City of Erie: Financial Condition Assessment and Trend Analysis

Presented by:
Gordon Mann and Vieen Leung

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PFM Group Consulting

1735 Market Street, 42 FL,
Philadelphia, PA 19103

215-567-6100

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. There are three steps to develop the multi-year plan.

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 use a baseline projection of the City's financial performance in a *status quo* scenario to diagnose the areas that need corrective action. **This is what we are presenting today.**

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 won't tell the complete story. So we'll meet 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.

Initiative development and plan delivery

- Guided by the quantitative analysis in the financial conditional assessment and the qualitative analysis in the management review, we will develop a series of recommendations (or initiatives). Those initiatives will be organized into one coherent plan document that we'll deliver at the end of this process.

Methodology: Source material

We have reviewed a variety of data and documents to guide our analysis and inform the growth rates that underlie the baseline projections. We have also discussed the City's revenue and expenditure trends, anomalies from those trends and forward-looking factors with the Finance Department. **Please note that we will meet a much wider range of officials and department staff during the management review. We will continue to evaluate new data throughout this process.**

Financial data	Other City documents	External references
• Historical results from 2014 to 2018 • External audits from 2015 to 2017 • 2019 adopted budget • 2019 multi-year projections • Debt schedule • Five-year capital plan	• 2019 Council budget handout • 2019 personnel roster • Collective bargaining agreements • Payment-in-lieu-of-taxes (PILOT) schedule • Property abatements provided through the Local Economic Revitalization Tax Assistance (LERTA) program	• Pension actuarial valuations • MMO projections provided by actuary • 2019 Official statement • DCED Municipal Statistics • State Tax Equalization Board (STEB) data • Bureau of Labor Statistics • American Community Survey

Where does Erie City government stand?

Benchmark comparisons

Before we dive into our analysis of Erie City government's financial performance, we want to give you a high-level overview on where Erie stands relative to external reference points. We have compared Erie to the four Pennsylvania cities closest to it in size and then to external standards for good fiscal health.

	Population	2019 General Fund Budget
Erie	**98,970**	**$82 million**
Allentown	120,128	$116 million
Reading	88,275	$94 million
Scranton	76,624	$97 million
Bethlehem	75,240	$78 million

We used publicly available information and credit rating reports to review Erie and these comparable communities in four areas.

1. **Credit rating** – *How credit worthy is City government?*
2. **Fund balance** – *Is the City in a stable position in terms of reserves?*
3. **Legacy costs –** *How much of the City's budget is consumed by debt and pension obligations?*
4. **Capital spending –** *How much is City government investing in core infrastructure?*

Benchmark #1: How credit worthy is Erie City government?

External credit rating agencies evaluate local governments on the relative likelihood that they can repay their debt in full and on time. A government's credit rating influences its ability to issue debt and the cost to do so. Governments with lower credit ratings pay higher interest rates so they have to spend more to borrow the same amount of money. The table below shows the most recent credit scores from Moody's and Standard & Poor's.

The scale below shows the range of scores that are considered investment grade. A score of 1 (AAA) is "prime" and the highest possible, while 10 is the lowest score in the investment grade category. Scores below 10 are considered "junk bonds."

	S&P	Moody's	Ranking
Bethlehem	A+ (stable outlook) (5 out of 10)	A2 (6 out of 10)	1
Erie	A (positive outlook) (6 out of 10)	Not Rated	2
Allentown	A (negative outlook) (6 out of 10)	A3 (7 out of 10)	3
Reading	Not Rated	Baa2 (9 out of 10)	4
Scranton	BB+ (Non-investment grade)	Not Rated	5

Score	S&P	Moody's
1	AAA	Aaa
2	AA+	Aa1
3	AA	Aa2
4	AA-	Aa3
5	A+	A1
6	A	A2
7	A-	A3
8	BBB+	Baa1
9	BBB+	Baa2
10	BBB-	Baa3
"Junk" bond	Below BBB-	Below Baa3

Very few Pennsylvania municipalities have a prime rating and it is rare for Pennsylvania's large cities to even reach the high investment grades (Scores 2 – 4). Pittsburgh has the equivalent of AA- (Score 4) and Philadelphia has A+/A2 as of 2017 (Score 5).

S&P: Strengths and weaknesses

S&P issued a credit rating report in March 2019 when the City started the process to refund existing debt.

"While Erie has been able to show economic gains through ongoing reinvestment and development, management is faced with challenges associated with a declining population and broadening its tax base because of increasing expenditures. Despite these challenges, city officials are credited with building and sustaining very strong reserve levels over the past five years. Even with the financial success management has achieved in previous years, the city is constrained by its very weak economy and elevated long-term liabilities..."

Strengths	Weaknesses
Strong management *Good financial policies and practices*	**Very weak economy** *Low buying income relative to US and low market values*
Strong budgetary performance *Surpluses in General Fund and across all govt. funds*	**Very weak debt profile** *High amount of debt relative to total govt. fund revenues*
Very strong budgetary flexibility *Good reserve levels relative to operating expenditures*	**Very weak contingent liability profile** *"Large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address the obligation"*
Very strong liquidity *Good cash levels relative to debt service and spending*	
Strong institutional framework *S&P's standard rating for Pennsylvania municipalities*	

Benchmark #2: Does Erie have stable reserves?

Unrestricted fund balance is a common measure of a government's financial reserves. Fund balance measures more than cash on hand. It includes receivables, which in Erie's case are mostly tax revenue that arrives early in the next fiscal year. It accounts for unpaid obligations to vendors (accounts payable), accrued payroll costs and amounts due for compensated employee absences. The table below shows Erie's unrestricted fund balance as a percentage of expenditures for the General Fund compared to the four peer cities.

	Unrestricted Fund Balance	2017 Operating Expenditures	Fund Balance as a % of Expenditures	Ranking
Reading	33,416,397	85,306,430	39.2%	1
Scranton	33,211,382	92,328,720	36.0%[1]	2
Erie	16,484,037	73,708,293	22.4%	3
Bethlehem	15,103,988	71,399,597	21.2%	4
Allentown	13,251,806	110,944,186	11.9%	5
Average (excl. Erie)	23,745,893	89,994,733	26.4%	N/A

Source: 2017 Comprehensive Annual Financial Report (CAFR)

S&P cited Erie as being "very strong" in this area, and so are other Pennsylvania cities. Erie's General reserves as a percentage of operating expenditures ranked **3 out of 5** in 2017. Erie's reserves were also above 16.7 percent, or two months of operating expenditures. That is the minimum amount recommended by the Government Finance Officer's Association. With the estimated $1.6 million deficit in 2018, Erie's unrestricted fund balance as a percentage of expenditures would drop to 18 percent as of the end of 2018.

[1] Scranton had a high fund balance as of the end of 2017 because it sold its sewer system in 2016. Prior that 2016, Scranton had an unrestricted fund balance of $5.0 million, equivalent to approximately 6% of operating expenditures.

Benchmark #3: How much does Erie spend on legacy costs?

Legacy costs refer to expenditures that City government makes now for obligations incurred in the past. We use each City's total expenditures on debt and pensions as a proxy for its legacy costs, though retiree health insurance and prior year workers' compensation claims can also be included in this category. The more a government spends on legacy costs, the less money it has to spend on services and associated employee compensation.

The table below shows debt expenditures in each City's governmental funds, so utility-related debt is excluded. Erie's spending is the lowest by a large margin in 2018. The recently executed refunding will drop debt payments lower than shown below for 2019 through 2021 ($1.7 million rising to $4.6 million) and then push it higher in 2022 ($8.2 million) and beyond.

Please note that these figures do not account for refunding or new debt activity after 2017.

	2018	2019	2020	2021	2022	2018-22 increase ($)	2018-22 increase (%)
Allentown	$9,372,002	$9,374,523	$8,591,610	$8,056,334	$8,055,602	($1,316,400)	-14.0%
Reading	$11,837,680	$11,651,010	$10,979,222	$11,502,514	$11,502,098	($335,582)	-2.8%
Scranton	$10,392,226	$10,406,769	$10,418,932	$10,437,157	$10,590,444	$198,218	1.9%
Bethlehem	$10,060,964	$10,278,377	$10,830,098	$10,808,042	$10,812,664	$751,700	7.5%
Erie	$3,630,843	$7,860,563	$7,864,384	$7,861,248	$7,858,229	$4,227,386	116.4%
Average (excl. Erie)	$10,415,718	$10,427,670	$10,204,966	$10,201,012	$10,240,202	($175,516)	-1.7%

Source: 2017 Comprehensive Annual Financial Reports (CAFRs)

Benchmark #3: How much does Erie spend on legacy costs? (cont'd)

The second major legacy cost is pension contributions. Every Pennsylvania city is required to make annual contributions to their employee pension plans, which is called the Minimum Municipal Obligation (MMO). 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 (administrative cost). The MMO is the required employer contribution after accounting for other revenues, including investment earnings and employees' contributions, and actuarial assumptions (e.g. mortality, inflation).

Erie's pension contribution in 2017 was $13.7 million, which was higher than Allentown ($9.8M) and Bethlehem ($8.2M) but less than Reading and Scranton. Many Pennsylvania cities saw a steep increase in their pension contributions over the last decade, in part to offset the investment losses experienced during the Great Recession. Erie's pension plans were 73.3 percent funded as of 1/1/2017, which is third -- better than Reading and Scranton but worse than Bethlehem and Allentown.

Pension contributions and funding level (across all pension plans)

	2013	2014	2015	2016	2017	2013-17 (%)	2017 Funding Level
Scranton	$9,490,449	$12,126,412	$12,301,982	$14,400,052	$18,811,562	98.2%	44.6%
Reading	$11,204,648	$11,115,158	$14,535,151	$15,546,645	$16,157,568	44.2%	67.9%
Erie	$9,838,198	$9,913,133	$11,785,781	$11,953,894	$13,670,454	39.0%	73.3%
Bethlehem	$9,731,077	$10,817,928	$8,852,659	$8,099,455	$8,237,270	-15.4%	83.4%
Allentown	$5,165,951	$5,569,086	$5,594,068	$9,560,661	$9,799,367	89.7%	84.3%
Average (excl. Erie)	$8,898,031	$9,907,146	$10,320,965	$11,901,703	$13,251,442	48.9%	75.1%

Source: 2017 Comprehensive Annual Financial Reports (CAFRs)

Benchmark #4: How much does Erie spend on infrastructure?

This is the inverse of legacy costs – these are City government's expenditures today on infrastructure (e.g. roads, bridges, facilities, large vehicles) that the organization and Erie residents will use for years to come. The types of City-owned infrastructure vary widely and our analysis excludes utility-related assets.

Cities report the total value of their assets each year, subtract amounts for depreciation or asset sales, and then add amounts for projects executed or purchases made that year. This simple analysis does not account for the types of projects executed or whether the City invested in new assets or renovations to existing assets. Large projects can skew the numbers in individual years. **A positive number simply means the City added more in asset value from an accounting perspective than it lost in a given year.**

	2015 Change	2016 Change	2017 Change	Average	Rank
Reading	($3,413,829)	($1,200,714)	($2,083,664)	($2,232,736)	5
Scranton	($4,719,192)	($754,709)	$407,865	($1,688,679)	4
Erie	**$3,012,468**	**$2,132,925**	**$1,088,886**	**$2,078,093**	**3**
Bethlehem	($1,172,706)	$9,732,543	$2,383,148	$3,647,662	2
Allentown	$14,458,025	$8,065,818	$5,757,312	$9,427,052	1

Source: 2015-2017 Comprehensive Annual Financial Reports (CAFRs)

Once again Erie is in the middle of the pack, lower than Allentown and Bethlehem and higher than Reading and Scranton. Those communities are in Commonwealth oversight (i.e. Act 47) so they have very limited ability to issue debt to pay for capital projects.

Financial trend analysis

Revenues at a glance

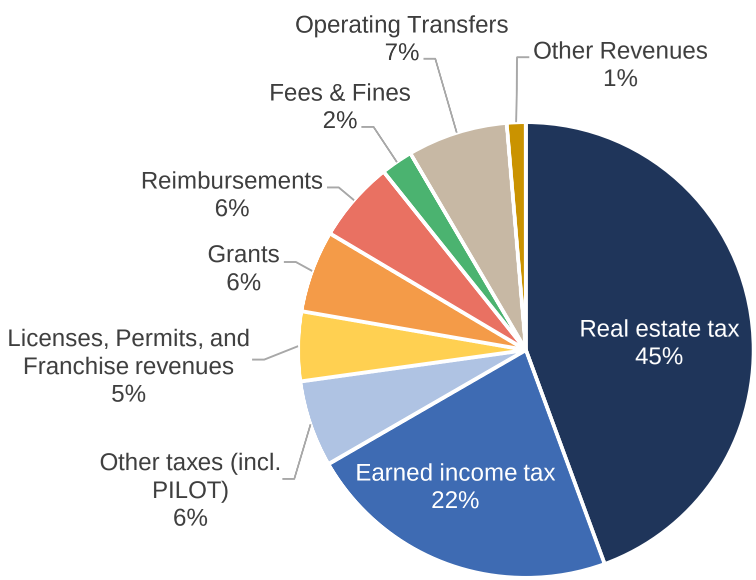
Like most Pennsylvania cities, Erie's General Fund revenues come primarily from its real estate and earned income taxes. In 2019, two-thirds of the City's adopted budget was funded by these two revenue sources. Tax revenues (which include the deed transfer, local services, parking, and amusement taxes) represent almost three-quarters of the General Fund total.

The next largest category is operating transfers ($5.8 million). The City leases its water system to Erie Water Works and receives an annual payment based on the terms in the agreement ($3.6 million in 2019). The City also transfers $1.1 million a piece from the Refuse/Recycling Fund and the Sewer Fund. The rest of the City's revenues come from the categories noted below.

For comparison the real estate and earned income taxes generate 67 percent of the revenue in Erie, 61 percent in Allentown, 49 percent in Reading and 48 percent in Bethlehem.

2019 Budget (Revenues)	
Real estate tax	36,174,024
Earned income tax	18,156,749
Other taxes (incl. PILOT)	4,993,209
Licenses, Permits, and Franchise revenues	4,022,000
Grants	4,733,670
Reimbursements	4,678,148
Fees & Fines	1,843,500
Operating Transfers	5,800,000
Other Revenues	1,097,000
Total General Fund Revenues	**$81,498,300**

2019 General Fund Revenues



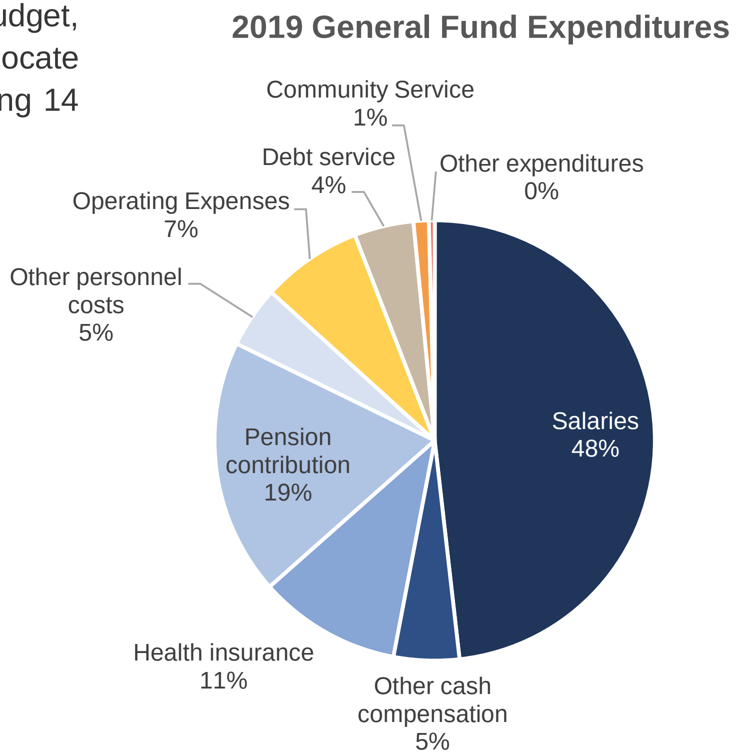
Expenditures at a glance

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 budget for personnel costs in 2019, including base salaries and other forms of cash compensation, the City's contribution to the cost of employee fringe benefits, workers' compensation, unemployment insurance and payroll taxes.

The City budgeted $6.0 million for operating expenses and $3.5 million on debt service in 2019, although the debt refunding in May 2019 will reduce expenditures to $1.7 million.

Spending on goods and services other than personnel ("operating expenditures") accounts for less than 10 percent of the 2019 budget, which is unusually low. For example, Allentown and Bethlehem allocate about 15 percent of their 2019 General fund budgets and Reading 14 percent to these purposes.

2019 Budget (Expenditures)	
Salaries	39,285,048
Other cash compensation	3,914,544
Health insurance	8,524,531
Pension contribution	15,299,339
Other personnel costs	3,655,705
Operating Expenses	6,007,363
Debt service	3,549,601
Community Service	918,169
Other expenditures	344,000
Total General Fund Expenditures	**$81,498,300**



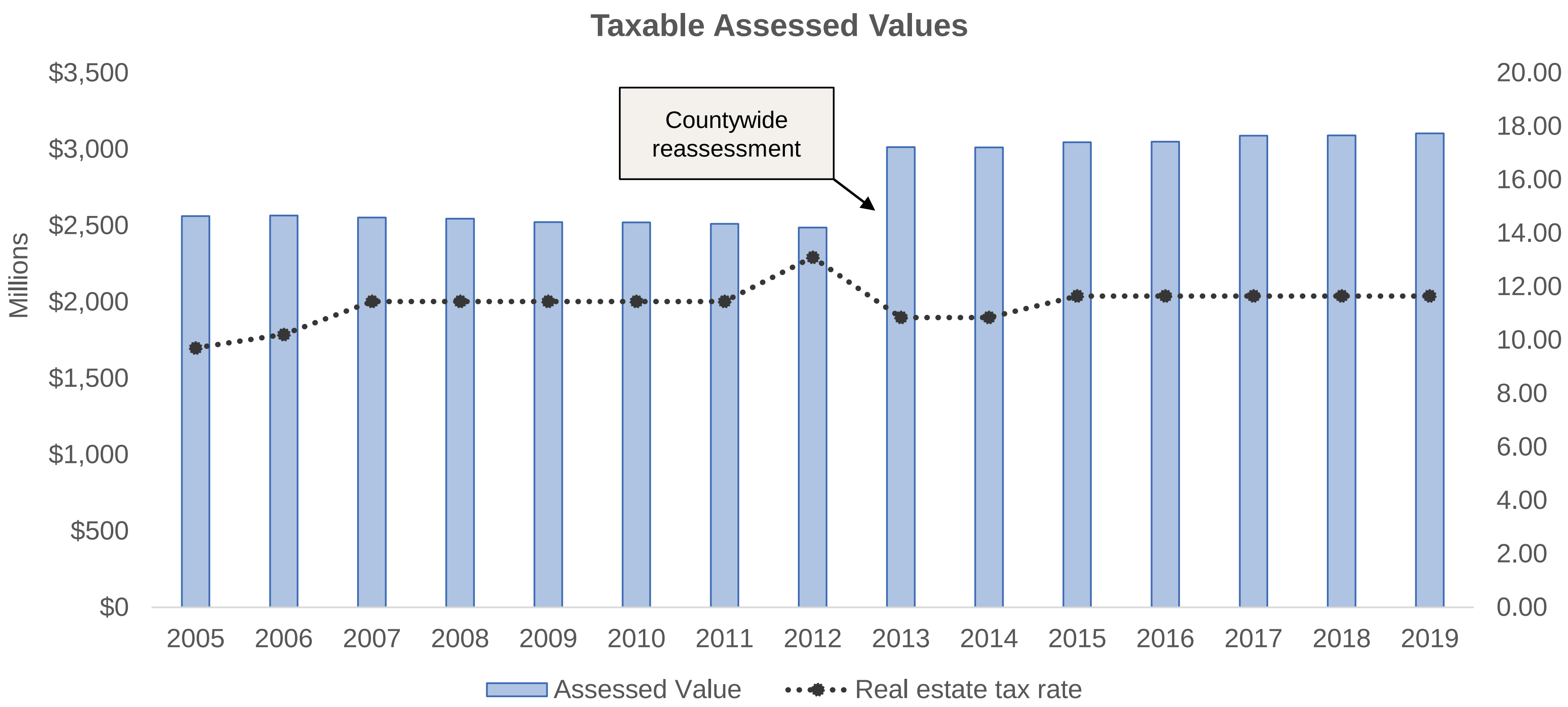
Eight key trends

To better understand the major budget drivers and the City's current financial condition, we have identified eight key financial trends that highlight Erie's financial challenges.

1. Real estate tax revenues, which account for almost half of the City's revenues, only grow when the tax rate does.
2. The City had minimal growth in its earned income tax base and revenues from residents and non-residents (commuters).
3. The City's non-tax revenues were driven by higher building permits in the last two years, although those increases may not continue over the next several years.
4. The City has relied on large one-time transfers into the General Fund from other funds in recent years.
5. Cash compensation has been growing by at least 4% annually as a result of across-the-board wage increases, longevity growth, overtime increases, and sick leave payout.
6. Health premium growth has been moderate, but the City has using the reserve in the Risk Management Fund to fund a portion of its health benefits costs.
7. Pension contributions may stabilize absent assumption changes. If the City updates the mortality table and reduce the investment assumptions, it would cost the City an additional $6 million annually.
8. Erie's debt service will be ramping up over the next five years, growing from $1.9 million in 2019 to $9.7 million in 2022 according to the most recent debt schedule.

Flat real estate assessments

The real estate tax is the City's largest revenue source, accounting for 45 percent of the City's total General Fund budget in 2019. The City levies this tax on the *assessed value (*not the market value) of *taxable property (not all property)* in Erie. That tax base has been flat since the County's reassessment in 2013 with growth of just 0.6 percent per year from 2013 to 2017. Residential properties account for about three-quarters of assessed taxable values. The assessed value of tax exempt properties ($1.3 billion in 2017) grew by 1.0 percent per year over the same period.



Note: The values of property receiving LERTA benefits are not included above

Trend #1: Real estate tax revenues grow only when tax rate increases

Since the tax base is flat, tax revenues only increase when tax rates do. Revenues increased when the City increased the tax rate in 2012. The City then dropped its tax rate after the 2013 County reassessment and the tax revenues stayed flat. The City had a 0.8-mill (7.4 percent) tax increase in 2015 and revenues increased by a similar amount. Even with that tax increase, real estate tax revenues only grew at an annual rate of 2.1 percent from 2013 to 2018. If the City did not increase its tax rate, its real estate tax revenues – the source of almost half of the City's General Fund budget – would have been flat.

So…we project the underlying real estate tax base to remain flat, although there will be slight increases when LERTA agreements expire.

Trend #2: Minimal growth in the EIT revenues

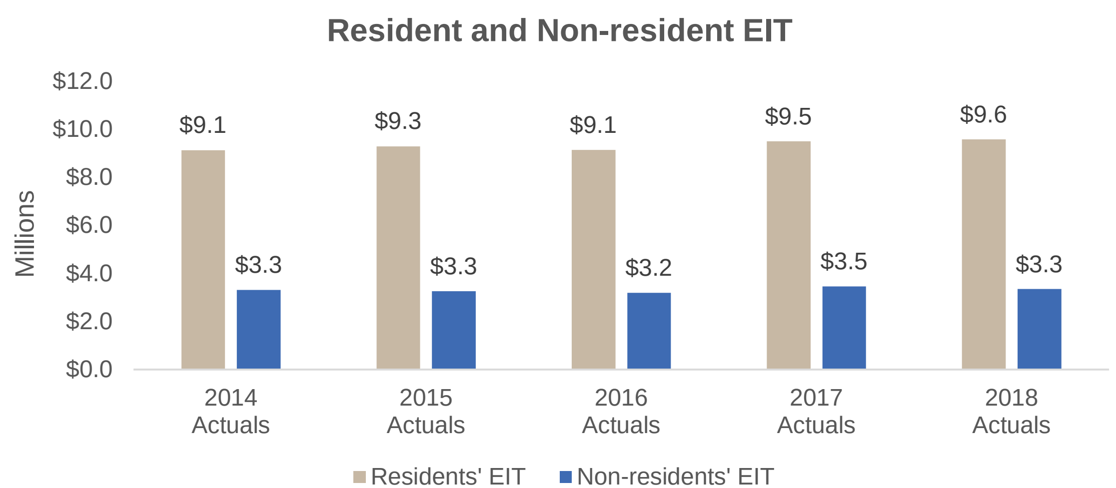
Erie residents pay a 1.65% earned income tax (EIT) with 0.5 percent going to the Erie School District and the rest to the City government. The City's portion is split between pension related costs (0.18 percent) and general purposes.

The City also levies a 1.18% non-resident EIT on people who work in Erie but live elsewhere. The City receives 0.18 percent for pension related costs and the rest is usually remitted to the person's home municipality. The City cannot tax non-residents to fund general operations by Pennsylvania law.

From 2014 to 2018, resident EIT revenues only grew by 1.2 percent annually and non-resident revenues only grew by 0.3 percent annually.

The resident EIT increase in 2019 will add approximately $6.5 million in additional revenues to the general fund, but, moving forward, we anticipate total EIT growth to be consistent with the historical growth of approximately 1.0 percent.

	2014	2015	2016	2017	2018	2019
Act 511 EIT (Erie Schools)	0.5	0.5	0.5	0.5	0.5	0.5
Act 511 EIT (City – General)	0.5	0.5	0.5	0.5	0.5	0.97
Act 205 EIT (City – Pension)	0.18	0.18	0.18	0.18	0.18	0.18
Total Resident EIT (%)	**1.18**	**1.18**	**1.18**	**1.18**	**1.18**	**1.65**
Home municipality	1	1	1	1	1	1
Erie's portion	0.18	0.18	0.18	0.18	0.18	0.18
Total Non-resident EIT (%)	**1.18**	**1.18**	**1.18**	**1.18**	**1.18**	**1.18**



Earned income tax base growth

External data shows that median earnings for Erie residents are growing by 2.0 percent, but the number of employed residents is dropping. Those factors combined drive the growth in resident EIT revenues below 2.0 percent.

Erie City Resident Earnings and Employment (2013 – 2017)

	2013	2014	2015	2016	2017	CAGR
Median earnings for workers	$21,157	$21,357	$21,948	$22,733	$22,868	2.0%
Median household income	$33,049	$33,007	$34,253	$35,205	$35,802	2.0%
Employment	42,531	42,411	42,820	41,929	41,094	-0.9%

Source: American Community Survey, 5-year estimates; Local Area Unemployment Statistics

There is no publicly available data that measures earnings for people who work in Erie and live elsewhere. The Bureau of Labor Statistics publishes data on the total wages for people employed in Erie County, regardless of where they live, and that amount grew by 0.8 percent per year over this period. Similar to the City, average wages within Erie County grew at a little faster rate but the number of workers dropped.

Erie County Employees' Earnings Growth (2013 – 2017)

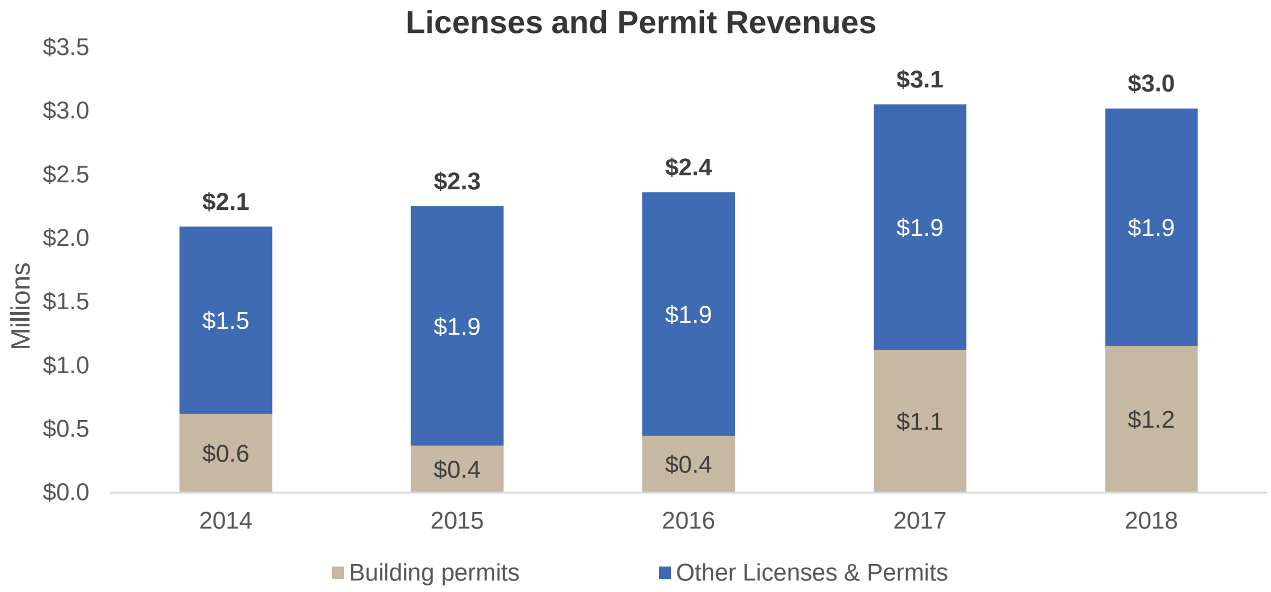
	2013	2014	2015	2016	2017	CAGR
Total wages	$4.8 million	$4.9 million	$5.1 million	$5.0 million	$5.0 million	0.8%
Average wages	$39,035	$39,708	$40,887	$40,861	$41,154	1.3%
Number of workers	123,982	124,110	124,658	122,533	121,550	-0.5%

Source: Quarterly Census of Employment and Wages (QCEW)

So…we project resident EIT to grow by 1.2 percent annually and non-resident EIT to grow at 0.3 percent annually based on historical trends.

Trend #3: Higher building permits revenues in the last two years

Revenues from building permits grew from $368,000 in 2015 to $1.2 million in 2018 because of new construction and renovation projects at UPMC Hamot and Erie Insurance. The 2019 budget anticipates $1.1 million in building permit revenue. Large projects (or lack thereof) cause these revenues to fluctuate so it is hard to rely upon them to fund recurring expenses.



So…instead of projecting this higher level of building activity will continue indefinitely and relying upon it to do so to balance the budget, the baseline projects these revenues to return to their historical average with the intention of using positive variations to supplement the very modest level of capital spending in the General Fund.

Trend #4: One-time transfers from other funds helped close the gap

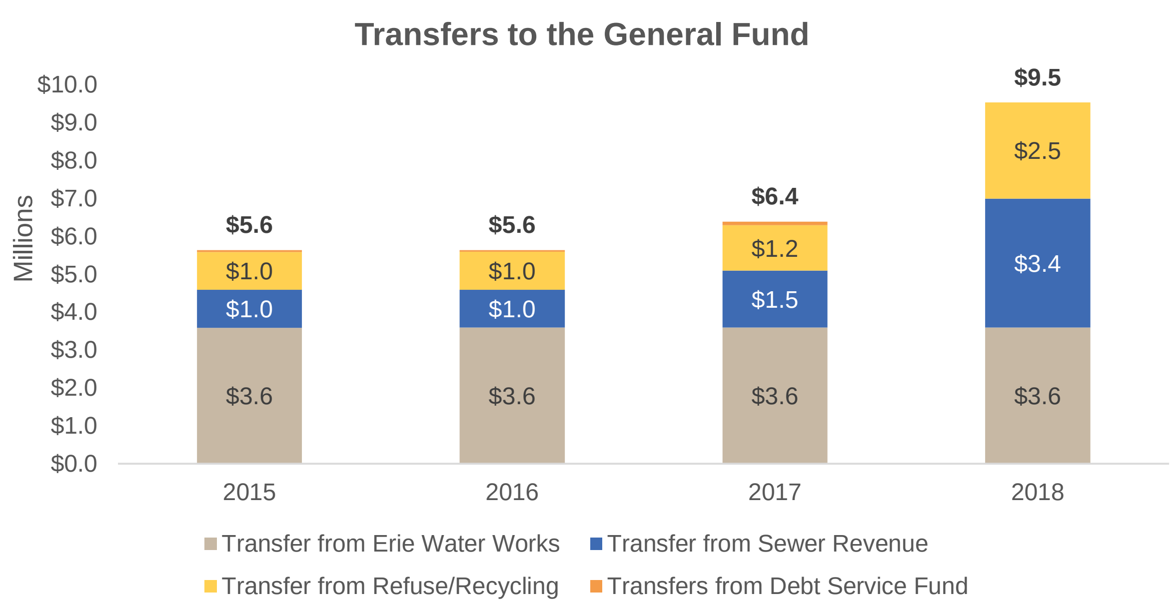
Erie's General Fund receives annual transfers from three major sources.

- **Erie Water Works:** The City owns its own water system, which consists of two water treatment plants, storage and pumping stations, and water mains. The City leases that system to Erie Water Works and 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, which equates to 1.7 percent annual growth since 2014.

- **Sewer and Refuse/Recycling Funds:** The City transfers money from these funds to the General Fund to help cover the cost of operations. This is separate from and in addition to the funds reimbursing the General Fund for the cost of service.

The Sewer and the Refuse/Recycling Funds transferred $1.0 million a piece to the General Fund in 2015 and 2016. Their transfers increased to $1.5 and $1.2 million respectively in 2017.

In 2018, the City more than doubled the transfers from both the Sewer and Refuse/Recycling Funds. Despite an increase of almost $3.0 million in transfer revenues, the General Fund still had a deficit of $1.6 million, and so did the other funds (see next page).



Deficits in the other funds

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. Even without that increase, this Fund would have had a $0.3 million deficit last year.

This fund has a $2.3 million unrestricted fund balance (or 24 percent of total expenditures) but there's a deficit here that needs to be addressed. Otherwise the transfer to the General Fund ($1.1 million in 2019) will eventually be at risk.

	2015 audit	2016 audit	2017 audit	2018 prelim
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**

Sewer Fund

The Sewer Fund finished 2018 with a $3.1 million deficit. The deficit was partly because of the $1.9 million increase in transfer payments. Even without that increase, the Sewer Fund would have had a $1.2 million deficit that was driven by an increase in debt service payments from $3.5 million to $6.5 million[1].

The Sewer Fund has an estimated $1.7 million negative fund balance at the end of 2018. The 2019 rate increases are expected to balance the budget, but only for two years. This transfer is also at risk without further rate increases.

	2015 audit	2016 audit	2017 audit	2018 prelim
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)**

[1] The debt payments were related to General Obligation bonds issued by the Sewer Authority.

Trend #5: Cash compensation has been growing by at least four percent annually

From 2014 to 2018, the City's spending on cash compensation increased by 4.5 percent annually, growing from $35.4 million in 2014 to $42.2 million in 2018. The growth was driven by the following factors:

1. All employee groups received at least 3.0% in annual **across-the-board wage increases** (see table to the right). In additional to these wage increases, employees also receive longevity payments (every year of service for police and fire and every four years of service for civilians). Police officers and firefighters also receive step increases and education benefit/bonuses.

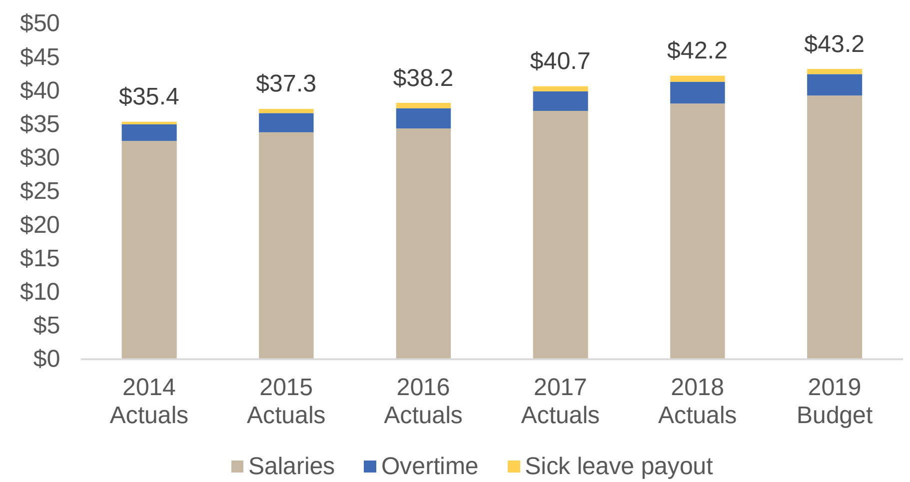
2. **Overtime** – driven primarily by police and fire – grew from $2.5 million in 2014 to $3.3 million in 2018, a 7.3 percent increase on an annual average basis. The 2018 results were higher than usual because of a large snow storm, but overtime spending still grew by 6.0 percent per year through 2017.

3. **Sick leave payouts** more than doubled from 2014 to 2018, growing from $400,000 to almost $900,000 over the five-year period. These are payments that employees receive when they convert unused sick days to cash when they leave the City for non-disciplinary reasons (e.g. resignation, retirement etc.). The 2013 FOP contract increased the amount of days that police officers can cash out for unused sick leave, giving them parity with the existing benefit for firefighters.

ATB Wage Increases, 2014 - 2018

	2014	2015	2016	2017	2018
FOP	4.0%	2.0% (1/1) 2.0% (7/1)	2.0% (1/1) 2.0% (7/1)	3.0%	3.0%
IAFF	3.0%	5.5% (1/1)[1] 2.0% (7/1)	3.0%	3.0%	3.0%
Teamsters	3.0%	3.0%	3.0%	3.0%	3.0%
AFSCME	3.0%	3.0%	3.0%	3.0%	3.0%

Total Cash Compensation ($ Millions)



[1] *The 5.5% increase was based on the provision in the contract to bring salary levels equivalent to 98% of Class A Police Patrolman Rate of Pay*

What about headcount?

Rising headcount could also explain growth in salary expenditures across all employees, but that does not appear to be a major factor in Erie's growth trend.

The number of budgeted positions dropped slightly from 515 in 2014 to 513 in 2018. We do not have data on the actual number of positions filled throughout this period, but there isn't a large variance between budgeted salaries and actual salaries in most years. Until 2017 the City spent a little less than budgeted on salaries, which is usually the case because of vacancies and turnover (i.e. a junior employee with a lower base salary replaces a more senior employee). Even the three percent variance in 2016 is not unusually high. The City spent a little more than budgeted in 2018. The pattern for individual departments may look different but, in aggregate, it does not look like the growth in cash compensation is the result of more employees.

General Fund Salary Expenditures[1]

	2014	2015	2016	2017	2018	CAGR
Budgeted salaries	33,115,059	34,325,166	35,425,743	37,359,936	37,778,050	3.5%
Actual Salaries	32,520,680	33,770,891	34,379,623	36,967,097	38,073,260	4.1%
Difference ($)	**594,380**	**554,275**	**1,046,120**	**392,839**	**(295,210)**	**N/A**
Difference (%)	**1.8%**	**1.6%**	**3.0%**	**1.1%**	**-0.8%**	**N/A**
Budgeted Headcount	515	516	517	517	513	-0.1%

So…assuming that headcount remains the same in a baseline scenario, we project 3 to 3.5 percent annual growth in salaries based on the across-the-board wage increases in the existing contracts and additional longevity growth.

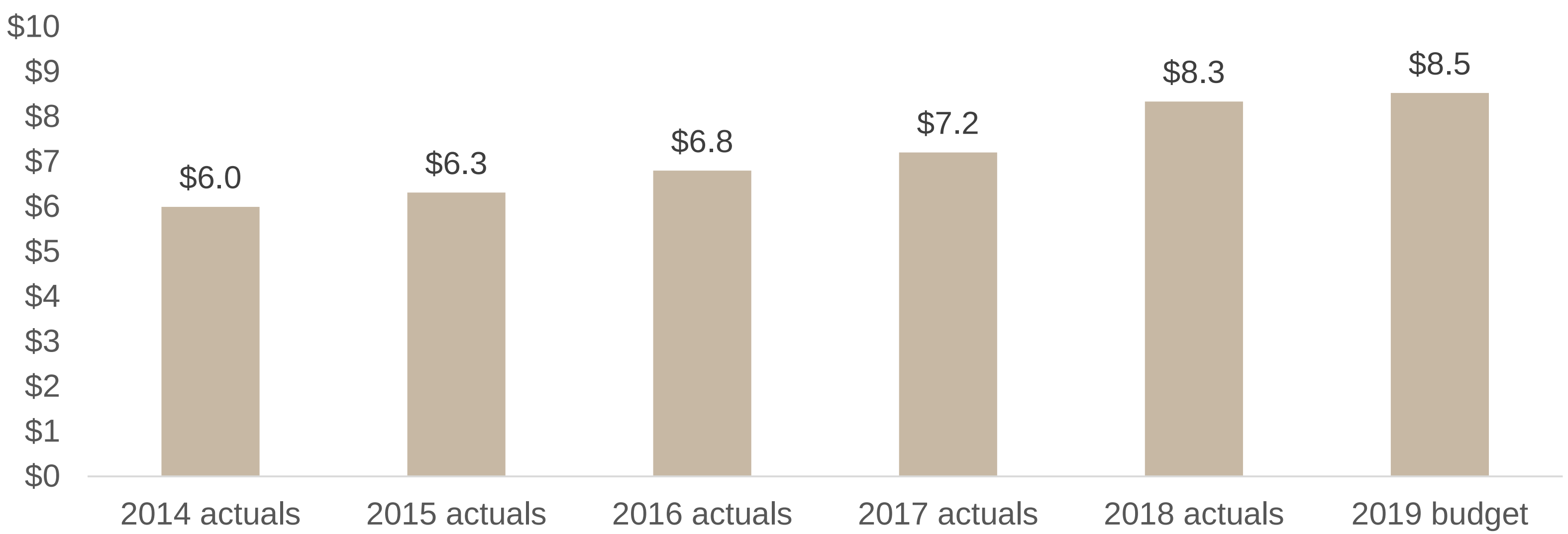
[1] *Includes full-time, seasonal, and part time salaries*

Trend #6: Moderate growth in health insurance spending…

The City is self-insured for health insurance, workers' compensation and general liability, meaning the City pays the cost of claims incurred instead of paying an insurance company a set amount per month, regardless of claims activity ("fully insured"). In a self-insured arrangement the City assumes the risk that the actual claim costs will be lower than the fully insured premium rates, with the reward being the City gets the savings when that happens. The City has additional stop-loss coverage for instances where the claim exceeds a certain level.

The City's spending on employee health insurance from its General Fund grew by 8.6 percent on average from 2014 through 2018. The City's General Fund expenditures jumped by $1.1 million (or 15.8 percent) in 2018 which suggests that the City had a bad year in terms of claims activity. The actual cause of the expenditure increase was something different.

General Fund Employee Health Insurance Expenditures (Millions)



…but the General Fund had to catch up on its obligations

The City uses a separate Risk Management Fund to pay its insurance claims with money flowing in and out of the fund as shown below. The General Fund's contributions into the Risk Management Fund should be tied to the spending out of it, with some reserves as a buffer for a year when claims jump. For example, claims jumped from $8.5 million to $9.5 million in 2017.

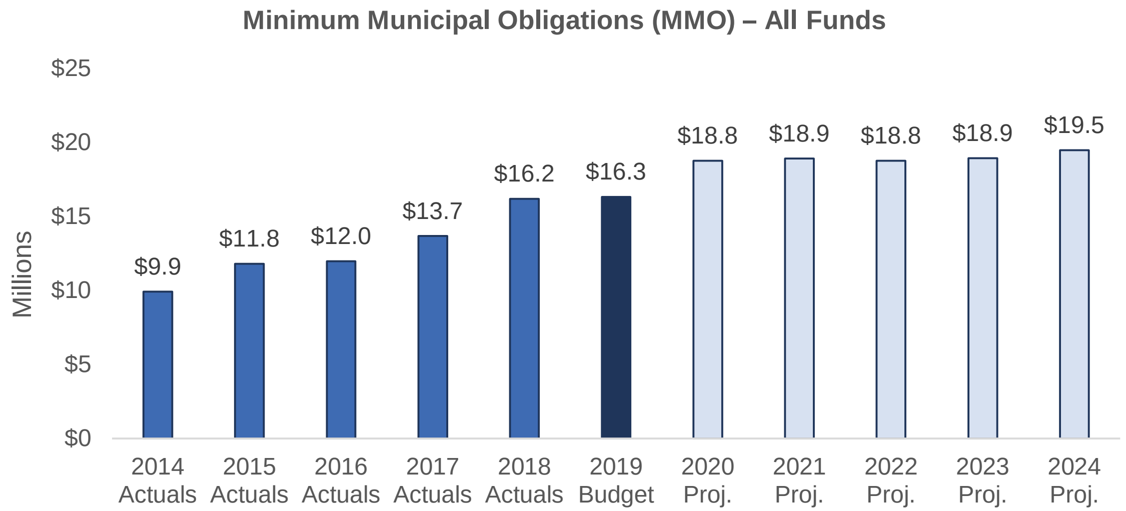
It appears that the General Fund has been using the reserve in the Risk Management Fund to cover the cost of claims. In 2014 the General Fund contributed $6.0 million and the employees contributed $1.2 million. The combined total was $0.8 million less than the actual cost of claims for these employees. So the Risk Management Fund absorbed the loss. That happened each year until 2018 when the General Fund contribution jumped by 15.8 percent and claim spending dropped by 4.3 percent. Essentially the City was drawing down the balance in the Risk Management Fund and then had to catch up.

	2014 actuals	2015 actuals	2016 actuals	2017 actuals	2018 actuals	2019 budget
General Fund transfer	5,993,965	6,308,876	6,796,556	7,202,857	8,338,851	8,524,531
Est. Employee contribution	1,207,136	1,218,585	1,274,439	1,424,220	1,363,283	1,453,387
Total Funding	**7,201,100**	**7,527,462**	**8,070,995**	**8,627,077**	**9,702,134**	**9,977,917**
Risk Management Fund Spending on GF employees	**8,047,572**	**8,123,902**	**8,496,262**	**9,494,801**	**9,088,555**	**9,689,245**
Surplus/(Deficit)	(846,472)	(596,440)	(425,267)	(867,724)	613,579	288,672

So…we project 5.0 percent annual growth in General Fund expenditures on health insurance which is a lower than historical growth in those figures (8.6 percent) but close to the historical spending growth absent the "catch up" payment.

Trend #7: Pension contributions may stabilize absent assumption changes

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 in the next actuarial valuation before stabilizing at approximately $19 million absent any changes in assumptions. However, if the City updates its mortality assumptions to reflect improving longevity of annuitants and reduces its investment assumption from the current 8.0% a more conservative 7.25%[1], the actuary estimates that the MMO will increase to approximately $25 million. If the City does not make these changes, there is a risk that funding levels will drop, which will also drive the MMO payments higher, holding other variables constant.



	No assumption changes	With assumption changes
2020	$18,755,000	$25,280,000
2021	$18,894,750	$25,444,600
2022	$18,756,487	$24,615,784
2023	$18,910,561	$24,793,816
2024	$19,454,283	$24,893,969

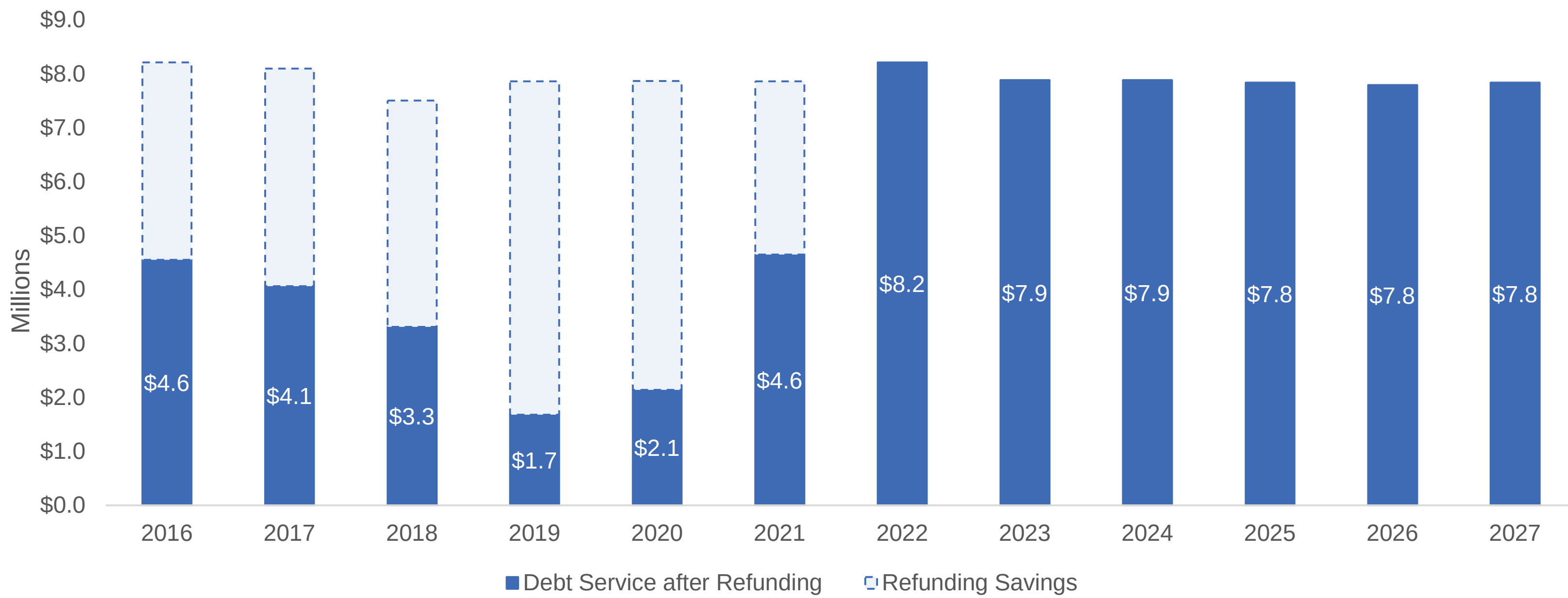
So…the baseline assumes approximately $19 million in MMO for the next five years. We also built in an alternate scenario to illustrate how the baseline would change if the City opts to update the mortality table and reduce the investment return assumption.

[1] *The national median is 7.25% according to NASRA Issue Brief: Public Pension Plan Investment Return Assumptions, February 2019*

Trend #8: Debt service is projected to ramp up

The City refunded a portion of its debt in May 2019, so General Fund debt expenditures will be $1.7 million this year instead of $7.9 million previously scheduled. The City will also pay less than scheduled in 2020 and 2021. In exchange the City will pay more starting in 2022 than previously scheduled. General Fund debt spending is scheduled to rise to $8.2 million in 2022 absent any further refunding or new debt being issued. The City uses these refunding moves to close its budget deficit. There is not money set aside for the scheduled rise in debt payments. It will have to increase revenues or reduce expenditures elsewhere to meet its rising debt obligations.

City of Erie General Fund Debt Schedule, 2016 - 2027

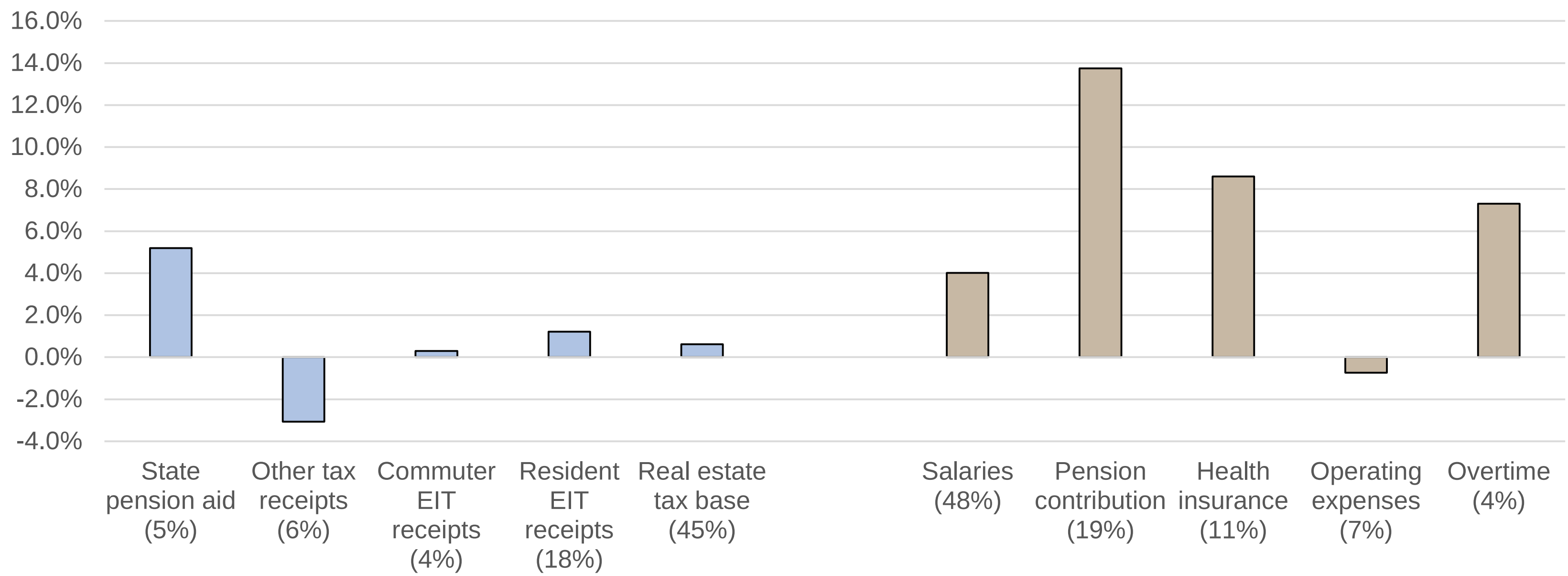


Key finding #1: Erie has a structural problem

Taking a step back from the individual trends, there are two high level findings that will shape the rest of our work. **The first 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, 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)



Key finding #2: Short-term fixes aren't working anymore

To manage the imbalance between revenue and expenditure growth, the City has been relying on short-term moves to close the deficit (see table below)[1]. Absent these moves Erie City government would have had a deficit each of the last five years except 2015 when it increased real estate taxes.

Recurring revenues from increasing the real estate tax from 10.85 to 11.65 mills

One-time transfer of $2.0 million from the debt service fund

Annual health insurance funding shortfall ranging from $0.4 million to $0.9 million from 2014 to 2017

	2014	2015	2016	2017	2018
Real estate tax	32,111,938	35,635,619	35,232,972	35,502,625	35,661,522
Earned income tax	12,427,589	12,547,051	12,327,204	12,946,697	12,917,770
Operating transfers	7,599,452	5,642,337	5,645,245	6,394,203	9,543,250
Other revenues	17,769,773	18,408,096	18,569,716	20,839,811	19,635,870
Total Revenues	**$69,908,752**	**$72,233,103**	**$71,775,137**	**$75,683,336**	**$77,758,411**
Personnel costs	53,394,822	57,473,909	59,027,432	64,057,047	69,144,311
Operating Expense	6,068,827	5,479,616	5,303,569	5,884,947	5,891,849
Debt Service	7,611,349	7,057,329	4,553,308	4,066,478	3,310,172
Other Expenses	911,643	853,399	895,550	943,060	964,210
Total Expenditures	**$67,986,641**	**$70,864,253**	**$69,903,574**	**$74,951,531**	**$79,310,542**
Surplus/Deficit	**$1,922,111**	**$1,368,850**	**$1,995,279**	**$731,805**	**($1,552,131)**

One-time transfer of over $4.0 million from the Sewer and Refuse and Recycling Funds. Both of those enterprise funds had deficits in 2018 ($1.6 million in the Sewer Fund and $3.1 million in the Refuse and Recycling Fund).

Debt refunding in 2015 and 2017 to reduce annual debt service spending

While these short-term fixes helped eliminate the operating deficits until 2018, the City cannot continuously rely on them to fix a structural problem. The limits of this approach are already visible. Last year the City caught up on its underfunding of the Risk Management Fund (employee health insurance) and had a $1.6 million deficit, despite also drawing down the balances in the Refuse/Recycling Fund and Sewer Fund. The 2019 budget has a $0.5 million deficit filled by using fund balance.

[1] *All bond proceeds and debt issuance costs have been excluded in this summary*

Five-Year Baseline Projection

What is a baseline projection?

The Early Intervention Program requires us to provide a baseline projection of the City's financial results in its General Fund. We use this diagnostic exercise to identify and quantify the magnitude of any structural deficit and provide an important reference point for gap-closing recommendations.

There are **two very important contextual points** to understand the baseline projection:

- **The baseline projection presents a status quo scenario.**

  Conceptually, the baseline is intended to represent a "carry forward" or "current services" set of assumptions, such that no changes in the level of services, headcount or tax rates are generally assumed, except in cases where already adopted into current law or consistent with existing policy.

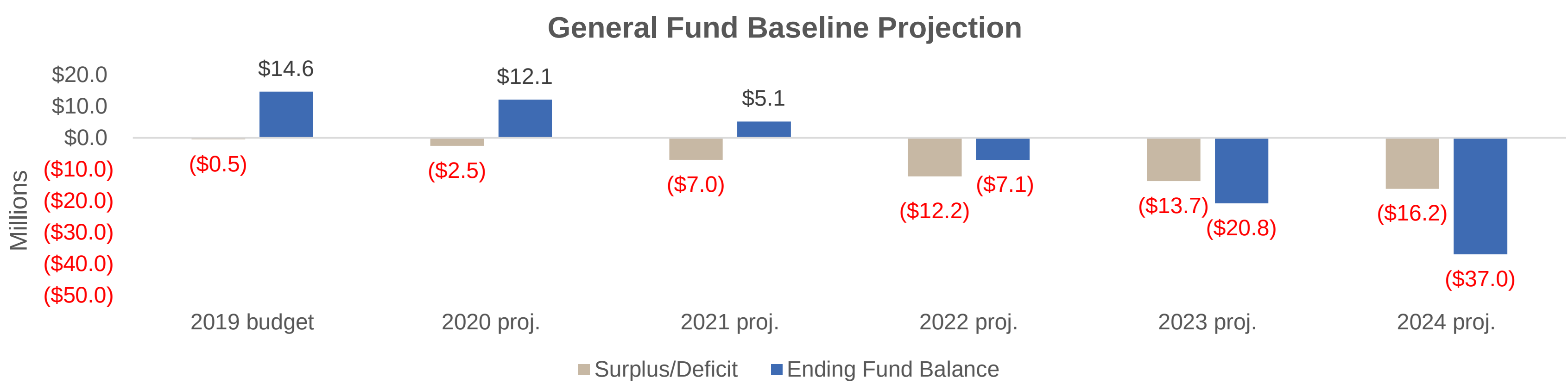
- **The baseline projection is not a prescription for Erie's financial policies, nor is it a prediction of future annual results.**

  The baseline projection is a diagnostic tool to show City government's finances absent corrective action. It is not a prediction of what will happen. It is also not a recommendation for what the City's tax rates, salary increases or headcount levels should be.

  Practically speaking, the City will have to take corrective action. The City is statutorily required to pass a balanced budget each year and it could not sustain the projected deficits in the baseline without exhausting its reserves. The question is how best to do that.

2019-2024 baseline projection

Absent corrective action, the City would have deficits growing from $2.5 million in 2020 to $16.2 million by 2024. By 2022, the City would exhaust its fund balance. City Finance has its own baseline projection that it updates regularly, which is good practice. Their deficits are higher in 2024 because we do not assume changes in the pension assumptions and the City does. ***Please note this is not a worst case scenario.*** We assume lower growth in salary expenditures than the City has historically had; 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.



	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)

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

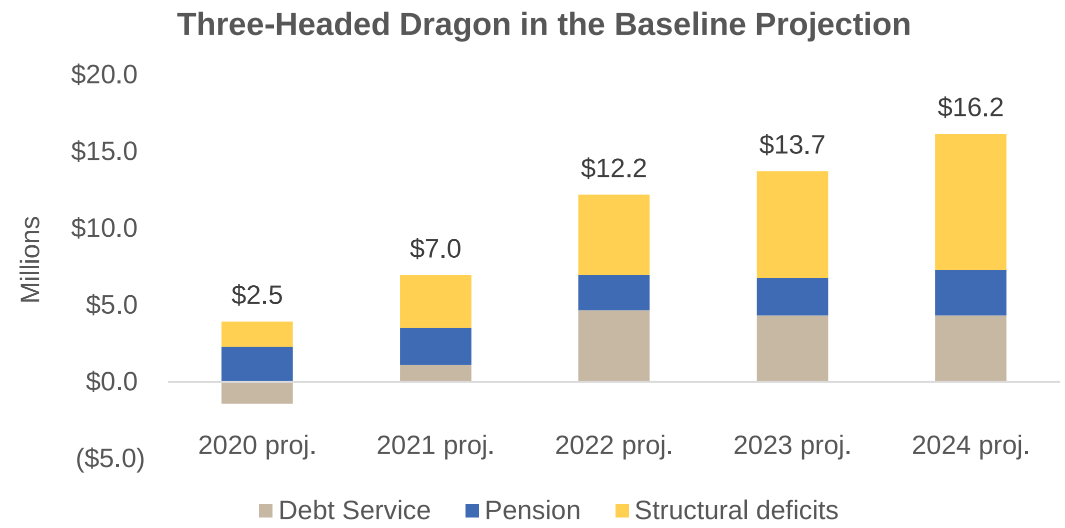
Three-headed dragon

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 (see prior slide). But even without those changes, the pension contribution increase in 2020 would account for $2.3 million of the $2.5 million 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 $4.7 million of the $12.2 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 $16.2 million deficit.



So what: Key conclusions

- When the credit rating agency evaluated Erie, the City received a good score relative to other comparably sized Pennsylvania cities. But that external evaluation also highlighted the City's struggles with debt, pensions and a weak economy, which is one of the major contributors to the structural deficit.
- Careful review of the City's major financial trends shows that most of the City's largest revenues are growing at a much slower pace than most of the City's largest expenditures. Revenues from real estate taxes and earned income taxes, which account for almost two-thirds of the 2019 General Fund budget, grew by less than two percent a year over the period reviewed. Spending on employee salaries and pensions grew by 4 and 13.7 percent over that same period.
- The City relied in part on moves with one-time benefits (drawing down the reserves in the enterprise funds) or those that push problems into the future (underfunding the fund that pays insurance claims) to close its deficits. Whatever benefit that provided in the past, it is not sufficient to close the deficit anymore. Even with debt refunding and large one-time interfund transfers, the City ran a deficit in 2018 according to its preliminary year-end numbers.
- The baseline projection is a diagnostic exercise to quantify the size of the City's structural deficits and provide guidance on where to target corrective action. Our baseline projection is similar to the City's own. We project **the City's General Fund deficit will grow from $2.5 million in 2020 to $16.2 million by 2024** and the fund balance will be depleted by 2022.
- The projected deficits are driven by a **three-headed dragon that is made up of a debt problem, a pension problem and a structural deficit problem**. While the City's most immediate deficit drivers are growth in pension and debt, the structural deficit grows at a faster rate than the other two and will be the City's largest deficit driver in a couple years. By 2024, the structural deficit ($8.9 million) will account for more than half of the $16.2 million projected deficit.

Next steps

- We will provide a more detailed narrative version of this report, including explanations for the assumptions underlying the baseline projection. That will comprise the first section of the eventual multi-year plan. We will also continue to update the projection based on new information or developments that occur throughout the year.
- To eliminate the baseline deficits, the City must slay the three-headed dragon with initiatives that have recurring impact. The City's previous reliance on short-term fixes for a structural problem isn't working anymore. So we will prioritize further review in the areas described in our trend analysis. We can't fix the problem if we don't focus on what is causing it.
- From a financial stand point, the goal is not to balance to zero. The City needs to have an appropriate level of reserves to provide a contingency against any economic downturn, to maintain its credit rating and for practical cash flow reasons at the beginning of the year. The City also should have a capital budget through which it makes some investment in the assets that people see, drive on, work in and play on every day.
- From a strategic stand point, the goal for this engagement is not just financial. As noted earlier, 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 won't tell the complete story. So our next step is to meet 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.