projects	\$79,000	\$1,730,500	\$581,500	\$0	\$0	\$0	\$2,391,000
Stormwater Projects	\$52,000	\$202,000	\$1,366,500	\$400,000	\$0	\$0	\$2,020,500
Water Projects	\$392,000	\$635,000	\$808,500	\$1,642,000	\$0	\$0	\$3,477,500
Arts Projects	\$6,500	\$50,500	\$0	\$0	\$0	\$0	\$57,000
Total	\$1,341,900	\$6,817,000	\$9,592,000	\$13,098,000	\$0	\$0	\$30,848,900
Unfunded	\$0	\$205,500	\$1,686,500	\$1,655,000	\$0	\$0	\$3,547,000



Source: City of Sebastopol 5-Year Capital Improvement Program
from the DRAFT FY 2023-24 Budget

Funding Options for Capital Projects

Pay-Go, Debt, & Grants



Funding Options for Capital Projects (Hypothetical \$10M Project)

Lease Revenue Bond, General Obligation Bond, Parcel Tax



	Lease Revenue Bond	General Obligation Bond	Parcel Tax
Annual Debt Service (30-year repayment)	\$750,000	\$750,000	\$750,000
Paid for by	General Fund	Property Owners: ~\$34 per \$100K A.V. per year; ~\$170 per \$500K A.V. per year	Property Owners: ~\$270 per parcel per year
Voter Approval Required	No	Yes – 2/3rds	Yes – 2/3rds
Tax Formula	N/A	Based on % of Assessed Value	Fixed Tax Formula
Use of Bond Proceeds	Capital Improvements Only	Capital Improvements Only	Capital Improvements, Programs or Services
Use of Tax Revenue	N/A	Debt Service Only	Debt Service and Operations
Key Benefit	No voter-approval required	Lowest interest rate	Most equitable tax distribution
Key Negative	General Fund Budget Burden	No ability to fund operational costs	Higher homeowner tax amount than GO Bond



Capital Funding Capacity in Water & Wastewater Enterprise Funds

- ▶ Water/Wastewater Rate Study (Willdan 2019)
 - ▶ Water/Wastewater rates implemented in FY 2019-20 through FY 2022-23
- ▶ Water/wastewater revenues insufficient to meet rising operating expenses
- ▶ Net Revenues insufficient to generate bonding capacity or fund CIP
 - ▶ New debt will typically require debt service coverage of 1.20x
- ▶ **The City has authorized a contract for a new utility rate study**
 - ▶ This rate study will propose new utility rate increases to support future capital

Water Enterprise Fund

	Actual			
	FYE 2019	FYE 2020	FYE 2021	FYE 2022
Net Revenues:	\$590,697	\$255,283	\$500,786	\$143,907
Debt Service:	\$141,949	\$142,515	\$192,484	\$158,197
Debt Service Coverage:	4.16x	1.79x	2.60x	0.91x

Wastewater Enterprise Fund

	Actual			
	FYE 2019	FYE 2020	FYE 2021	FYE 2022
Net Revenues:	\$251,222	(\$142,289)	\$6,037	(\$377,713)
Debt Service:	\$90,117	\$89,132	\$96,423	\$72,852
Debt Service Coverage:	2.79x	-1.60x	0.06x	-5.18x



Source: City of Sebastopol Annual Comprehensive Financial Reports



3D. HEADWINDS FOR CITY'S FINANCIAL HEALTH: LEGISLATIVE/POLITICAL

Possible Legislative/Political Headwinds to Consider

Local initiatives to terminate existing transaction and use tax measures

California Business Roundtable Initiative (November 2024 Ballot)

Any other legislation impairing the City's current/future revenue

California Business Roundtable Initiative (Initiative #21-0042A1)

- Limits ability of voters and state and local governments to raise revenues for government services
- **Revisions to local tax authority:** Requires voter approval for taxes applied to territory that is annexed; Requires sunset date on all new taxes; General tax ballot label must say “for general government use”
- **Revisions to local fee authority:** Fees must be “reasonable to the payor”. “Actual cost” of providing the product or service for which the fee is charged is defined as the “minimum amount necessary to reimburse the government...”
- **Retroactive Window: Taxes and fees approved after January 1, 2022, will sunset in December 2025 if not readopted in compliance with the initiative**





4. ADDITIONAL REVENUE SOURCES



Sebastopol Has Done A Lot... What are Actions for the Future?

Voluntary Taxes

Studies

Actions for the Future



- Transaction and Use Tax
- Business/Franchise Tax
- Transient Occupancy Tax
- Utility Users Tax

- Fire Department Feasibility Study (Completed 2023)
- City-Wide Staffing Study (Completed 2023)
- Fee Study (Completed 2020)
- Utility Rate Study (Currently in progress; previously completed in 2019)
- Fiscal Sustainability Assessment (in progress)

- Potential Sales Tax Increase
- Potential Utility User Tax Increase
- Potential Transient Occupancy Tax Increase
- Potential Parcel Tax (June 2024)?*
- Cost Allocation Study (Most recently completed in 2000)
- Cannabis Tax Feasibility Study

*Use of tax revenues to be determined

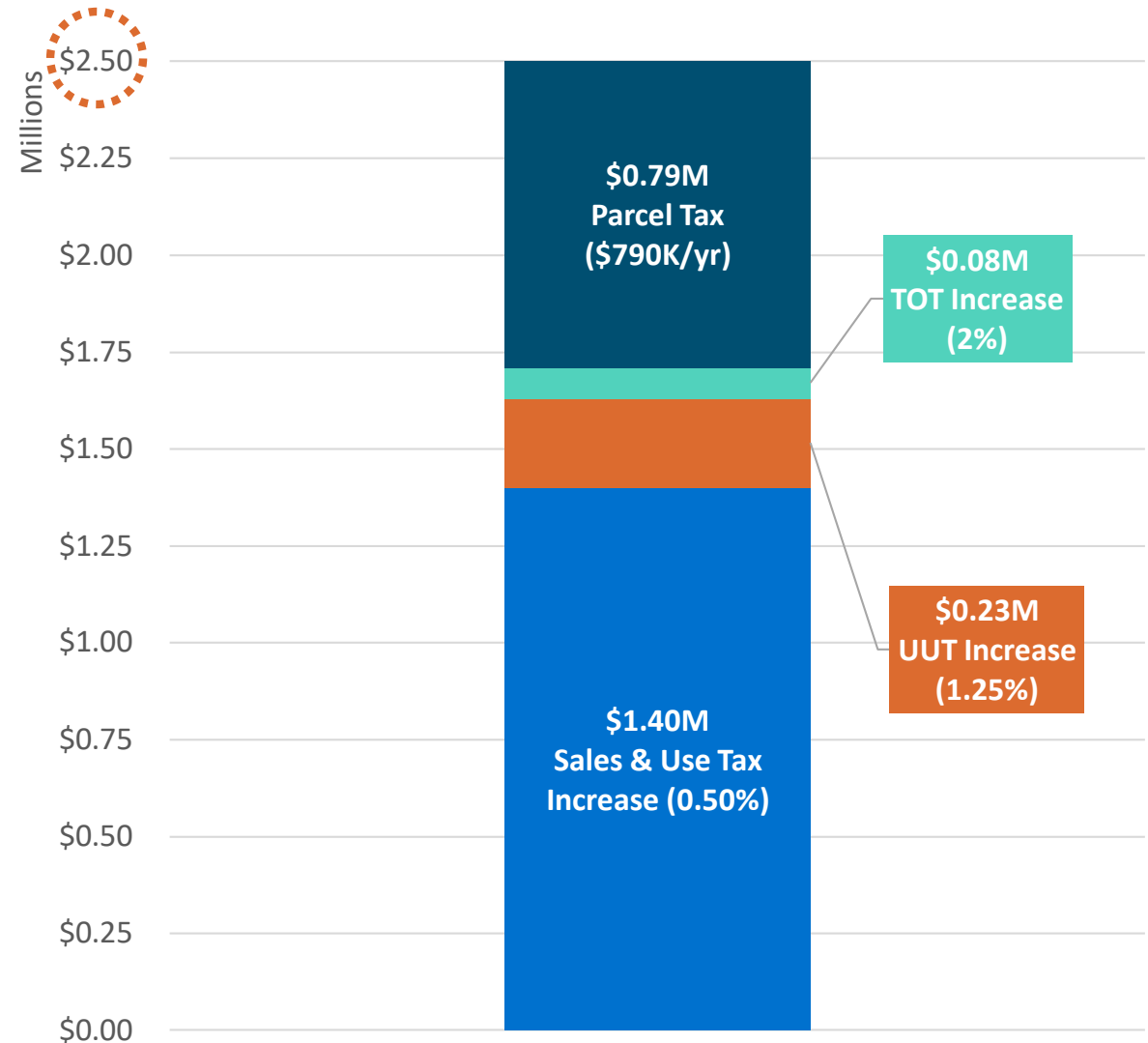


Potential Revenue Enhancements

\$2.5M Hypothetical Funding Gap Goal

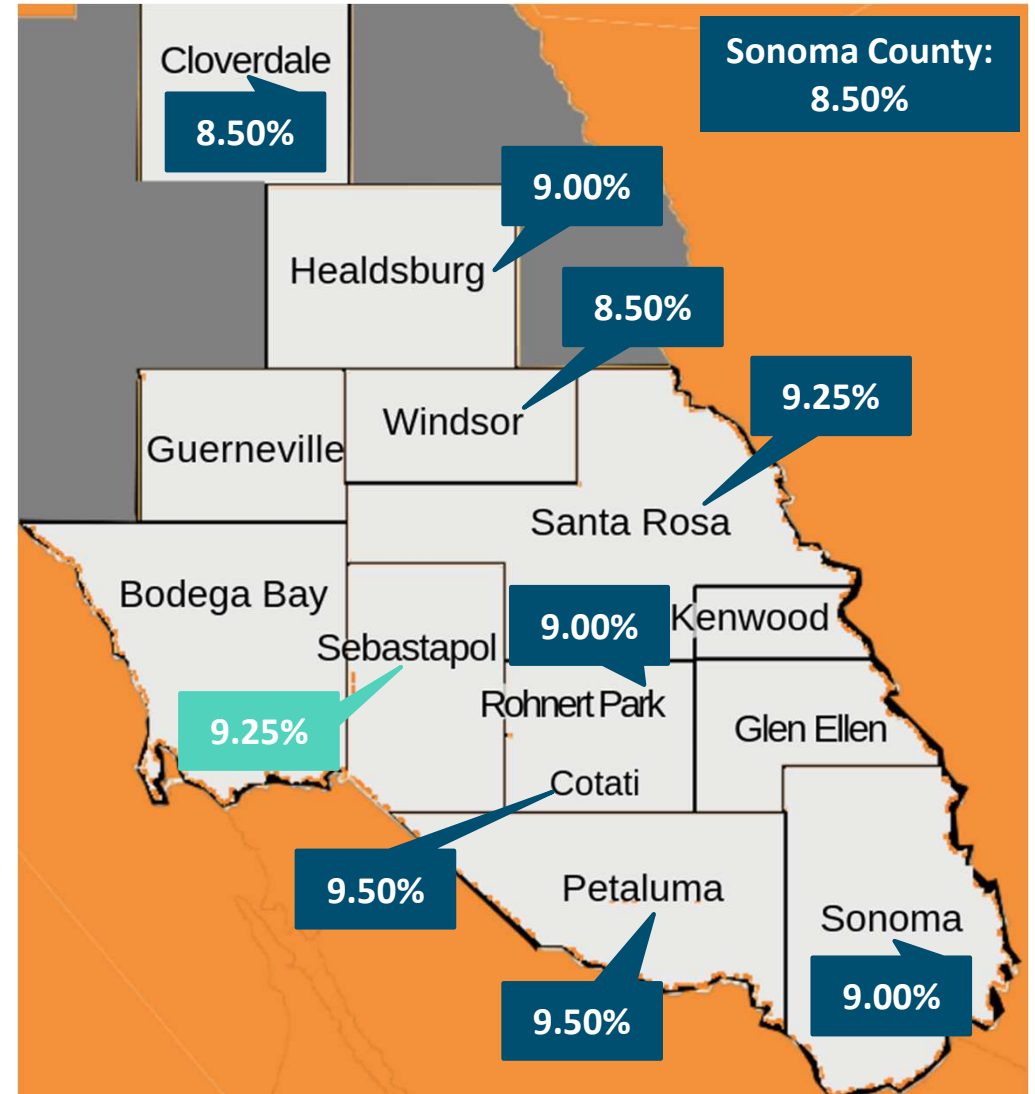
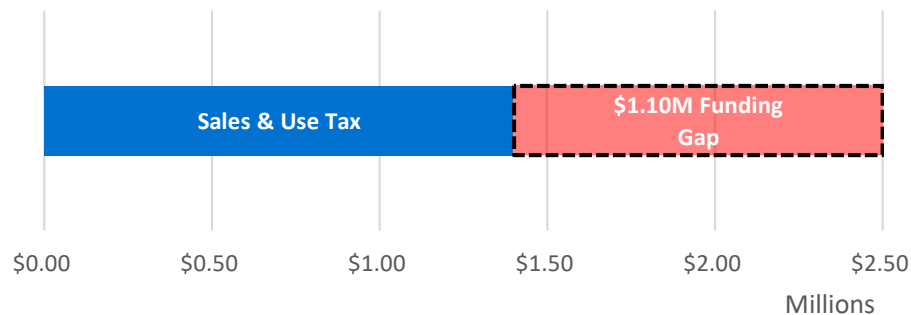


- ▶ Hypothetical \$2.5M funding gap is filled in with the following:
 - ▶ Sales & Use Tax Increase of 0.50% → \$1.40M/year
 - ▶ UUT Increase of 1.25% → \$0.23M/year
 - ▶ TOT Increase of 2.00% → \$0.08M/year
 - ▶ Potential Parcel Tax in June 2024 → \$0.79M/year
- ▶ This \$2.5M funding gap goal can be reached in various ways
 - ▶ E.g., larger parcel tax and lower sales & use tax increase; cost containment strategies



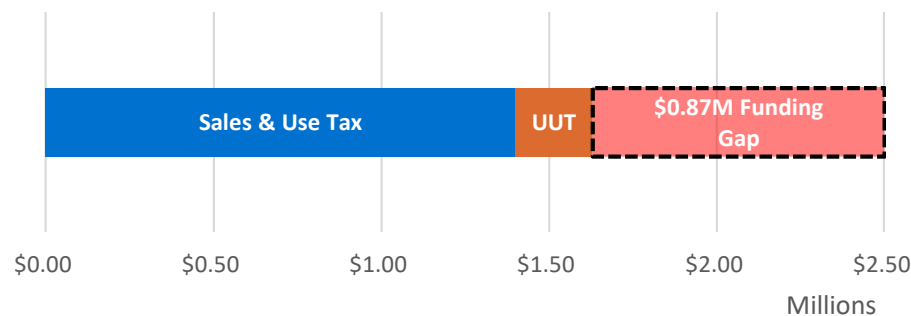
Sales & Use Tax Rate

- ▶ City sales & use tax rate (9.25%) 2nd highest within nine major Sonoma County cities
 - ▶ Cotati/Petaluma (9.50%)
- ▶ Sales & use tax rate for Sonoma County, any of its cities, and the Sonoma County Transportation Authority is currently capped at 10.25%
 - ▶ CA Senate Bill 152 (2018) raised the cap from 2% to 3% above the State/local base sales & use tax rate of 7.25%
 - ▶ The City currently has capacity for 1% in new taxes, however future countywide taxes could utilize some of this capacity
- ▶ Increasing the City's rate by 0.50% is projected to generate an additional ~\$1.4M/year

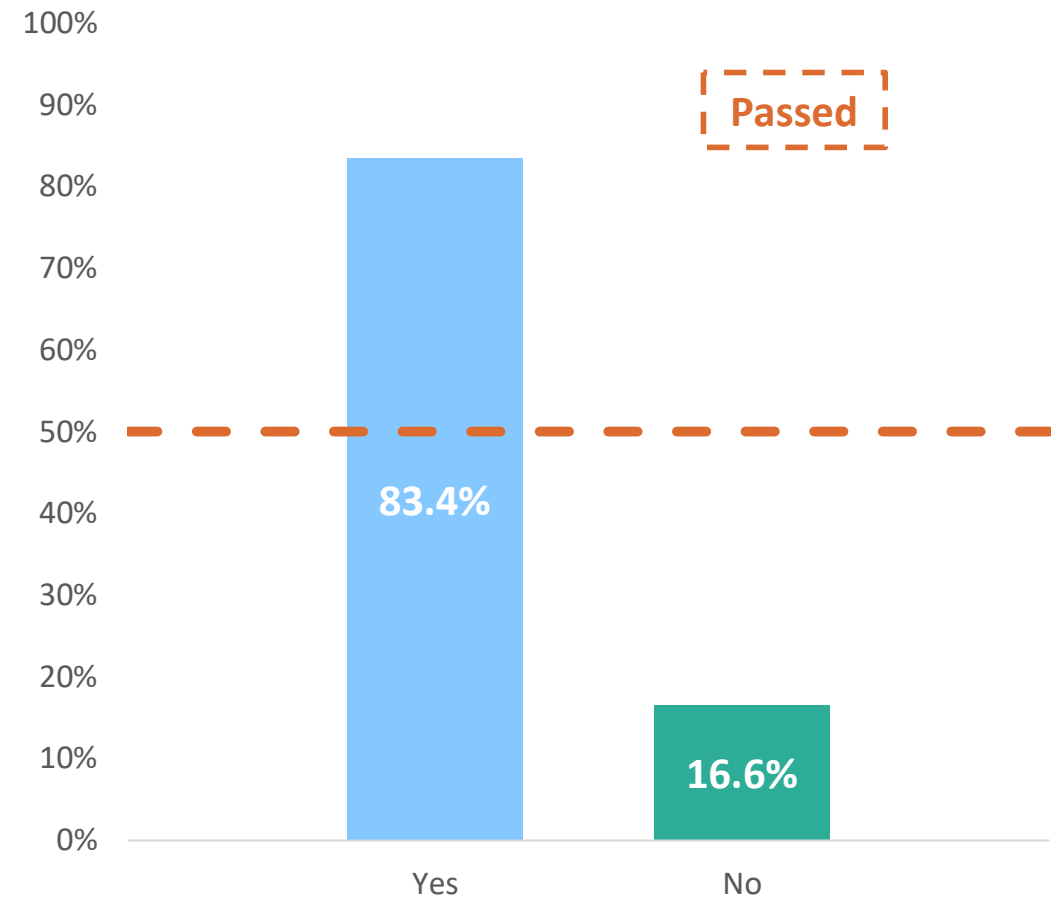


Utility Users Tax

- ▶ In the November 2022 election, the City’s Measure N passed, maintaining the City’s 3.75% Utility Users Tax (“UUT”) and removing the tax’s sunset clause
 - ▶ **Primary Objective:** Maintain City services including Police and Fire, 9-1-1 emergency services, park maintenance and repair, youth and senior recreation and for unrestricted general revenue purposes
 - ▶ **Revenue projection:** \$700,000/year
- ▶ Santa Rosa UUT rate → 5.00%
 - ▶ Measure N increase from 3.75% to 5.00% = an additional ~\$230K/year

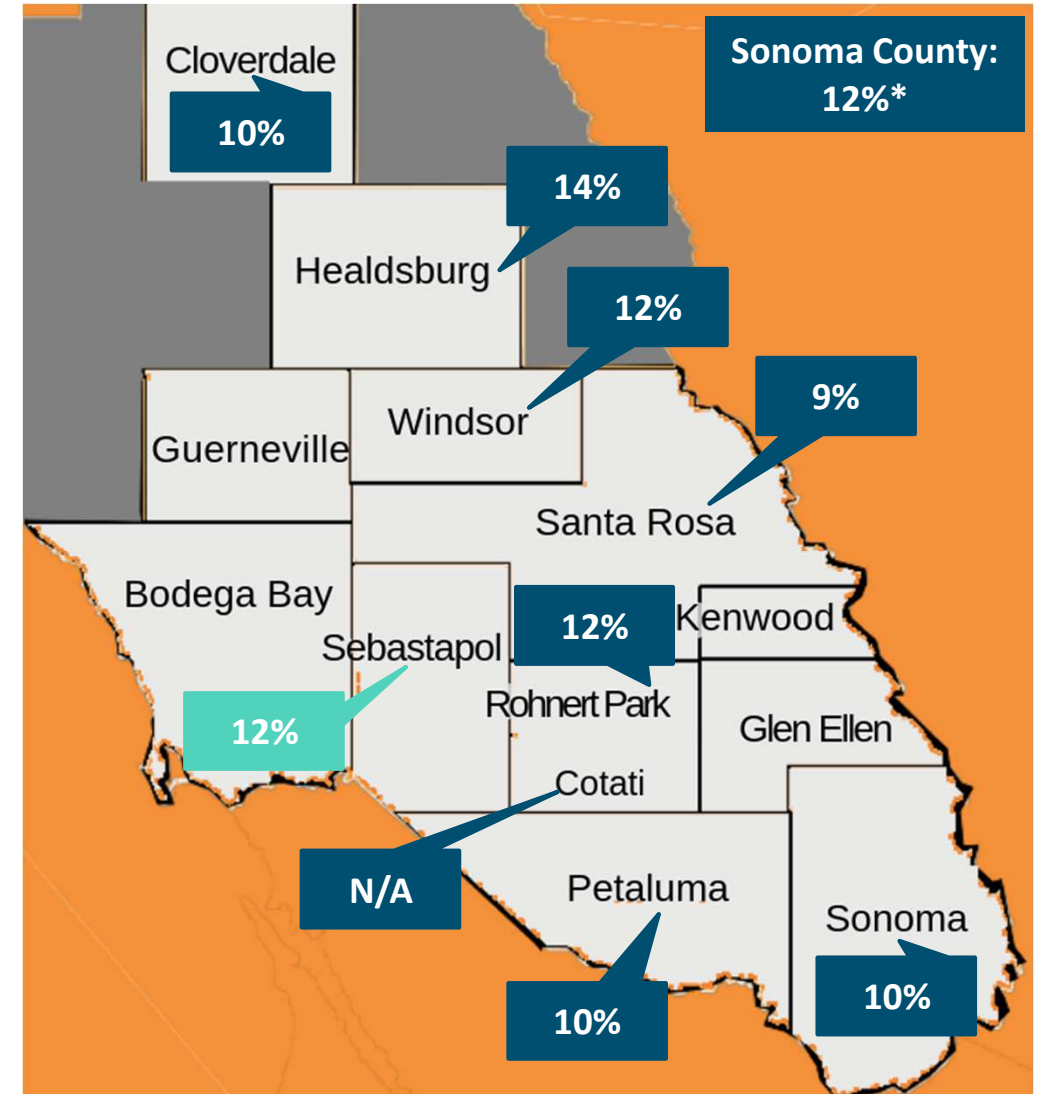
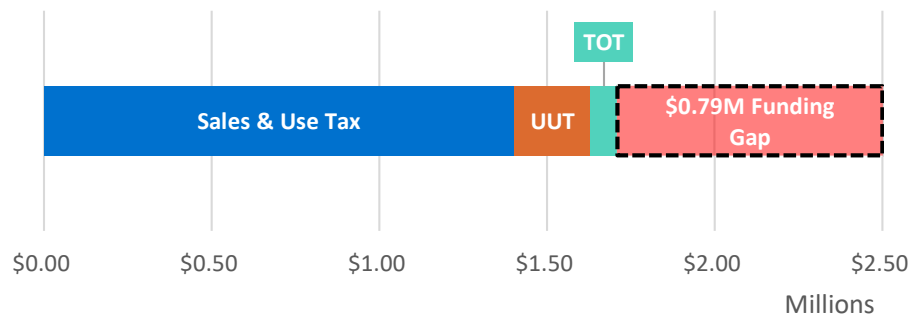


Sebastopol Measure N (November 2022)



Transient Occupancy Tax

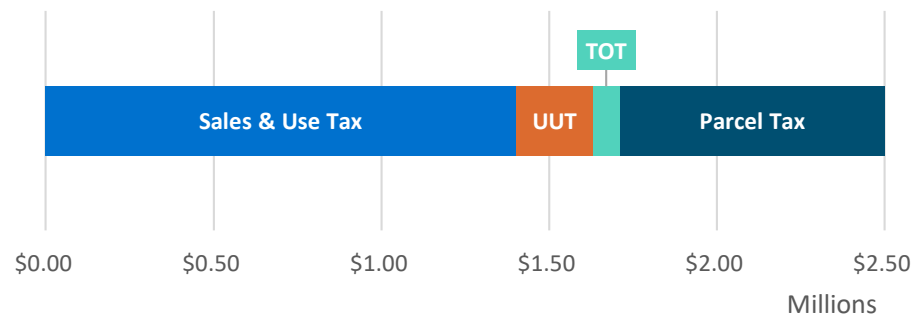
- ▶ In the November 2018 election, the City’s Measure R passed, increasing the City’s Transient Occupancy Tax (“TOT”) from 10% to 12%
 - ▶ Revenue projection: \$514K/year
- ▶ City’s TOT rate is 2nd highest (tied) of the nine major Sonoma County cities
 - ▶ Healdsburg has the highest (14%)
- ▶ Increasing rate to 14% is projected to generate an additional ~\$80K/year
- ▶ Additional TOT revenue also possible from future hotel development, such as the anticipated Hotel Sebastopol



*Levied in Sonoma County at a rate of 12% for accommodations at lodging and camping facilities in the unincorporated areas of the County.
 Source: Sonoma County Economic Development Board Transient Occupancy Tax Report (Q3 2022)

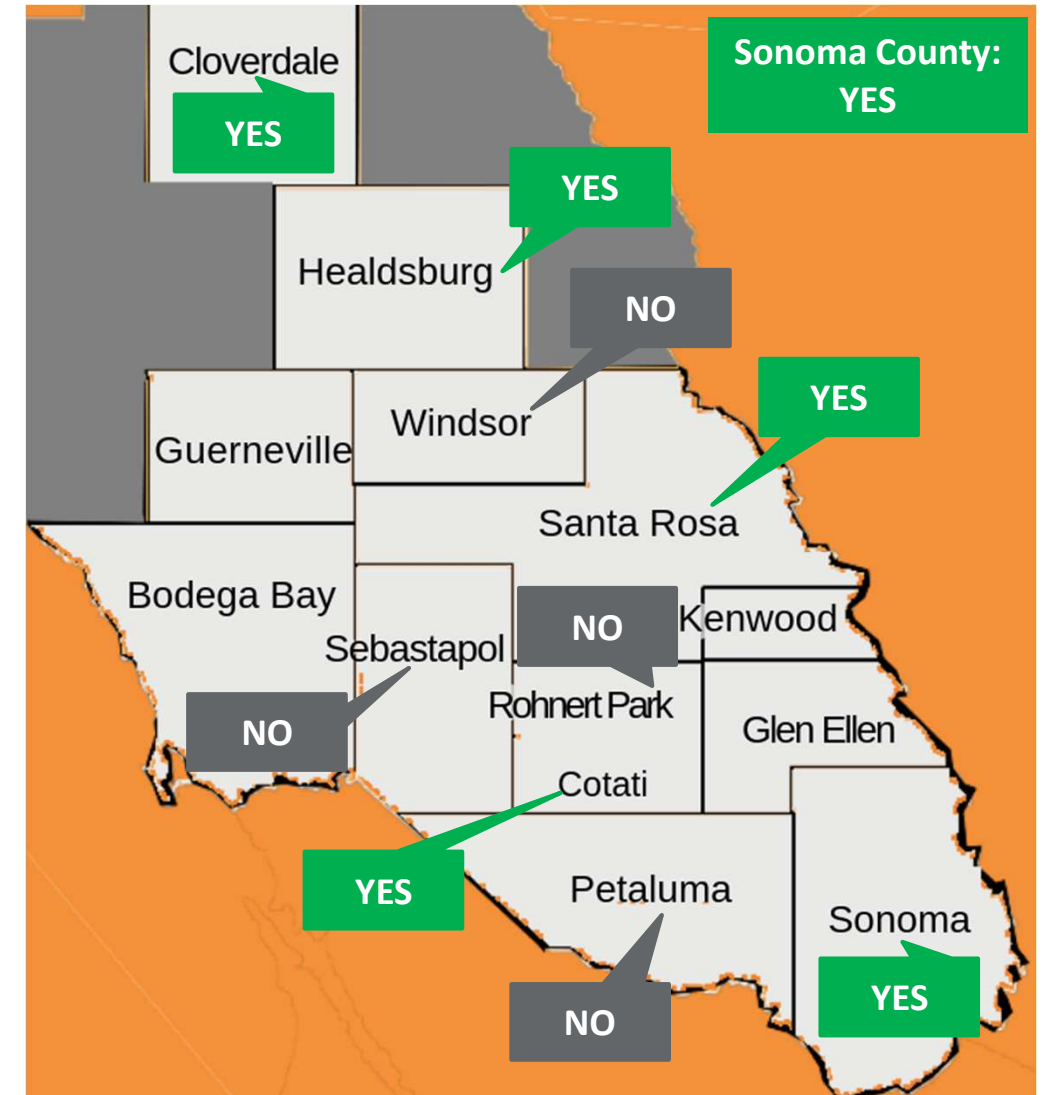
Parcel Tax

- ▶ A parcel tax is a special tax (similar to a CFD) on a parcel/unit of real property
- ▶ The tax differs from a property tax in that it is not based on the value of the property
 - ▶ It is generally based on either a flat per-parcel rate or a rate that varies based on use or size of the parcel
- ▶ Parcel taxes may be imposed for any municipal purpose, such as funding services, improvements to infrastructure, streets or parks, and protection of open space
- ▶ **Limitations of Use:** A parcel tax may be levied as a general tax or restricted for a special purpose
- ▶ **Procedure for implementation:** Parcel taxes may be levied for general purposes or restricted to a particular purpose. Parcel taxes require two-thirds voter approval
- ▶ **Potential levy as it relates to the City:** Generating \$790K in annual revenues (the amount remaining to fill the hypothetical funding gap goal) would require an annual ~\$290/parcel levy
 - ▶ The annual levy would need to be verified by a special tax consultant



Local Cannabis Tax

- ▶ Tax imposed on the sale, cultivation, distribution or manufacturing of cannabis
- ▶ 5 of 9 Sonoma County cities have Cannabis Tax
 - ▶ Sonoma County also has a Cannabis Tax
- ▶ Cannabis Tax Revenue:
 - ▶ Cotati: \$0.59M (FY 2020-21 actual)
 - ▶ Santa Rosa: \$1.8M (budgeted for FY 2022-23)
 - ▶ Healdsburg: \$0.5M (projected in ballot measure)
 - ▶ Sonoma: \$0.15M (budgeted for FY 2022-23)
 - ▶ Cloverdale: \$0.27M (FY 2021-22 actual)





5. FINAL TAKEAWAYS



Final Takeaways

- ▶ Without action or significant growth in revenues (not projected), the City's projected structural financial deficit will reduce / eliminate its reserves over the next 3-5 years
- ▶ Recommended that the City of Sebastopol...
 1. Identify economic development (i.e., increasing the tax base) opportunities
 2. Evaluate and attempt to secure revenue enhancements (i.e., increasing the tax rate on existing tax base)
 - ▶ Sales Tax Increase, UUT Increase, TOT Increase, Potential Parcel Tax (June 2024), Cannabis Tax
 3. Develop long-term pension funding strategy to manage CalPERS UAL, the City's largest debt
 - ▶ A Section 115 Trust can be created and dedicated towards stabilizing future pension costs
 4. Identify cost containment opportunities

