City of Erie Five-Year Plan: Draft Recommendations

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Early Intervention Program (EIP)

Public Financial Management (PFM) is developing a five-year financial plan for the City of Erie with financial support from the Pennsylvania Department of Community and Economic Development and its Early Intervention Program (EIP) /Strategic Management Planning Program (STAMP). There are three phases in the multi-year planning process.

Financial condition assessment

- We need to have a shared understanding of City government's current fiscal position and the critical factors driving its financial performance. We used a baseline projection of the City's financial performance in a *status quo* scenario to diagnose the areas that need corrective action.

Management review

- City government does not exist for purely financial purposes. It exists to deliver critical services to the people who live in, work in and visit Erie. Similarly, numbers alone don't tell the complete story. So we met with department managers and other staff to discuss what their departments do, how they do it and why they do it, in relation to the Mayor's vision statement. We combined this information with the financial analysis and developed a series of recommendations (or initiatives). **We're presenting some of the major recommendations today.**

Initiative development and plan delivery

- We'll collect input on our draft recommendations, potentially amend them and then produce one coherent plan document with the work from all three phases. The Plan will include guidance on how to prioritize the initiatives and how to integrate this type of multi-year planning process into the City's annual activities so it is a tool and not just a one-time event. We'll deliver the Plan near the end of the City's 2020 budget process.

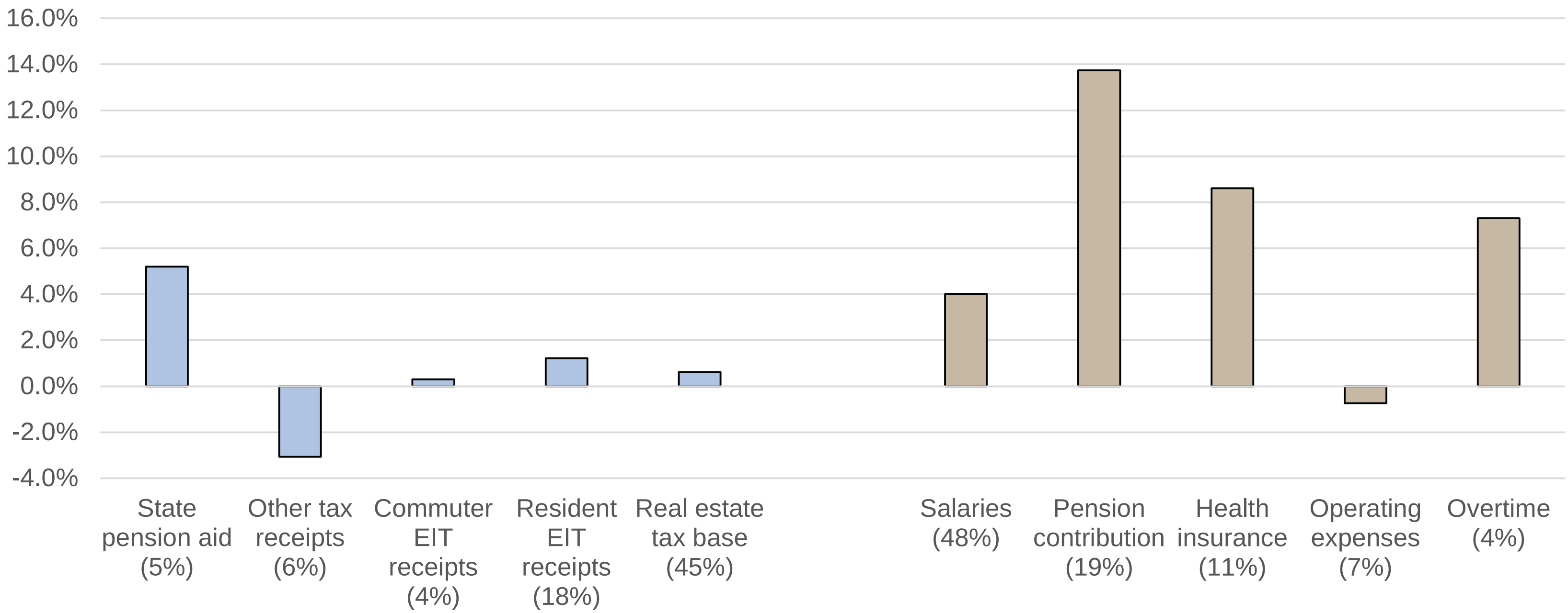
Refresher:
Financial Condition Assessment

Key finding: Erie has a structural problem

One of the primary findings from the Financial Condition Assessment is that **most of the City's major expenditure categories grew much more quickly than most of the City's major revenue categories – the City has a structural deficit.**

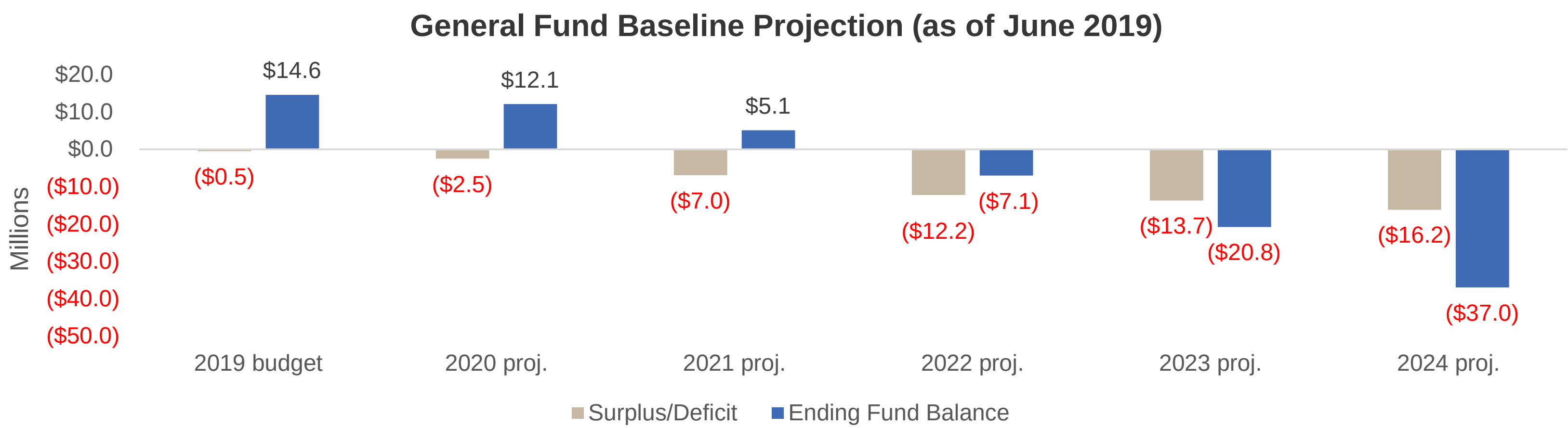
Two-thirds of the City's General Fund revenues come from the real estate and earned income taxes and they grew by less than 2 percent a year from 2014 through 2018, absent tax increases. Two-thirds of the City's General Fund expenditures are on salaries and pensions and they grew by 4.0 percent and 13.7 percent per year. There is no path to fiscal stability if the major revenues grow at this slow a rate and there is no path to fiscal stability if the major expenditures grow this much more than the revenues.

Compound Annual Growth Rates for 2014 through 2018 (General Fund only)
(Percentages in parentheses show the share of the 2019 General Fund Budget)



2019-2024 projections (June 2019)

Earlier this year we presented a baseline projection that presents a status quo scenario, assuming no changes in the level of services headcount or tax rates except in cases where they were already adopted into the current law or consistent with existing policy. At the time, we projected that the City would have deficits growing from $2.5 million in 2020 to $16.2 million by 2024 absent corrective actions. By 2022, the City would exhaust its fund balance.

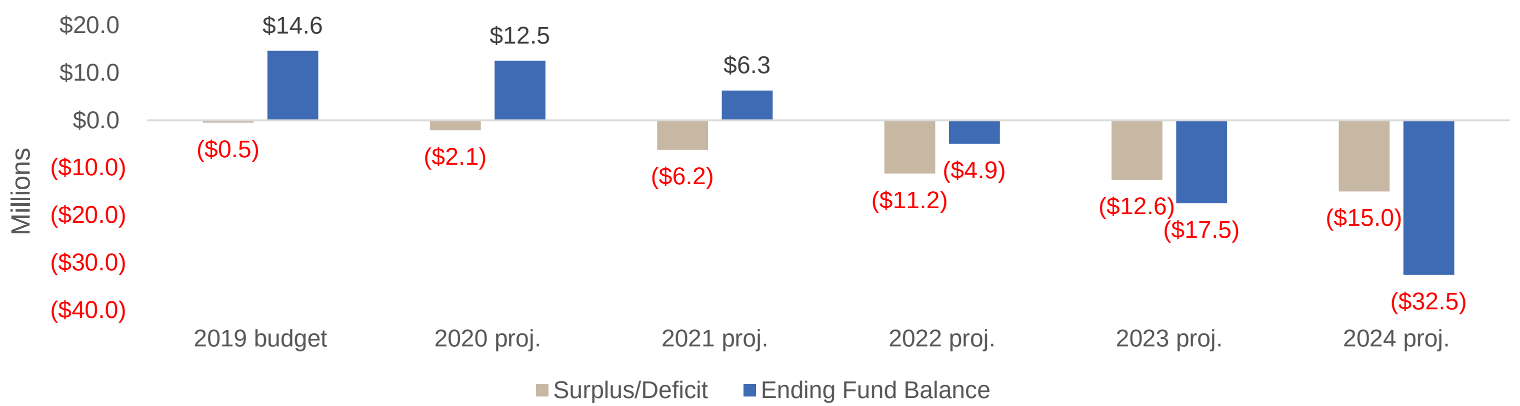


	2019 Budget	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.
Revenues	$81.0	$82.1	$82.6	$83.2	$84.0	$84.6
Expenditures	$81.5	$84.6	$89.6	$95.4	$97.7	$100.8
Surplus/Deficit	($0.5)	($2.5)	($7.0)	($12.2)	($13.7)	($16.2)
Fund Balance	$14.6	$12.1	$5.1	($7.1)	($20.8)	($37.0)

2019-2024 baseline projection (updated)

Since we presented the financial condition assessment in June, we updated the baseline to include the impact of the most recent IAFF agreement. The baseline projection now shows the City having a $2.1 million deficit in 2020 growing to $15.0 million by 2024. ***Please note this is not a worst case scenario.*** We assume lower growth in salary expenditures than the City has historically had (except IAFF); no changes in the assumptions that drive the pension contributions; and a continuing transfer payment from the Sewer Fund that had a negative fund balance at the end of 2018.

Updated General Fund Baseline Projection



	2019 Budget	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.
Revenues	$81.0	$82.1	$82.6	$83.2	$83.9	$84.6
Expenditures	$81.5	$84.2	$88.8	$94.4	$96.5	$99.6
Surplus/Deficit	($0.5)	($2.1)	($6.2)	($11.2)	($12.6)	($15.0)
Fund Balance	$14.6	$12.5	$6.3	($4.9)	($17.5)	($32.5)

Note: the 2019 budget shows a $0.5 million deficit because it used $0.5 million in fund balance to balance its budget.

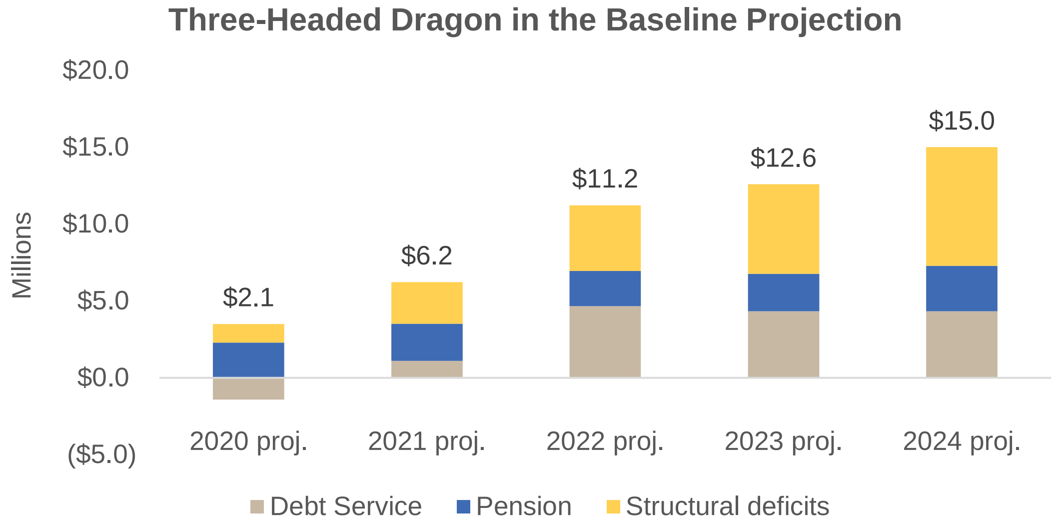
Three-headed dragon

We broke down the projected deficits in the baseline scenario into three more manageable pieces – debt, pension contributions, and structural deficits.

- **The pension problem**: Based on information provided by the actuary, the City's required contributions to the employee pension plans will rise from $16.3 million in 2019 to $18.8 million next year, after which it will remain at approximately the same level. If the City updates the assumptions regarding mortality and investment earnings, the hole is larger. But even without those changes, the pension contribution increase in 2020 would be the largest driver of the General Fund deficit in 2020. This is the most immediate problem.

- **The debt problem**: Absent corrective actions, the City's scheduled General Fund payments for existing debt would increase from $1.7 million this year to $8.2 million in 2022. The jump in debt service would account for more than half of the $11.2 million deficit that year. That problem arrives later.

- **The structural deficit problem**: Like many other Pennsylvania cities, the revenues that fund Erie's City government grow at a slower rate than the expenditures. This structural deficit – the imbalance between recurring revenues and recurring expenditures – starts smaller but grows faster than the pension-driven deficit. By 2024, the structural deficit would account for more than half of the $15.0 million deficit.



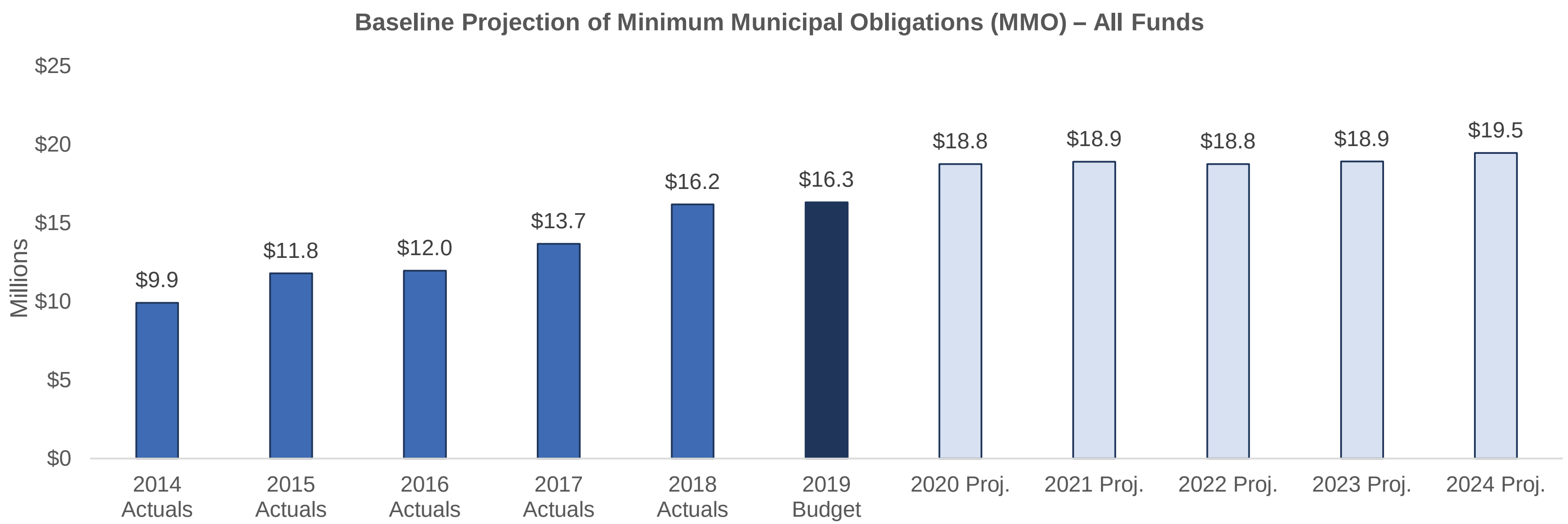
Draft recommendations

Pensions: The most pressing problem

Based on information provided by the actuary, the City's required contributions to the employee pension plans will rise from $16.3 million in 2019 to $18.8 million next year. This is the largest driver of the projected General Fund deficit in 2020 and the most immediate problem.

The City's pension contributions (Minimum Municipal Obligations or MMOs) grew from $9.9 million in 2014 to $16.2 million in 2018 for overall growth of 63.2 percent, or 13 percent on an annual average basis. Moving forward, the City's actuary projects MMOs to increase again next year and then stabilize at $19 million in a status quo scenario. The $18.8 million projected payment for 2020 is twice the payment just five years ago.

Key question: Why are Erie's MMOs growing so rapidly?



Pensions: MMO basics

Every Pennsylvania city is required to make annual contributions to their employee pension plans, which are called the Minimum Municipal Obligations (MMOs). The MMO is the sum of three items: (1) the cost of pension benefits accrued in the current year (normal cost); 2) the cost to pay off the pension plans' unfunded liability (amortization cost) and 3) the cost to administer the plans, which has historically been less than 1 percent of the total (administrative cost). The table below shows the normal costs, amortization costs and MMOs for the three pension plans since 2014. The MMO shows the City's net responsibility after the employee contributions (6.0 percent for police and fire; 6.5 percent for non-uniformed employees).

Key question: Why are the police and fire amortization costs growing so much?

Pension MMOs and Major Components ($ Millions)

	2014	2015	2016	2017	2018	2019	CAGR
Police - Normal Cost	$1.5	$1.6	$1.7	$1.6	$1.7	$1.7	3.1%
Police - Amortization Cost	$3.2	$4.0	$4.0	$5.0	$6.2	$6.2	14.6%
Police – MMO	$4.0	$4.9	$4.9	$5.9	$7.2	$7.2	12.4%
Fire - Normal Cost	$1.3	$1.3	$1.4	$1.5	$1.6	$1.7	5.4%
Fire - Amortization Cost	$2.9	$3.6	$3.6	$4.5	$5.5	$5.5	13.1%
Fire – MMO	$3.7	$4.4	$4.4	$5.4	$6.4	$6.4	11.7%
O&E - Normal Cost	$1.6	$1.6	$1.7	$1.7	$1.8	$1.9	4.1%
O&E - Amortization Cost	$1.6	$1.9	$1.9	$1.7	$1.9	$1.9	3.5%
O&E - MMO	$2.2	$2.5	$2.6	$2.4	$2.6	$2.7	4.1%

Pensions: Assumptions matter

The actuary prepares pension valuation reports every other year that show the pension plans' assets and liabilities; performance since the last report was prepared; how that performance compares to the plans' assumptions; and the resulting amortization cost. The actuary repeatedly finds that the City has "actuarial losses" in its pension plans because the assumptions do not match what is actually happening. There are three categories for these losses:

- **Investment experience loss:** The pension plans assume 8 percent annual investment return and the actual earnings have been less than that. This is partly because the actuarially calculated value of the pension assets are higher than the actual market value of the assets. This accounted for 35 percent of the loss in the 2017 reports and 45 percent in the 2019 reports. There are seven-figure losses in both years for all three plans.

- **Contribution loss (or slippage):** The actuary's calculations show the amount the City should contribute on January 1 of the year when the analysis is completed. The City doesn't actually make the higher contribution amount until some time in the fall of the following year. This is not unusual for Pennsylvania municipalities, but the 20-month lag between those two steps creates a loss. This accounted for 32 percent of the loss in the 2017 reports and 28 percent in the 2019 reports. The losses are entirely in police and fire ($1 million - $2.6 million) because they are the compounded result of other actuarial losses in those plans.

- **Plan experience loss:** This category includes the impact of any differences between assumptions and actual experience with employee salary growth, retirement age and mortality. It also includes the impact of police and fire DROP features. This accounted for 33 percent of the loss in the 2017 reports and 34 percent in the 2019 reports. The largest losses are in fire ($4.1 million in 2017, $4.3 million in 2019) and then more sporadic in the other two plans.

Each of these losses is incorporated in the City's amortization cost and repaid over time. The actuary projects that, absent any changes, the City will continue to have actuarial losses in the future that will replace the losses as they are paid off.

Pensions: Recommended action plan

The City needs to have a well-rounded response starting in the 2020 budget that does the following:

- **Take action now:** The City theoretically could use the 2017 pension valuation reports one more time in 2020 instead of using the 2019 pension valuation reports that require a larger contribution next year. That only postpones action on a pressing problem and could make it worse, at least in terms of the "contribution loss."

- **Fix the assumptions that are driving the costs higher:** The actuary has recommended lowering the City's 8 percent earnings assumption to 7.25 percent which is the national median. He also recommends updating the mortality tables from the current set that dates back to the 1980s. Making these changes will increase the City's contribution in the short term, but eventually result in higher funding levels and a more stable level of contributions. The actuary has provided several scenarios with different mixes of the possible changes.

- **Increase the distressed pension tax:** Residents and non-residents pay an additional 0.18 percent earned income tax to cover a portion of the City's MMOs. In consultation with the actuary, the City should decide what level of assumption changes are prudent, make them starting with the 2019 pension valuation reports and then increase the distressed pension tax accordingly starting in 2020. The distressed pension tax is paid by residents and non-residents so it spreads the cost burden across a larger base than a real estate tax increase or service cuts would.

- **Make portions of the City's pension contribution throughout the year:** Like many other cities, Erie makes its contribution to the employee pension plans in the final third of the year, after it receives its Commonwealth pension aid. Subject to the City's cash flow needs, the City should make portions of this contribution earlier in the year to minimize the "contribution loss."

Pensions: Recommended action plan (continued)

The provisions on the prior page address the funding side of the pension equation. The City also has to address the cost of benefits.

- **Pursue a more affordable level of pension benefits for new hires:** Through collective bargaining, the City and unions should negotiate a level of pension benefits that complies with State law but has a lower total cost. Options include changing what is included in the pension benefit calculation (uniform allowance, shift differential) and changing the Deferred Retirement Option Plan (DROP) program. For the non-uniformed employees, this includes considering a defined contribution style plan that replaces the defined benefit plan for new hires. The City's actuary can assist the parties by estimating the cost of potential provision changes or recommending changes that meet a percentage savings target.

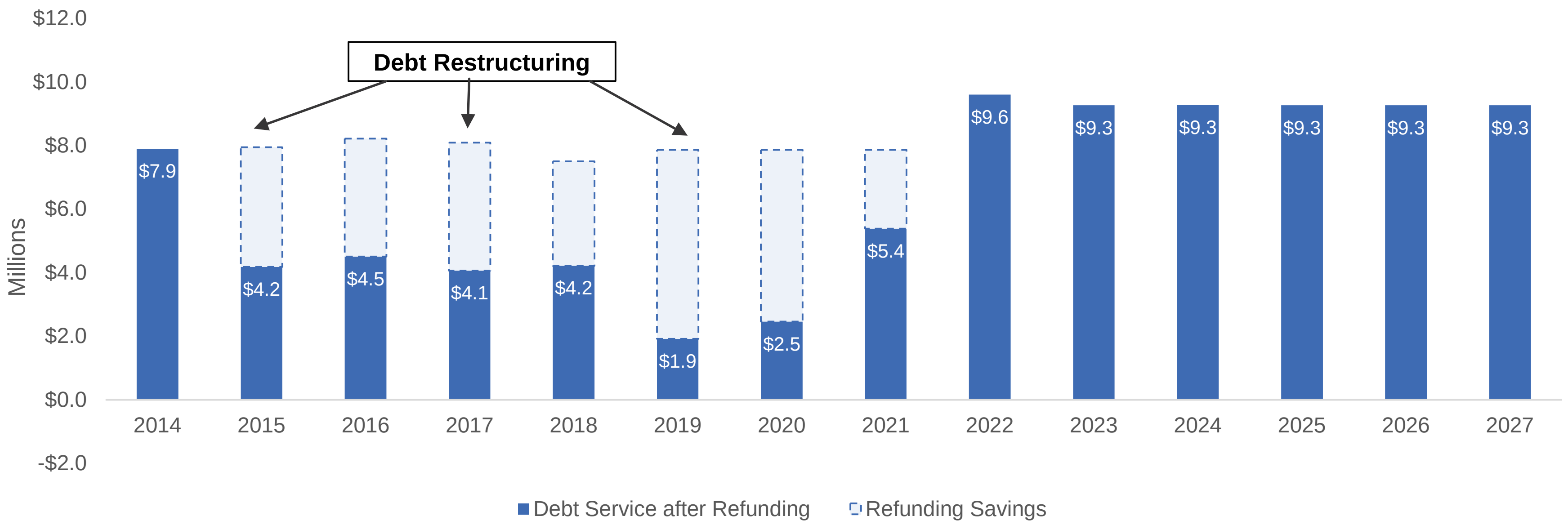
- **Revisit the 457 deferred compensation plan:** In addition to the traditional defined benefit pension plan, the City offers a second retirement benefit under the provisions in the federal internal revenue code. The City makes a matching contribution of 50 percent of the employee's contribution up to a percent of salary, similar to the 401(k) plan concept. The City allocates $0.8 million from its General Fund in 2019 for this supplemental pension benefit, in addition to the $15.3 million pension MMO. The City's contributions for this additional benefit grew by 7.2 percent per year from 2014 to 2018 as employee participation grew.

  The City is struggling to afford its contributions to the traditional pension plan which raises the question of whether it should contribute toward an additional level of benefits. Options include lowering the percent of salary that the City contributes, creating an offset that ties the City's contributions to its MMO levels, or freezing the City contributions entirely. Employee eligibility and contribution levels could remain the same so employees can continue to make their own contributions if they choose. We assume the City would have to negotiate any changes to the 457 plan for union employees but could take immediate action for non-represented employees starting in 2020. Considering the likelihood of higher taxes on residents effective January 2020 to fund the cost of the traditional pension plans, we encourage the City and unions to open discussions on this point as soon as practical.

Debt: The drawbacks of short-term refunding

The City has primarily used short-term restructurings where it “scoops out” principal payments for the next one to three years and “tosses” those payments into the future. At that point the payments cost more because of the interest that accumulates after the scoop-and-toss. This is a valid tool for mitigating one-time cash flow difficulties, but it has minimal long-term benefit for addressing the City’s structural problems. It also creates problems like the situation shown below where the City has to find an additional $2.9 million in make its scheduled debt payments when they rebound to $5.4 million in 2021 and then find another $4.2 million when they rise to $9.6 million in 2022.

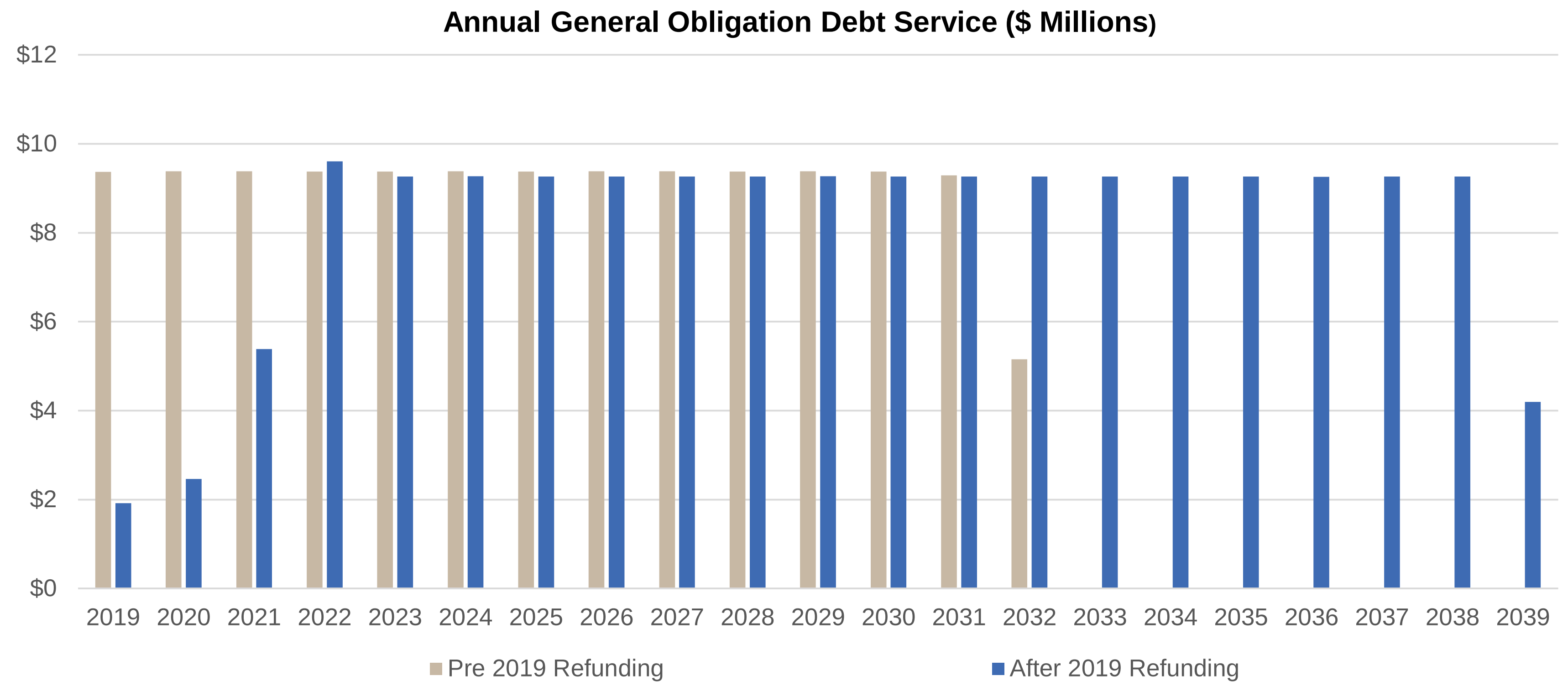
City of Erie Debt Schedule, 2014 - 2027[1]



[1] *Includes debt service paid from both the General and Sewer Funds*

Debt: 2019 restructuring

In 2015, 2017, and 2019, the City used taxable and tax-exempt debt restructurings to lower its scheduled debt payments to address budgetary pressures and to issue new debt to fund new capital projects. The most recent restructuring completed earlier this year reduced the City's scheduled debt payments from the General Fund by $7.4 million for 2019, $6.9 million for 2020 and $4.0 million for 2021. It also added $9.3 million in debt payments for 2033 through 2038 and increased the City's total debt service in the General Fund from $127.0 million paid over 14 years to $171.8 million paid over 21 years.



Recommendation: Consider a longer-term restructuring approach

Instead of using these short-term scoops which only generate savings for a couple years, the City should evaluate whether it can do a longer term restructuring that permanently reduces debt service levels, potentially by extending the payments into the future. In that scenario the City would have one, smaller increase in debt payments than is currently scheduled and a predictable level of debt payments into the future. It is also more efficient since the City will only have to pay the fixed costs associated with any debt transaction once instead of paying them repeatedly every two years.

The City should also consider hiring an independent financial advisor that has an explicit fiduciary duty to the City, unlike other professionals involved in the bond sale. As a "best practice," the Government Finance Officers Association recommends "issuers hire a municipal advisor prior to the undertaking of a debt financing unless the issuer has sufficient in-house expertise and access to current bond market information." The independent financial advisor can also guide the City on issues like:

- Choosing the best type of financing tool, including guidance on how to use Capital Appreciation Bonds. The City uses CABs which allow it to defer interest payments until final maturity of the bond, but they are more expensive to issue and refund.
- Establishing a formal debt policy to guide decisions on how and when the City will use restructurings and other debt tools. Adoption of a formal debt policy is considered a best practice by rating agencies.

Capital: Establish a stormwater management fee

Stormwater is the runoff created when rain, snow or melted ice flows over land and impervious surfaces such as roads, sidewalks, or parking lots. The runoff carries pollutants and dirt into the region's streams and lakes. City government owns and maintains a system of storm sewers that convey runoff to Elk Creek and Lake Erie. The City's stormwater management consultant reported that the majority of the City's stormwater management costs are currently funded by the sewer fee.

The scale of the City's storm sewer system, the risk associated with its age, the many competing demands for capital funding, and the limitations on the City's ability to use its existing funding sources to meet these needs all lead to the conclusion that the City needs to establish a dedicated revenue stream to cover the full cost of storm water system maintenance and improvements. A fee is an appropriate way to deal with the costs of maintaining and improving the system because every parcel owner – not just those subject to municipal taxes – benefit from a properly functioning storm water system and should contribute to the cost of maintaining it.

With the help of the county Department of Planning and Community Development and grant funding from the Pennsylvania Department of Environmental Protection, there is a stormwater management study already underway for the City and Millcreek Township. This is a good first step. **Once the study is completed, the City should adopt a stormwater fee and transfer the costs of any storm water expenditures in the General and Sewer Funds to the newly created Stormwater Fund.**

Capital: Change the funding mechanism for road paving

The City receives Liquid Fuels funding from the Pennsylvania Department of Transportation ($3.0 million in 2018) and uses a portion of that money to fund street light energy costs. Liquid fuels funding can be used for activities ranging from road maintenance to traffic control infrastructure, including street paving. Erie funds its road paving by issuing bonds that are repaid over 20 years.

The City Department of Public Works raised the possibility of finding another source to cover street light costs so that the Liquid Fuels money can be used for paving. There is merit to this proposal because of the mismatch between the 20-year bond repayment schedule and the useful life of street paving, which can be 10 to 15 years depending on the street. The $10 million that the City borrowed this year to resurface streets will benefit taxpayers for the next 10 – 15 years, but the bond will not be fully paid back until 2039, at which point the same roads may have to be resurfaced again. Borrowing money also has a higher cost than using pay-as-you-go resources like Liquid Fuels funding since the borrowed money has to be repaid with interest.

The question is where the City shifts the street costs when it uses Liquid Fuels money for paving. The General Fund already has a projected deficit so it cannot cover the additional costs in the near term. One option is to establish a streetlight assessment, similar to the stormwater fee concept, that would provide a funding stream for the costs of street lights repairs, improvements and utility costs. Funding the streetlights as a utility, like water or electricity, would broaden the base of people paying for these costs. While the City can get more money for road paving by issuing debt than it does from its annual Liquid Fuels allocation, this trade would allow the City to at least reduce the size of its borrowing and the associated debt costs..

After the City completes the stormwater management process, it should consider whether that same concept can be applied to street lights and use the Liquid Fuels funding for road paving instead.

Capital: Develop a formal capital budget and five-year CIP

The City currently has an informal five-year capital spending plan where the departments' "wish list" items are tracked on a spreadsheet. Ideally the City should have a capital improvement plan (CIP) where it inventories, prioritizes and funds potential projects over several years with the annual allocations for individual projects then incorporated in the City's regular budget cycle. The CIP and capital budget should have a mix of projects with some focused on repairing, renovating, and replacing existing infrastructure and others focused on more strategic investments in new assets.

The development of capital budgets, bond proceed tracking protocols, implementation of a project prioritization process, and development of a capital project database are all components that should be included in the development of a CIP. The City should start implementing this recommendation in the 2020 budget by adding a capital budget page to its budget document that includes the following components:

- 2020 capital funding source by type (e.g. bonded debt, pay-as-you-go, grants, and contributions/donations)
- 2020 capital budget by project, project type, responsible department, and funding source

Once the 2020 budget is adopted, the City should expand the capital budget to include a five-year CIP and a formalized process for capital planning.

The City should also establish a **capital budget and planning policy** that describes eligibility for capital projects and the process for developing the capital improvement plan. According to the best practice guidance provided by the Government Finance Officers Association, capital projects should generally have an estimated useful life of at least two years following the date of acquisition and should be at least $5,000 for any individual item. Having a capital policy that clearly defines capital eligibility will prevent the City from spending its capital dollars on operating items.

Pension and debt: Looking for game changers

Most of the recommendations to this point involve changes that would, over a period of time, help lead to more stable levels of City payments for employee pension contributions and debt with the intention that improved pension funding levels or better use of debt tools will eventually lead to lower payments for those two items.

The City should also evaluate its options for generating a large amount of money that can be put toward either of these needs in the next 24 months so that the City's MMO contributions or the scheduled debt payments are lower and the projected deficits are smaller for the years to come.

Asset monetization is a tool that other Pennsylvania communities have used to pay down large liabilities. The basic concept is that a local government signs a long-term lease with a third party giving it the right to operate a revenue-generating system and retain that revenue over several decades in return for a large upfront payment. There are many variations on this basic theme involving the terms of the lease, limits on the third party's ability to increase rates and the structure of any proceeds. Asset monetization is not a quick or simple process, and some communities have considered their options and decided not to pursue it.

The City has asked us to provide guidance on whether it should pursue asset monetization with its water and sanitary sewer system. Similar questions were raised regarding the City's two golf courses, though the scale of those operations and their revenue generating potential is substantially smaller than the two utilities.

The ultimate answer to whether the City should monetize any of these systems depends on several factors beyond the financial realm including those related to quality of service, the pros and cons of public utility ownership and the roles that these systems play in economic and community development. Without more detailed analysis and broader discussion involving community input, it would be premature to recommend that the City make a particular move. For now we are providing:

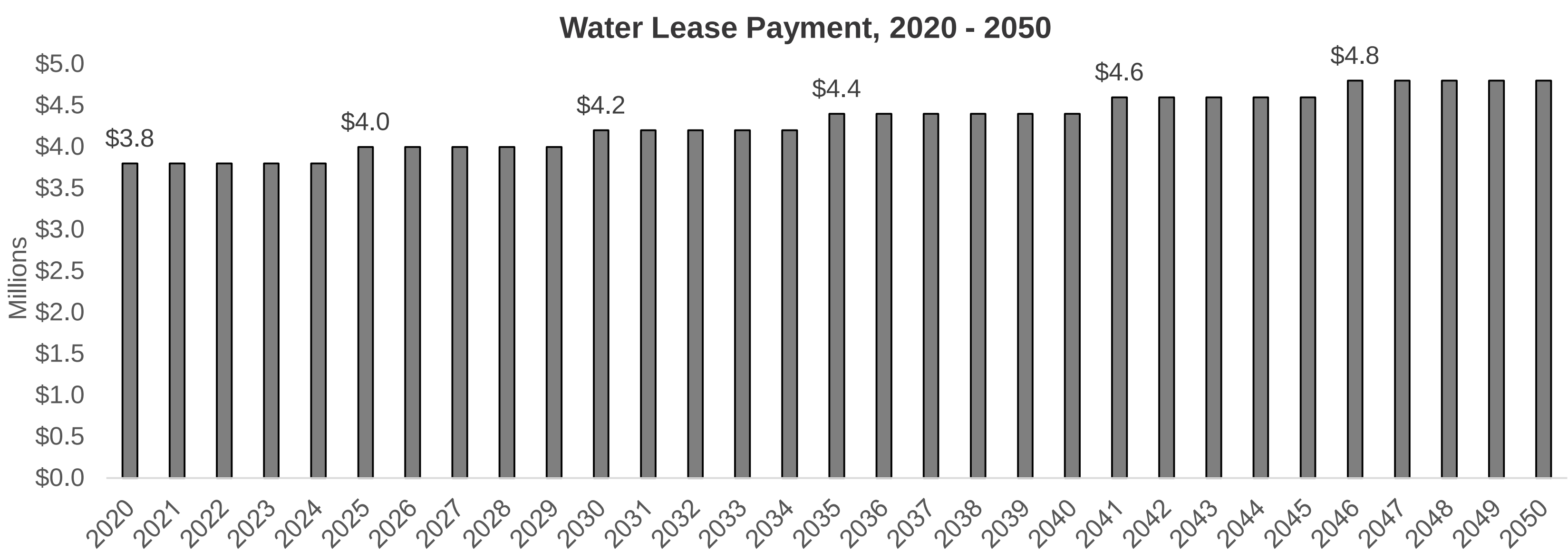
1) A clearer picture how each of these systems contributes to or draws resources from the General Fund; and

2) A recommended process and timeline for evaluating the options that the City has for asset monetization.

Water system: Current arrangement

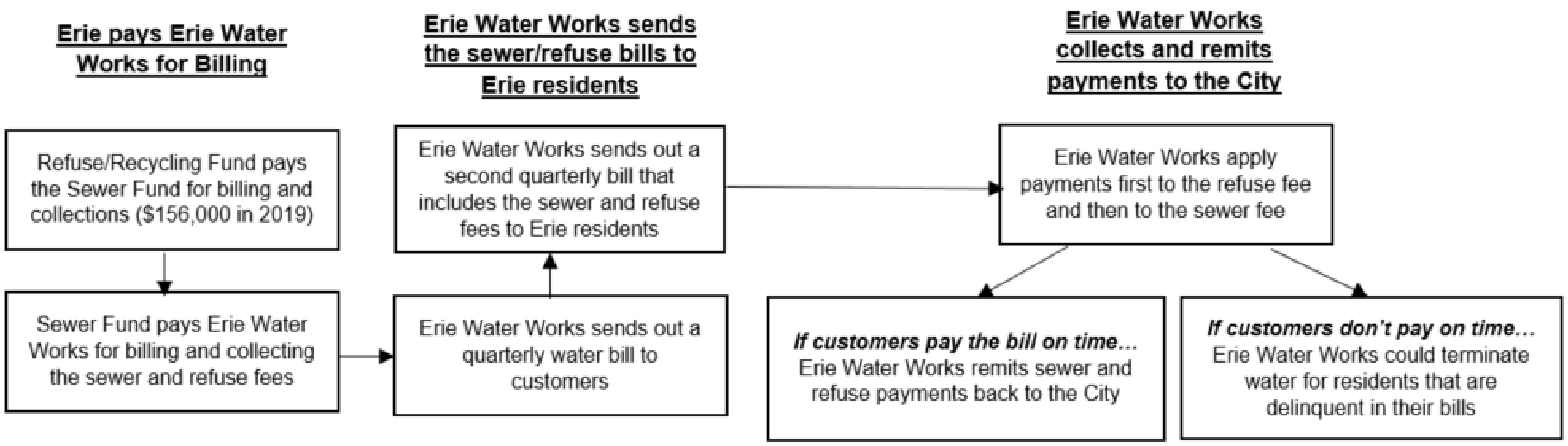
The City owns its water system that consists of two water treatment plants, storage and pumping stations, and water mains. In 1991, the City entered into a lease agreement with Erie Water Works (EWW) to operate the system. The City receives an annual payment based on the terms in the agreement ($3.6 million in 2019). That amount will increase to $3.8 million in 2020 according to the lease schedule.

According to the most recent amendments to the lease agreement, the lease payment will grow by $200,000 every five years after 2020 and will expire in 2050, at which point the lease payment will be $4.8 million. The annual growth from 2020 through 2050 based on the increase in the agreement equates to an annual average growth of 0.8 percent. From 2020 to 2050, the City will receive a total amount of $133.4 million. Upon the termination of the lease, the water system will remain the property of the City.



Water system: More than the lease payment

In addition to this annual lease payment, the City receives service from EWW which handles sewer and refuse billing on behalf of the City. This combined collection model shown below gives the City and EWW more leverage to pursue delinquent accounts, which the City reports has helped improve the collection rate and reduced the amounts of receivables. According to the City's annual financial statements, the amount of refuse/recycling receivables dropped from $2.4 million in 2014 to $1.5 million in 2017. The following chart shows how Erie Water Works collects and remits payments to the City.



Other benefits to the current arrangement are harder to quantify, but also important. For example, the City appoints a majority of members to the EWW board which provides local control over projects and rate increases. EWW is also an active partner in the City and regional economic development efforts since its financial health as a public utility is tied to the financial health of the community itself.

EWW's proposal

Erie Water Works has proposed an arrangement in which it borrows money that it would use to make a large upfront payment to City government and effectively buy the system from it, instead of making annual lease payments through 2050. The size of that upfront payment would be determined in part by the interest rates at which EWW could borrow money, but in one proposal the estimated upfront payment was $75 million.

In one version of the proposal, the City would invest a large portion of the upfront payment, gain earnings on that investment, and gradually drawn down the principal amount each year as a replacement for the lease payment. Some versions of the proposal carve out part of the upfront payment so the City could use it as a local match to attract funding from other levels of government or private investors to stimulate economic development, which would in turn grow Erie's tax base and generate more revenue for City government.

For now we recommend the City consider asset monetization mostly within the context of whether it is an effective tool for slaying the pension and debt parts of the three-headed dragon so that it can close the projected General Fund deficits. The City needs to be certain that the Return on Investment (ROI) for any use of proceeds is worth more than the value of the annual lease payments that it would no longer receive. Paying down existing debt may provide a more certain, readily quantifiable ROI than investing in more prospective economic development projects.

Setting aside the potential use of any proceeds, the City first needs to answer a more basic question – how much is the water system worth?

The EWW proposal sets a payment amount according to the present value of the scheduled lease payments and its understandable interest in borrowing an amount that EWW can afford without burdensome rate increases. But, as the system's owner, the City needs to consider what the system is actually worth before doing a sale or long-term lease.

Asset monetization process

Based on PFM's experience in guiding other Pennsylvania communities through this process, we recommend the following phased approach to determine the best way to leverage this critical asset to address the City's financial challenges. The first step is to determine the system's value and collect the other information that the City's leaders need to make an informed decision. The City can work through that process during the first half of 2020. Then it can decide whether it wants to do a direct negotiation with the EWW, run an open bidding process or do a hybrid of the two. **The mention of potential private sector interest should not be misinterpreted as a prejudice toward a sale or lease to private operator.** There is value to the current arrangement with EWW and reasons for keeping it that go beyond the potential size of an upfront payment. But City leaders need to do their due diligence on the system and their options before making that decision.

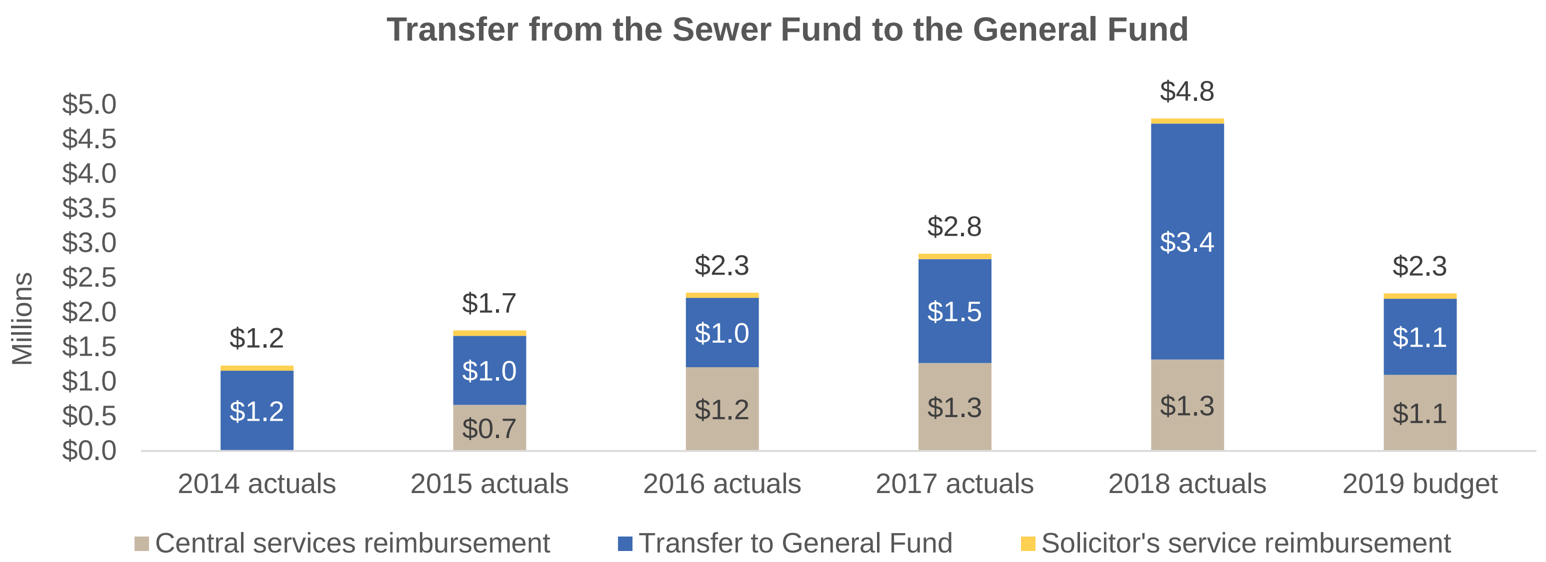
Phase 1: Analysis & Valuation (1 – 3 months)	• Define City objectives and establish financial framework • Determine baseline asset value • Research private sector interest and capabilities • Seek investor/operator feedback and level of interest • Explore impacts of monetization on City ratepayer and City
Phase 2: Transaction Development (4 – 6 months)	• Run RFQ/RFP process • Pre-qualify bidding team and initiate due diligence • Determine transaction structure • Finalize preferred procurement process via large spectrum of processes • Finalize transaction documents • Evaluate proposals and select acquirer(s) • Initiate stakeholder outreach and education
Phase 3: Transaction Execution (1 – 12 months)	• After acquirer(s) selected, initiate closing process • Further due diligence • Proceed through regulatory process (if required) • Close transaction(s)

Sanitary sewers: Connection to the General Fund

- **Central service reimbursements**: The General Fund receives approximately $1.3 million in reimbursements from the Sewer Fund for work done by General Fund employees that is related to sewer operations. This $1.3 million central service reimbursement includes cost of administrative functions (budget, payroll, accounting, IT, purchasing) and public works functions (fleet maintenance; engineering; custodial work).

- **Solicitor's service reimbursement**: The General Fund also receives $75,000 in annual reimbursement for the work the City Solicitor does for the Sewer Fund.

- **Transfers**: On top of these reimbursements, the City transfers money from the Sewer Fund to the General Fund for the cost of operations. The transfers were $1.0 million in 2015 and 2016; rose to $1.5 million in 2017; spiked to $3.4 million in 2018; and then dropped back to $1.1 million in 2019.



Sanitary sewers: Projected deficits put transfers at risk

As we shared in June, the Sewer Fund finished 2018 with a $3.1 million deficit, driven partly by the $1.9 million increase in transfer payments to the General Fund. But even without that increase, the Sewer Fund would have had a deficit because of the increase in debt service payments from $3.5 million to $6.5 million.

Sewer Fund Historical Financial Performance, 2015 - 2018

	2015	2016	2017	2018
Sewer Fund Revenues	$20.3	$22.1	$20.7	$22.4
Sewer Fund Expenditures	$19.6	$19.4	$20.2	$25.5
Sewer Fund Net Result	**$0.7**	**$2.7**	**$0.4**	**($3.1)**
Unrestricted Fund Balance	**($2.4)**	**$0.2**	**$1.4**	**($1.7)**

The City projects the Sewer Fund deficits to continue over the next five years unless the City increases its sewer rates. Our independent evaluation yielded similar results in terms of the projected deficits.

Projected Sewer Fund Expenditures, 2019 – 2024 (As Shown in 2019 Budget)

	2019 Budget	2020 Projected	2021 Projected	2022 Projected	2023 Projected	2024 Projected	Average growth
Projected expenditures ($ Millions)	$24.0	$24.5	$25.3	$25.9	$26.8	$27.4	2.7%
Annual cost per household	$313	$331	$349	$360	$379	$389	4.5%
Assumed rate increases	N/A	5.8%	5.4%	3.2%	5.2%	2.7%	4.5%

What should the City do with its sewer operations?

The Sewer Fund has the same structural deficit as the General Fund. Sewer revenues were flat from 2014 through 2018 and will continue to be flat absent economic development activity that increases system usage. Personnel expenses rose by 3.7 percent per year and operating expenses rose by 1.9 percent per year, even without the transfer payment. The Sewer Fund will also have to cover higher employee pension contributions and larger debt payments in future years, just as the General Fund does.

Theoretically the City could reduce the transfer payment to balance the Sewer Fund budget in the near term, but that would create a larger hole in the General Fund. The Sewer Fund transfer has the advantage over General Fund revenues that are often capped or, in the case of the real estate tax, have a smaller base of rate/tax payers. Eliminating the transfer payment also would not fix the structural deficit in the Sewer Fund.

The City should reduce expenditures in the Sewer Fund by shifting expenses related to the stormwater sewers to a separate fund and any savings achieved through collective bargaining will carry over to this fund, too. But, until the user fee revenues have some growth, the City will need to increase its rates to support the sewer systems and maintain the $1.1 million General Fund supplement.

Recommendation: Schedule and make smaller annual rate increases

The City has traditionally enacted rate increases once every 3 to 5 years. Unless those sporadic rate increases are larger than the City needs to cover its costs at the time, this approach does not work. The costs rise annually and the revenue does not, which endangers the Fund's ability to make the transfer payment that the City relies upon. It also produces steeper rate increases like the ones shown below (18.9 percent in 2010, 20.4 percent in 2014, 15.1 percent in 2019). Instead the City should make smaller, regular increases in the sewer rates every year and set a schedule for those increases over the next five years so the system's users can plan for them.

Metered Rates for 0-70 CCF (Hundred Cubic Feet)

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
$1.85	$1.85	$1.85	$2.20	$2.20	$2.20	$2.20	$2.65	$2.65	$2.65	$2.65	$2.65	$3.05

Golf course: Focus on fixing the deficit first

The City owns two golf courses – the nine-hole Joseph C. Martin Golf Course and the Downing Golf Course – which have their financial activity tracked in a separate enterprise fund.

The Golf Fund has had operating losses in most recent years. Those losses have been relatively small but, unlike the sewer system, the Golf Course also does not make any "central service reimbursement" payment to the General Fund to cover the cost of time and services provided by employees budgeted there.

	2014	2015	2016	2017	2018
Operating revenues[1]	453,007	476,307	510,599	491,079	436,048
Operating expenditures	547,106	527,552	495,029	528,244	474,322
Net Operating	**(94,099)**	**(51,246)**	**15,570**	**(37,166)**	**(38,275)**
Ending fund balance	**($1.0M)**	**($1.2M)**	**($1.2M)**	**$1.2M)**	**($1.3M)**

If the operating losses at the two golf courses continues, the City will eventually have to offset those deficits using General Fund subsidies, like it did in 2017. In that case the general tax paying public would be subsidizing a recreational service used by a small portion of the population. As small as the subsidies are relative to the City's projected deficits, the City's goal should be to make the courses truly self-sufficient, including any reimbursement to the General Fund for cost of service and paying for necessary capital improvements.

[1] *Excludes transfers from other funds*

Golf course: What about selling the courses?

The City reports that J.C. Martin has a deed restriction such that the land has to remain dedicated to parks and recreation.

Downings does not have a deed restriction but it sits in Harborcreek Township. An external appraisal conducted in 2006 found that the market value of the course's assets was $2.2 million and the market value of using the course for an "alternate, highest and best use" was $2.1 million. Those values could be higher since the appraisal is more than a decade old but, based on that assessment, it is unlikely that the course is worth enough such that selling it would produce a large enough upfront payment to impact the City's debt or pension burden.

Recommendation: Bring the courses' finances into balance

The deficits in the golf course are small relative to the City's challenges in the General Fund, but the City is not financially in a position to subsidize golf, nor is it equitable for the City to keep fees frozen for people using this service while requiring the users of other services (like refuse collection or sewers) to pay the full cost of service through more frequent rate increases. The City has not increased the fees at the courses in the last 10 years.

The City should first calculate the value of services provided to the Golf Course by other funds and include that in the budget. Even if the short-term result is the budget shows a larger deficit than the course can cover, it is important to have a more complete estimate of the course's dependence on the General Fund. The City should also increase the fees to help cover this deficit, just as it has done or should do with other enterprise funds.

The City should also seek and retain the services of a consultant specializing in golf courses who can provide an independent evaluation of the courses' potential to breakeven in this market, whether that is through continued City management or a private operator. A subsequent phase of EIP/STMP funding could pay for this evaluation.

Finally the City should set a clear deadline for the course to become breakeven with the understanding that the City will consider closing or selling Downings golf course if that is not achieved.

Refuse/Recycling Fund

The Refuse/Recycling Fund had a $0.3 million deficit in 2016 largely because waste and recycling processing fees increased from $1.6 million to $2.0 million that year. Those fees dropped slightly in 2017, so the deficit also dropped. In 2018, the City increased the refuse/recycling fund transfer to the General Fund from $1.2 million to $2.5 million. In part due to the increase in transfer to the General Fund, the Refuse/Recycling Fund had a $1.6 million deficit in 2018.

Refuse/Recycling Fund Historical Financial Performance, 2015 - 2018

	2015 Actual	2016 Actual	2017 Actual	2018 Unaudited
Revenues ($ Million)	$8.5	$7.8	$8.1	$8.0
Expenditures ($ Million)	$6.8	$8.0	$8.1	$9.6
Net Result ($ Million)	**$1.7**	**($0.3)**	**($0.1)**	**($1.6)**
Unrestricted Fund Balance	**$3.6**	**$3.5**	**$4.0**	**$2.3**

Similar to the Sewer Fund, the City projects the Refuse/Recycling Fund deficits will continue over the next five years unless the City increases its refuse fees ever year. Our independent evaluation yielded similar results in terms of projected deficits.

Projected Refuse/Recycling Fund Expenditures, 2019 – 2024
(As Shown in 2019 Budget)

	2019 Budget	2020 Projected	2021 Projected	2022 Projected	2023 Projected	2024 Projected	Average growth
Projected expenditures ($ Millions)	$8.4	$8.7	$8.8	$8.9	$9.0	$9.6	2.7%
Annual cost per household	$220	$250	$254	$258	$262	$280	4.9%
Rate increases	N/A	13.6%	1.6%	1.6%	1.6%	6.9%	4.9%

What should the City do with refuse collections?

Similar to the Sewer Fund, the Refuse/Recycling Fund provides two primary payments to the General Fund. It reimburses the General Fund for the cost of services provided by employees in that fund including administrative functions and public works functions, like fleet maintenance. It also makes a supplemental transfer payment to the General Fund, which was generally been $1.1 million except for 2018 when it was $2.5 million.

This fund also has the same structural deficit problem that the Sewer Fund does. User fee revenues were flat from 2014 to 2018 and, given the demographic trends, that is unlikely to change in the near term without rate increases. Personnel cost growth has been lower in this fund (1.9 percent) but non-personnel costs have grown more, especially for tipping fees (7.3 percent) and other operating costs (6.4 percent).

Unlike the Sewer Fund, though, the transfer payment from Refuse and Recycling does not spread the cost burden for City services across a broader base than other sources like the real estate tax. As the chart to the right shows, the opposite is true since City residents pay for City trash collection while commercial and non-profit property owners use private haulers.

	Pay property tax?	Pay sewer fee?	Pay refuse fee?
Residents	Yes	Yes	Yes
Non-profits	No	Yes	No
Commercial	Yes	Yes	No

As the system currently stands, the City needs to increase its rates if it wants to keep the $1.1 million transfer to the General Fund. As Finance's projections show, the fund will slip into deeper deficits absent regular rate increases. Outsourcing is not viable in the near term because the City would have to replace the refuse system's payments to the General Fund, which private collection would likely not provide. Some savings may be possible through collective bargaining or efficiency measures, like route optimization.

In the long term we encourage the City to revisit the transfer payment and consider whether it should be reduced for the equity reasons cited above.

Other revenue initiatives

Measure the success of economic development programs

The City uses a number of economic development tools to incentivize tax base growth, the most notable tool being the LERTA. Working with the Assessment Office, Economic Development staff should estimate how much assessed value a particular project will add to the tax rolls, how much it will increase the City's total revenues, and when that growth will occur. The City should also work with its EIT collector (Berkheimer) and Erie Water Works to determine how much these projects will increase EIT revenues and sewer revenues. That will provide a fuller measure of the costs and benefits associated with this program.

Administer new fees to recover costs

The City should continue to explore opportunities to levy new fees to recover the full cost of services. Doing so allows the City to charge the cost of providing the service to individuals or entities who directly benefit from the service instead of sharing that burden among taxpayers who may not benefit from those services. Potential new fees include the false alarm registration fee, fire inspection fees, and general contracting license fee.

To minimize administrative costs in collecting new fees, the City should improve its information technology system and allow residents to pay their fees and fines online. The City already allows residents to pay its real estate tax online, and should expand that option for all fees and fines. Doing so will require the City to update its website and contract with a vendor to provide the online payment services, but it will help reduce the need to hire an additional clerk for billing and collections every time the City levies a new fee. It will also help the City improve its revenue collection efforts and may help reduce delinquencies. This is a good candidate for a second phase of EIP/STAMP funding.

Renegotiate agreement with the Parking Authority

Given that the current agreement with the Erie Parking Authority has expired for almost two years and the contribution from the Parking Authority has declined significantly since the agreement's expiration, the City should renegotiate a new agreement with the Authority as soon as possible to set the amount for 2020. To help advance those efforts, one potential option to use the waived parking tax (estimated at between $500,000 and $700,000 based on $5.5 million in parking receipts) as the basis for negotiations.

What about personnel costs?

Similar to most local governments, the majority of the City's spending is on personnel cost. The City allocates 88 percent of its $81.5 million General Fund budget for personnel costs in 2019. We addressed pensions earlier (19 percent of the budget), but that still leaves employee salaries (48 percent), other forms of cash compensation (5 percent), other personnel costs (5 percent) and health insurance (11 percent).

There are two major variables in personnel costs – the number of employees the City has and the total cost of compensation for each employee. **We will have recommendations that impact both variables, with the preference that the City and unions can achieve savings relative to the baseline projection by focusing on the cost of compensation.**

We will outline a strategy for the Administration to consider as it enters collective bargaining with the police in 2020, the AFSCME in 2021 and Teamsters in 2022. We will also offer guidance for ways to control the growth in employee health insurance costs.

If the City and unions are not able to reach agreement on provisions that achieve the level of savings the City need, then the City would need to reduce headcount. We are not recommending any large scale reduction in headcount for 2020, though we have identified some areas where the City may be able to reallocate resources and manage cost growth over the term of the five-year plan. That analysis is underway and our recommendations will be discussed first with the departments whose operations would be most directly impacted and then incorporated in the final plan document.

Our recommendations related to employee compensation will be incorporated in the final Plan and public information.

Other expenditure initiatives: IT needs

As discussed previously, the City needs an improved IT platform to collect its fees and fines online. In addition, the City should consider the following improvements, some of which may be eligible to be funded through a subsequent phase of EIP/STAMP.

- **Code enforcement software**: Giving the HUD audit findings and the existing problems with the code software, the City needs to improve the way it tracks code enforcement data. In the immediate term, the City should upgrade the software as soon as possible and move all historical data into the new software system. Discussions with the City indicates that the data storage is currently fragmented as some of the historical files are stored in the City's servers while others are stored in the software. Code inspectors will also need training and time to be accustomed to the software upgrade. Once the City has fully implemented the new software, the Department should develop a plan to more intentionally track performance data and use that to inform and manage daily operations. Having a coordinated system would also allow the City to more easily identify trends that are improving or on the decline within neighborhoods.

- **Integrated GIS system for the sewer/stormwater systems**: A integrated GIS system would help the City digitalize its existing data for its sewer and stormwater systems and facilitate data collection so that the City can more easily identify maintenance and capital needs. The upfront cost of obtaining a fully integrated GIS system may be funded by a subsequent phase EIP/STAMP funding, although the City may also build in any recurring stormwater-related software cost in the stormwater fee.

- **Data-driven efficiencies**: The City recently started working with the new Erie Innovation District on a pilot program that focuses on using a data-driven approach to gain efficiencies in the way City government delivers services. The City should work to identify priority areas to explore as future "use cases" so that the data-driven analyses can be used to help City government gain operational efficiencies.

While improvements in information technology capacity will undoubtedly help the City deliver services more effectively and efficiently over time, it is important to note that City staff will also have to be part of the solution. Performance measures are only useful when department staff track data accurately, store them in the appropriate data systems, regularly report and analyze the data trends, and use those data to inform and drive daily operations.

Next steps

The recommendations we provided today are potential options for the City to close part of the 2020 budget gap. To align our work with the City's 2020 budget process, we propose the following next steps.

- **Receive input on the draft recommendations from City staff**: Once the City has had a chance to digest the information we presented today, we would like to receive any input and feedback you may have on these major recommendations to incorporate in the final Plan document.
- **Draft Plan document**: The final deliverable for this Five-Year Plan is a Plan document. We are already working on drafting the Plan and will continue doing that and incorporate any feedback we receive from the City.
- **Deliver the Plan document**: We will deliver the final Five-Year Plan to the City toward the end of the budget process so that the Administration and Council can focus on developing and adopting the 2020 budget over the next couple months. We encourage the City to incorporate the major recommendations we presented today in the 2020 budget. Once we have completed the Plan document, we will come back for final plan delivery and presentation.