To: MOFD Finance Committee
From: Steve Cohn
Date: January 21, 2016
Subject: MOFD Budget, LRFP and Balance Sheet documents

I will not be able to attend your January 22 committee meeting but would like to convey the following thoughts on MOFD's three primary financial documents:
1) Budget
2) Long Range Financial Plan
3) Balance Sheet

Budget

I do not suggest that the District revise its detailed budget document but rather suggest that it provide an "executive summary" document for the benefit of the Board and the community which more simply explains ins and outs and changes over the years. Attached is such a document. Its "differences" from the existing budget document are as follows:

1) It compares the current year's projected actuals to the budget and the actuals of nine prior years. It compares them as a percent (increase or decrease), not as a dollar amount. (Although the dollars can be calculated.)

2) It compares the current year's budget to several (but not all) prior years' budgets.

3) It compares actuals to budgets (for several but not all years)

Revenue

4) Tax revenue (ad valorem and parcel) is shown as a single line item. The ad valorem tax is not bifurcated between the General Fund and the Debt Service Fund and the parcel tax is not bifurcated between the General Fund and the Capital Projects fund. It all comes into the General Fund and then amounts are transferred out to the various other funds (as expense).

5) Ambulance fees are net of all collection expenses and rebates.

6) Strike Team revenue is net of all strike team expenses, including personnel expenses.

7) Special revenue to the other funds, like to the Capital Projects Fund, are not included at this level.

Expenses

8) Permanent and Temporary salaries are combined as a line item.

9) Payroll Taxes and Processing Fees are combined as a line item.

10) Pension costs (payment to CCCERA) is a line item but it is bifurcated into Normal Costs and UAAL Payments. Employee contributions are included in the bifurcation. I have estimated the

breakdown (Normal Costs = 28% of Permanent Salaries; employee contribution = 24% of Permanent Salaries; UAAL Payment = net of MOFD + Employee contributions minus Normal Cost).

11) Transfer to Debt Fund (being 100 percent pension obligation bond) is included as an employee benefit expense.

12) Employee contributions are netted from active and retiree medical expenses.

13) OPEB is bifurcated into Normal Costs (per Bartel report) and UAAL Payment (total payments net of Normal Cost).

14) Total salaries and benefits (including Pension Obligation Bond expense) subtotaled as percent of total expenses. (86%)

15) Total Operating expenses (net of Ambulance Billing Fees and Strike Team Supplies) shown as a single line item.

16) Transfer of funds to Capital Projects Fund is equal to the fire flow tax but this need not be the case. (The Fire Flow Parcel Tax, at least Orinda's tax, was never supposed to be solely for capital projects.)

17) Fund Balances, additions and reductions, including the Pension assets, detailed.

18) Note: There is no line item for "use of money" (earnings of fund balances) even though the General, Capital, and Debt Service funds add up to almost $10 million. Even one year US Treasuries are yielding 0.6 percent interest which would be $60,000 per year on $10 million. Not much relative to a $23 million budget but better than a sharp stick in the eye.

Long Range Financial Plan (LRFP)

I have little issue with the layout of the LRFP and commend the 15 year planning horizon. I think of the LRFP as the "looking forward" version of the "looking back" budget document. These should be two documents with equivalent line items and the MOFD LRFP's line items are close to those in the "executive summary" budget document I propose.

The issue I do have with the LRFP is that I believe that the growth rates on the various line items should be reviewed and, if not changed, justified. I present alternative growth rates which end up with very close to the same result as the current (1-22-2016) LRFP. I explain the growth rates I choose.

1) Ad Valorem Taxes. MOFD suggests tax revenues will increase at 5% next year and then 4% thereafter. It is fine to be conservative but I believe that this understates the reality that currently properties in Orinda (and I believe the same is true in Moraga but my knowledge base is Orinda) are assessed at well under market value and each time a property is sold the assessed value increase is such that the tax base is significantly increased. In addition, Wilder is finally selling and these 240 properties, selling at over $2 million each, could/will add ten percent to the Orinda tax base over the

next ten years. As for the sale of existing properties; the lowest one third of assessed value homes (those homes owned the longest time therefore the most likely to sell) in Orinda are assessed at only 20% of their market value. Therefore, when one sells and it is re-assessed at full market value, the assessed value increases 400%. On average, about 4 percent of Orinda's homes sell per year. If half of these (2 percent of all Orinda homes) are in the "bottom 1/3", then the total tax base will increase 8 percent as a result of these sales alone. And since 33 percent of all Orinda homes are in this category, this "phenomenon" can continue for some time if only 2 percent sell each year. Add in the 1 percent annual increase for Wilder and the 2 percent statutory increase for all homes that don't sell and a very large, sustainable increase, well in excess of the 4 percent assumed by the MOFD LRFP, can be justified. In my revised LRFP I have used 5 percent which is MOFD's historic (19 year) rate of increase and even that is probably too conservative.

2) Fees (ambulance and other). The historic (15 year) inflation rate has been 2.6%. There is no reason to believe the next 15 years will be different. There is also no reason, unless MOFD chooses to constrain fee growth, to believe that fees for services will not increase with inflation. Ambulance fees are market driven and there is no reason not to collect these fees from insurance that includes this coverage. As for other fees, since MOFD is showing a $100 million surplus over the next 15 years it may choose to reduce of suspend these fees but that is a policy decision that should be addressed in a strategic plan.

3) Most Expenses. There is no reason to believe that expenses that MOFD does control (salaries) or does not control (medical expenses, operating expenses, etc.) should not increase with inflation. Some categories of expenses (Overtime and workers comp) should increase at the same rate as salaries. Salaries and the normal cost of pension might increase slower as 3@50 employees retire and are replaced by less expensive "tier 2" (A detailed sub-model of salary and pension cost should be developed as these two costs elements are currently 50 percent of all expenses.)

4) Over the past 19 years MOFD's 5 percent annual revenue increase (twice the rate of inflation) has been totally used to increase employee compensation. Including the $60 million in existing unfunded liabilities, over 100% of total revenue has gone to employee compensation. There is no reason for this to continue. Revenue increases in excess of inflation should be devoted to increased user services going forward. The MOFD LRFP shows $116 million in unrestricted reserves by 2030. My revised LRFP, with higher revenue growth but higher expense growth also, still shows over $108 million. Plans for this excess should addressed in a long range strategic plan.

Balance Sheet

MOFD's GASB defined balance sheet is deceiving MOFD and the community. The assets and liabilities it claims are so far off of reality that an outside observer would have a hard time believing that the GASB balance sheet and a "real world" balance sheet were describing the same entity. I am not suggesting that MOFD not produce a GASB balance sheet, but I am suggesting that it produce an "executive summary" balance sheet so that the managers of MOFD and the community have a better feel for with they are dealing with.

The crux of the problem comes from how employee retirement benefit liabilities, and offsetting assets, are portrayed. The facts are, from a balance sheet perspective, retirement benefits are the tail

that wag the dog. Trying not to get MOFD's "operational" balance sheet lost in the "employee benefit" balance sheet is a difficult problem.

In the past, GASB's solution was to keep employee benefits "off balance sheet", in the footnotes. Unfortunately, this "out of sight" approach created an "out of mind" attitude and when liabilities started to soar or assets drop, no one noticed until it was too late. Now GASB is taking a different approach by putting the employee benefits on the balance sheet but trying to, again, not bury the operations assets and liabilities with employee benefits assets and liabilities that are several times as large. They are accomplishing this, with the pension, by having GASB 68 only report the "net" (asset or liability) and not separately report assets and liabilities. This is almost as dangerous as before. Take MOFD which has, operationally, $15 million in assets and virtually zero liabilities. This is overwhelmed by MOFD's $200 million in employee benefit liabilities offset by $140 million in assets, most of this being MOFD's pension ($170 million in liabilities). If that pension was fully funded it would show up on the GASB balance sheet as a zero net asset. And yet, $170 million in liabilities would be lurking, unseen, and $170 million in assets would be unseen while being at risk. Now, if the liabilities were "non-recourse", only recourse to the assets, there could be a case for this "net" disclosure. But they are not. If the assets all of a sudden lost 30 percent of their value, as they did in 2008, a $50 million net liability would show up on the balance sheet; from nowhere. It is not good stewardship to allow this to happen even the GASB says it is OK.

Another problem with the GASB balance sheet is that it has "phantom" assets and liabilities which are not real.

The first is a $22 million "prepaid pension" asset. This asset appeared when the Pension Obligation Bond was borrowed in 2005. While the pension assets and liabilities were reported in the footnotes, when the pension obligation bond was borrowed, it was determined that this was "real debt" and should be on the balance sheet. However, it was apparent that borrowing money does not change the net position, in "merely" balloons the assets and the liabilities. So in addition to the $28 million debt liability, a $28 million "above the line" asset was added which was called a "prepaid pension asset" (although there was nothing "prepaid" about curing the pension underfunding). All of a sudden, MOFD which had $10 million in assets and no liabilities, had $38 million in assets and $28 million in liabilities. No net change. What happened below the line? The $28 million net pension liability disappeared (became zero). So no change in above the line net and a $28 million improvement below the line. Magic!! $28 million in debt disappeared.

Fast forward to this year. The net pension position has again (coincidentally) degraded to a $29 million net liability and GASB 68 brings it above the line as a net liability. What about the $28 million "prepaid pension" asset? Over the years it has been "amortized down" to $22 million (as the pension bond has been paid down) but it is still there. Now the "double dip" is all above the line. Is the $22 million "prepaid pension" really an asset? No. It is a GASB "smoke and mirrors" accounting "trick" that they do not believe they can just take off the books just because the pension assets and liabilities have been moved to above the line.

So what did they do? They added a phantom liability to partially offset the phantom asset. This is $6 million of "Deferred Pension Inflows". Does MOFD really owe CCCERA $6 million more than the $4.6 million it paid last year? I don't think so. This is just another accounting gimmick to "smooth" the shock of putting a $29 million liability on the balance sheet and taking a $22 million asset off it.

The bottom line is that MOFD has $171 million in pension liabilities and $142 million in pension assets for a $29 million net liability and that is it. There is no additional $22 million asset nor another $6 million liability.

In addition, there is the issue of OPEB. This is the "sort of pregnant" problem. A $6.5 million liability is on the balance sheet. But Bartel said that if we start an OPEB fund, which we have (however modestly) we can increase our discount rate (to 7.25%) and our total OPEB liability will decrease to $12.5 million. So why are we only showing $6.5 million? It's either a liability or it's not. We are showing half of our OPEB liability because GASB says we can, again, so we don't "shock" the sensibilities of the readers. Forget reality. Forget understanding what we really owe.

So how does this all add up?

On the asset side:

Start with the GASB $41 million
Take away the "phantom" $22 million "prepaid pension"
Add $143 million in pension assets.
And you end up with $162 million in assets (four times what GASB states)

On the liability side:

Start with the GASB $64 million
Take away the "phantom" $6 million "Deferred Pension Inflows"
Increase the $29 million net pension liability by $142 million to its $171 million gross value
Increase the $7 million OPEB liability by $6 million to its $13 million value
And you end up with $206 million in liabilities (three times what GASB claims)

And the resulting net is $45 million, twice $23 million that the GASB balance sheet shows.

Do you show the facts or some tortured hybrid that bears little resemblance to reality? What does obscuring the truth gain you?

And speaking of obscuring. I assume that most of you have, or once had, a home mortgage. If that mortgage was originally $1 million and the interest rate was 5.00% and it was a 30 year mortgage, your monthly payments were about $5,400. If you were doing a 30 year budget, you had to budget in $5,400 a month for thirty years and if you added it all up you would have found out that while the loan was "only" $1 million, over 30 years you were liable for, your total undiscounted liability, almost $2 million in payments. Now you could prepay the loan at any time and get out of the extra $1 million in interest so maybe the only number you needed to know was the $1 million principal balance (unless you didn't have a million dollars to prepay it).

Why do I bring this up? MOFD has a pension liability of $170 million. This is equivalent to the $1 million mortgage. However, like the average homeowner MOFD does not have $170 million to prepay it but unlike the average homeowner, MOFD could not prepay it even if it had the funds to do so. Now MOFD does have $140 million in savings but, unless they are in US Government securities (which they are not), that money is "at risk". Therefore, while MOFD hopes that $140 million does not "disappear" it might be prudent for MOFD to understand how much it is really going to have to pay out over time (60 years, not 30).

With its GASB 68 report, CCCERA gave MOFD the ability to fairly accurately estimate how much the total liability is. What CCCERA told MOFD was that if the discount rate it uses to discount the projected pension liabilities increases 1 percent (from 7.25% to 8.25%), its discounted liability will decrease by $20 million from $171 million to $151 million. And if that discount rate decreased by 1 percent (from 7.25% to 6.25%) then the discounted liability will increase by $24 million from $171 million to $195 million. What this knowledges allows, is for us to estimate the average life (or more precisely the "duration") of the pension obligation and by knowing that, a zero discount rate can be applied and the total non-discounted value of the pension obligations can be determined. And the total is, $615 million over 60 years. Spread across how many employees, active and retired? That is a lot of money and it is valuable information to have, even if none of us will be around to see it all spent. I believe a truly informative balance sheet should show not just the discounted present value of liabilities (and assets), but their projected un-discounted values also to see how much we are relying on the power of discounting. Remember, the reason that there is a pension UAAL is not because MOFD has underfunded the pension plan, but because the pension plan assets have not earned as projected (the assumed discount rate was too high). What if it is still too high? CCCERA has given you the ability to project the impact. That information should not be "lost".

Finally, the problem of the employee benefit tail wagging the operations dog. This can be solved by bifurcating the balance sheet into two balance sheet, one for operations and one for employee benefits, and then consolidating them. And comparing each balance sheet, and the consolidation, to prior years.

Conclusion

I have tried to produce a trio of reports that give a clear and concise view of MOFD's financial condition.

* The Budget document shows what MOFD has spent in the past.
* The Balance Sheet shows where MOFD is today.
* The Long Range Financial Plan predicts the future.

I hope you find this useful.

Steve Cohn