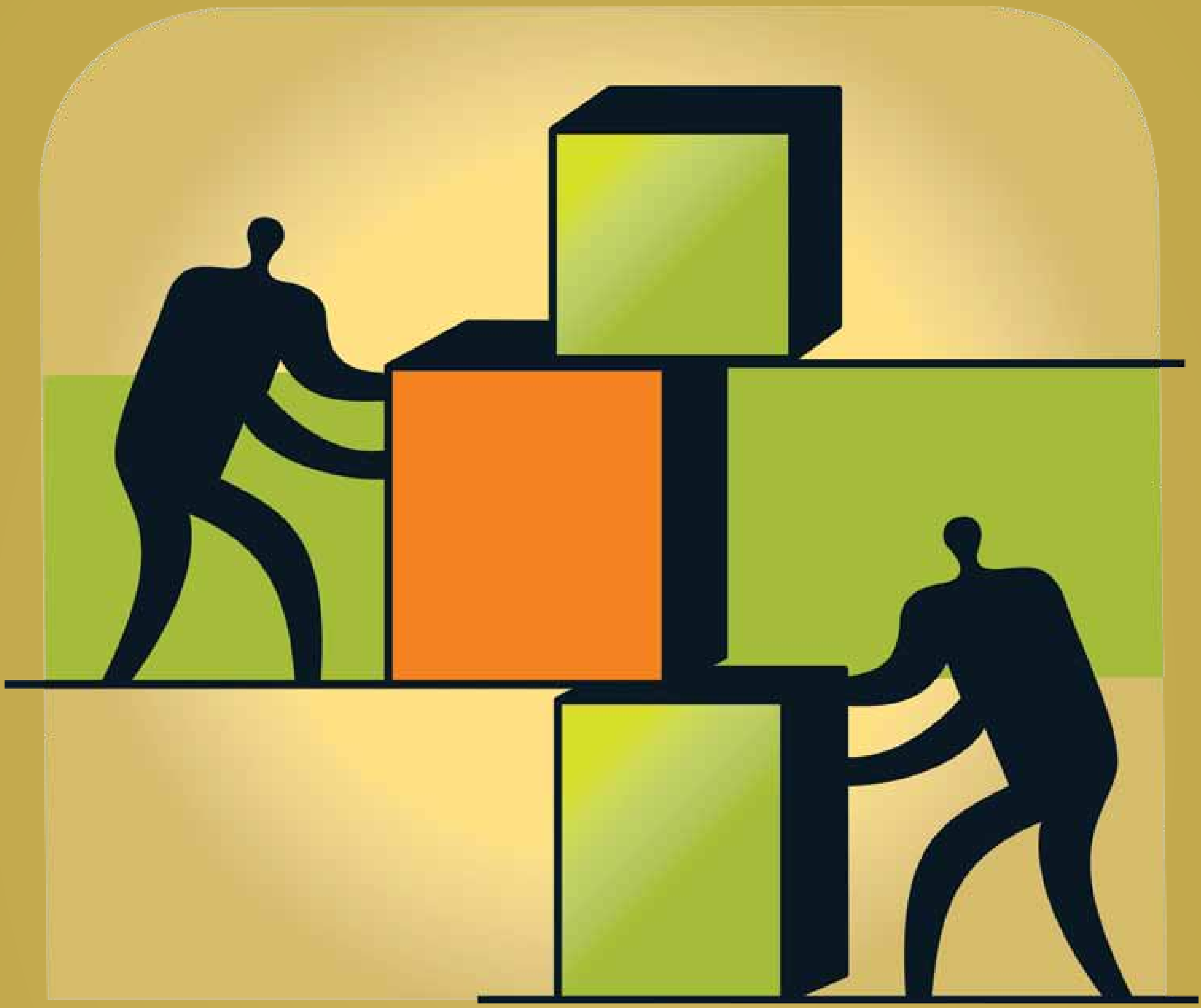

County of San Diego Strategically Aligns Its Assets and Liabilities

BY EBONY SHELTON,
JOAN BRACCI, AND
JOSHUA RAMIREZ

For more than a decade, the County of San Diego, California, has worked to strategically align its assets and liabilities to mitigate both short- and long-term risks and needs. This has engrained a discipline within county leadership at all levels of the organization to be consistently mindful of long-term risks when evaluating immediate needs and opportunities. Specifically, the county has taken a long-term approach to aligning and matching assets to growing liabilities. As a result, fund balance has been strategically increased since 2006, with the goal of managing growing liabilities in the areas of pension and capital infrastructure renewal. The county made use of unanticipated property tax growth during the housing bubble to prepay liabilities and cash fund capital.

Implementing the strategy led to an execution model that was fundamentally based on several GFOA best practices (see Exhibit 1). The execution model included:

- A comprehensive review and codification of financial policies.
- Review and evaluation of short-term needs through the assessment of discretionary services while also considering alternate service delivery models.
- Reducing and avoiding new liabilities in the areas of pension and capital through the use of recurring and nonrecurring revenues.

> Today, the County of San Diego has AAA ratings from Moody's Investors Service, Standard & Poor's, and Fitch Ratings — a result of the strategy, if not its goal.

As a result, the county was able to:

- Prepay $422.1 million towards retirement-related costs from 2005 to present (in addition to the actuarially determined contribution).
- Avoid $1.2 billion in costs related to OPEB and implement lower retirement benefit tiers.
- Avoid $1 billion in financing costs by paying cash for capital improvements over a ten-year period.

Today, the County of San Diego has AAA ratings from Moody's Investors Service, Standard & Poor's, and Fitch Ratings. This wasn't the goal of the strategy, but the strategy clearly demonstrated the credit strength of the county, as evidenced by the two rating upgrades the county received since the strategy was deployed.

In an effort to help other agencies replicate this strategy, the following case study summarizes how the county executed this strategy, including the specific guidance from GFOA best practices, difficulties that occurred along the way, and benefits to the county.

THE STRATEGY IN ACTION

From June 1997 to June 2001, the San Diego County Employees Retirement Association (SDCERA) averaged annual investment returns of $168.6 million and an average annual unfunded actuarial accrued liability (UAAL) of $227.5 million. In 2002, the county enhanced retirement benefits in order to attract and retain a strong work force composed of the best and brightest employees. The county was aware that this would increase annual costs and had a plan for how to address these costs. However, in June 2002, SDCERA experienced a $92.0 million investment loss, which augmented the financial impact of the enhanced benefits (also known as Tier A), increasing the county's retirement system UAAL from $238.8 million in 2001 to $1.2 billion in 2002.

The enhanced benefits, combined with economic volatility, made the County of San Diego's pension and retirement system one of its most vulnerable risks — from 2002 to present, the UAAL grew at an average rate of 10.7 percent, or an average of $111.1 million per year. Near the end of 2006, it also became clear that other postemployment benefits (OPEB) offered to retirees presented significant long-term financial pressure. Over 20 years, OPEB would have resulted in costs to the county of $60 million to $70 million annually. In addition to OPEB and pension, the county's capital infrastructure was aging and required renewal. These factors were, and with the exception of OPEB, remain the county's largest financial risks. However, this fiscal strategy has positioned the county to effectively manage these risks going forward.

As a result of the housing marking boom before the recession, the county experienced double-digit assessed value growth. Understanding that these growth levels were unsustainable and following the guidance in the GFOA best practice, *Achieving a Structurally Balanced Budget*, the resultant recurring growth in revenue was used to address one-time liabilities instead of implementing new, ongoing programs or expanding existing programs. These resources also strategi-

Exhibit 1: Ways in Which County of San Diego's Execution Model Was Based on GFOA Best Practices

County of San Diego's Use of GFOA Best Practices	Compelling Need for Best Practice	Outcome After Implementation of Best Practice
Achieving a Structurally Balanced Budget	Double-digit assessed value growth during the 2000s housing bubble was unsustainable.	Excess revenue during the housing bubble was used for one-time expenditures rather than new or expanding programs. Over time, the policy language was strengthened to reaffirm commitment to best practices.
Sustainable Benefit Tiers	Economic volatility, investment losses, and other factors are major pension risks.	The county created new retirement tiers, closed its Other Postemployment Benefits (OPEB) to new employees, and developed a strategy to prepay pension-related costs.
Multiyear Capital Planning	The county faced significant capital improvement needs.	The county avoided $1 billion in financing costs by paying cash for $830 million of capital over a 10-year period.
Adopting Financial Policies	Financial practices and operations should be memorialized.	The county maintains and periodically updates long-term, financial, fees, fund balance, and other fiscal policies. Key components of financial policies have been codified in ordinance.
Fund Balance Guidelines for the General Fund	The county faced criticism from external stakeholders regarding the strategic long-term goals of the organization, with much of the discussion being focused on the county's fund balance levels.	The policy was codified in ordinance and language was strengthened clarifying targets according to recommended GFOA standards.
Debt Management Policy	Excess revenue (as a result of better-than-anticipated assessed valuations) at year's end created additional fund balance.	Any excess revenue from assessed valuations is now repurposed into the following year's budget to reduce the UAAL, to accelerate repayment of outstanding obligations, or to avoid the issuance of new debt by cash funding capital projects.
Alternate Service Delivery: Shared Services Examining the Benefits of Managed Competition	The organization was required to identify and prioritize minimum service levels by program.	These two best practices allowed the county to review every program with a goal of identifying those eligible to be consolidated, outsourced, re-engineered/generate revenue, or eliminated.

cally generated fund balances for one-time capital and/or one-time pension expenses. The resources generated by this fiscal policy decision resulted in the creation of a pension stabilization strategy that also funded one-time capital expenses.

Ultimately, the county addressed pension requirements by actively managing benefits and asset levels. In alignment with GFOA's best practice on *Sustainable Benefit Tiers*, new retirement tiers were established, the group of retirees eligible for OPEB was closed, and a combination of recurring and nonrecurring revenues were used to prepay pension obligation bond debt and make voluntary contributions to increase assets of the retirement system. Recurring and nonrecurring revenues were also used to avoid the issuance of new debt by cash financing of capital infrastructure.

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MANAGING RETIREMENT LIABILITIES

As a long-term strategy, the county established additional retirement tiers that have a lower cost to both the county and employees. In August 2009, a new, lower retirement benefit level known as Tier B was successfully negotiated and implemented for new employees. Based on calculations from the retirement system's actuary, Tier B was anticipated to lower costs by approximately 4.5 percent of payroll.

Shortly after the lower tier was implemented, the effects of the Great Recession were realized, with the market value of the retirement system's assets experiencing a 25 percent loss. As a result, statewide reform efforts began, and a new Tier C was created, effective January 2013, through statewide legislation known as the California Public Employees' Pension Reform Act of 2013 (PEPRA). The actuary calculated Tier C would lower employer contributions per employee by an estimated 8.3 percent of payroll.

In January 2018, the county successfully negotiated and established a Tier D for general (non-safety) employees. This is the third new retirement tier for general employees in the past ten years, and it is anticipated that it will lower rates by 2.25 percent from the current Tier C payroll rates. Tier D is the lowest benefit level currently allowable under California law for 1937 Act Retirement systems.

The county has also made contributions in excess of its actuarially determined contribution to increase retirement assets. From fiscal year 2004-05 to date, the county has made voluntary payments totaling \$158.1 million. In addition, the county has prepaid \$264 million of its pension obligation bonds, and anticipates the final repayment of these bonds within the next ten years.

The county initially anticipated that the required annual contribution for OPEB would be approximately \$60 million to \$70 million, and would continue to increase. However, to further reduce retirement-related liabilities, the county closed its OPEB retiree health insurance program to Tier A and subsequent members in June 2007. This created an estimated \$1.2 billion in savings over 20 years, or roughly \$44 million in annual savings. Currently, the OPEB retiree health program has a closed group of 4,500 members and costs the county approximately \$20 million annually.

MANAGING AGING INFRASTRUCTURE AND AVOIDING CAPITAL DEBT

By leveraging the same revenues generated by unsustainable growth in property tax revenues, the county was able to avoid \$1 billion in financing costs by paying cash for \$830 million of capital over a ten-year period. The county was able to achieve this by developing a multiyear financing plan that captured and planned for these anticipated revenue streams as a funding source. This financing strategy, along with the county's five-year capital improvement needs assessment process, was significantly influenced by GFOA's *Multiyear Capital Planning* best practice.

CODIFICATION OF MANAGEMENT PRACTICES

Understanding that financial policies are the center of strategic long-term financial management, the county has a history of applying the GFOA best practice, *Adopting Financial Policies*. For years, the county had relied on the guidance included in this best practice to incrementally implement and update policy; this is reflected in the county's long-term obligations and financial management policy, its fees and full cost-recovery policy, and its fund balance policy, to name a few.

In an effort to depoliticize and further strengthen its policies and alignment with the strategic financial management approach, the county initiated a comprehensive review of all financial policies in 2015, using the GFOA best practice *Adopting Financial Policies*, and the National Advisory Council on State and Local Budgeting budget practices. Internally this initiative was referred to by the organization as the "Good Governance Package." In addition to reviewing

and updating policy to ensure that all facets of the GFOA best practice and NACSLB practices were succinctly captured, in certain instances the policies were codified into ordinance, such as the 2017 Fund Balance and Reserve Ordinance. In addition to strengthening the policy through adoption of an ordinance, the policy clarified fund balance targets for the general fund as recommended in the GFOA best practice *Fund Balance Guidelines for the General Fund*, as well as codification to ensure a structurally balanced budget by prohibiting the use of nonrecurring revenues to support ongoing expenditures, as recommended in the *Achieving a Structurally Balanced Budget* best practice. The adoption of an ordinance strengthened existing board policy that prohibited the use of one-time resources to support ongoing expenses.

By leveraging the same revenues generated by unsustainable growth in property tax revenues, the county was able to avoid $1 billion in financing costs by paying cash for $830 million of capital over a ten-year period.

As mentioned previously, there has been criticism by external stakeholders such as community groups and organized labor regarding the strategic long-term financial policy, with much of the discussion being focused on the county's fund balance levels and targets. In an effort to communicate the prudence of the strategy, the county used the GFOA best practice *Fund Balance Guidelines for the General Fund* to educate stakeholders on how the policy targets aligned with recommended industry standards. Adopting and relying on this best practice as guidance has paved the way for a more focused discussion on differing political agendas and priorities.

In addition, in 2017, the county codified select management practices included in its long-term obligations and financial management policies. This included a requirement to allocate the one-time budgetary fund balance generated by over-realized general purpose revenue (the result of better-than-anticipated assessed valuations in the immediate year) to make a one-time excess contribution to reduce the UAAL — which is consistent with GFOA's best practice regarding the use of one-time revenues. These revenues are then programmed into the subsequent year's budget to be allocated on an ongoing basis. Another key management practice that was codified is a requirement to reinvest capacity created by general purpose revenue, which was previously allocated to retired or refunded debt obligations, to accelerate the repayment of outstanding obligations or to avoid the issuance of new debt obligations by cash funding capital projects. Finally, the county's debt limit was codified consistent with GFOA's best practice, *Debt Management Policy*.

SHORT-TERM NEEDS

During the Great Recession, the State of California faced a combined deficit of $66.7 billion. At the same time, locally generated revenues such as property tax and sales tax also dipped, causing the county to experience $150 million in revenue declines. In preparation for these and other budget changes, the county relied on guidance from GFOA to mitigate short-term risks, specifically GFOA's best practice on *Alternate Service Delivery: Shared Services*. The county used the ele-

The County at a Glance

- San Diego County is the fifth-largest county in the nation covering 4,261 square miles, approximately the size of the state of Connecticut.
- It is the southernmost major metropolitan area in the state.
- The county is home to 3.3 million residents, making it the second largest county by population in California and the fifth-largest in the nation.
- The county is governed by a five-member board of supervisors.
- The region includes the largest concentration of military in the world, making the military presence an important driver of the region's economy.
- In addition, San Diego is a thriving hub for the life sciences/biomedical and technology-oriented industries and a popular travel destination.

ments of this best practice, along with *Examining the Benefits of Managed Competition*, to conduct a comprehensive review of every county program with a goal of identifying programs eligible to be "Consolidated, Outsourced, Re-engineered/Generate Revenue, or Eliminate" (CORE).

The initiative quickly became an essential process of future budget development cycles, resulting in innovations such as the elimination of outdated internal policy restrictions that had limited the use of certain discretionary revenues. The county was also able to identify opportunities to reduce service levels while limiting impacts on service delivery and to eliminate or reduce non-mandated discretionary services.

CONCLUSIONS

The County of San Diego takes a long-term approach to aligning and matching assets to growing liabilities by strategically increasing its fund balance. In the 2000s, the county's UAAL was $1.2 billion, OPEB was $1.8 billion, and estimated capital needs was $1 billion — significant liabilities that had to be addressed incrementally. The county took a short- and long-term approach to liabilities, and it also codified management practices.

The county implemented several GFOA best practices, on achieving a structurally balanced budget, creating sustainable benefit tiers, improving multiyear capital planning, adopting financial policies, and more. Following these new practices, the county prepaid $422.1 million in retirement-related costs since 2006, avoided $1.2 billion in OPEB costs, and avoided $1 billion in financing costs by paying cash for capital improvements.

EBONY SHELTON is director of the County of San Diego's Office of Financial Planning. **JOAN BRACCI** is the manager of the County of San Diego's Office of Financial Planning. **JOSHUA RAMIREZ** is a financial policy and planning officer with the County of San Diego.

"Leveraging GFOA Best Practices in the Strategic Management of Liabilities" is one of GFOA's 2018 Awards for Excellence in Government Finance winners in the Exceptionally Well Implemented GFOA Best Practices category. Learn more at gfoa.org.