# REPORT OF THE PENSION WORKING GROUP

CHIEF OPERATING OFFICER MELISSA MALONE
COUNCILWOMAN NIRVA LAFORTUNE
COUNCIL PRESIDENT PRO TEMPORE SABINA MATOS
COUNCIL PRESIDENT DAVID SALVATORE
COUNCILMAN SAMUEL D. ZURIER

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## Introduction

In 2011, the City faced a "Category 5 fiscal hurricane" that required drastic and painful actions, including cuts in services and pay (closure of schools, 10% budget and pay reductions, etc.) and revenue increases (nonprofits, State aid, tax increases, etc.) It was not enough. In 2012, Mayor Taveras announced that, absent pension reform, the City would have no choice but to go into bankruptcy.[1] That year, most stakeholders (employees, retirees) ultimately agreed to $170 million in pension savings, and the courts upheld the reforms against legal challenges from the remaining opponents.

While this massive campaign averted catastrophe, everyone understood that the full pension deficit (which prior to the 2012 reforms exceeded $900 million) was much greater, and that more work was needed. Since then, current City employees have agreed to incremental improvements in successive collective bargaining agreements, but the pension deficit has continued to increase, exceeding $1 billion (and growing) as of July 1, 2017.[2] While this figure (and the 25.28% funded ratio) is unsettling in the abstract, the future impacts on City services will cause real harm to people's lives. Under the status quo, the City's annual required contribution ("ARC") to the pension fund will increase by $38 million (from the current level of $78 million to $116 million) over the next decade, at the end of which the funded ratio will have reached 41.4%. Exhibit 1 (Segal Consulting Actuarial Evaluation as of June 30, 2016).[3] Five

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1 "Providence Mayor Moves Financial Woes to Fore," New York Times, April 30, 2012.

2 City of Providence, Comprehensive Annual Financial Reports for Fiscal Year Ending June 30, 2017.

3 The calculation assumes an 8% rate of return on the retirement fund investments. Were this reduced to a lower figure, the deficit would increase. For example, most recent financial report, the unfunded liability as of June 30, 2017 was calculated to be $1.00 billion assuming an 8% rate of return, and $1.15 billion assuming a 7% rate of return. *See* City of Providence, Comprehensive Annual Financial Report, Fiscal Year Ending

years after that, the City's ARC will increase another $22 million (to $138 million) , while the funded ratio will rise only to 58%, below the State's 60% threshold for "critical" status, with even more drastic increases after that.[4] The City's current tax levy is $350 million; therefore, the 2033 ARC would require 40% of all the property tax dollars raised this year.

The City's increasing budgetary commitment to pension costs already is a major drag on the City's finances. Since 2001, the City's ARC has doubled, from $39 million to more than $78 million. This added $39 million expense has prevented the City from improving services and/or reducing taxes. For example, $12-$13 million of the lost revenue could have added 100 police officers to the force, bringing Providence closer to the levels it enjoyed in 2007. Alternatively, $21 million from the revenue the City has lost from increased pension payments could have reduced the commercial tax rate (which, at $36.70 per $1,000 valuation, is one of the nation's highest for major and mid-sized cities)[5] by more than $6.00, providing relief to resident businesses while spurring a construction boom without a need for tax treaties or stabilizations. Both of these initiatives could be in place today (with millions more to spare) if today's ARC were at the 2001 level. Instead, the City is currently on a course to increase its annual pension

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June 30, 2017 (referred to below as "2017 Annual Financial Report"), p. 51, viewable at https://www.providenceri.gov/wp-content/uploads/2018/01/Comprehensive-Annual-Financial-Report-2017.pdf

4 For example, the 2038 projected ARC under the status quo is $164 million. The Fitch rating agency classifies public pension plans (based on an assumed rate of return of 7%) as "healthy" if the funded ratio is above 70%, and "weak" if the ratio is below 60%. *See* http://www.ncpers.org/Files/2011_enhancing_the_analysis_of_state_local_government_pension_obligations.pdf.

5 In a 2017 study (based on 2016 tax rates), the Lincoln Land Institute ranked the commercial tax rate in Providence as fifth highest in the country among a cohort of major cities. *See* "50 State Property Tax Comparison Study" viewable at https://www.lincolninst.edu/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2016-full.pdf

contributions by another $38 million over the next decade, money that will be raised either by painful and counter-productive tax increases, or by harmful reductions in vital City services.

As grim as the "status quo" projection is, it may prove to be excessively optimistic. Last year, for example, the pension fund received $83.8 million in contributions from the City and City employees, while paying out $103.1 million in benefits to retirees, a gap of almost $20 million.[6] Fortunately, the pension fund received a 12.2% return on its investments, yielding the pension fund a net gain of just over $15 million; however, it would not be prudent to assume extraordinary investment returns going forward.[7]

In short, the unfunded pension liability is Providence's version of the global warming crisis, an existential threat looming on the medium-term horizon that becomes more difficult to solve with each successive year of inaction.

In this Report, the Working Group presents an overview of this crisis, describing its origins, current trends and possible tools to resolve it. The Report also recommends the City engage all stakeholders to develop and adopt a sustainable plan to fund the pension at a ratio of 60% or greater by June 30, 2028.

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6 City of Providence, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2017, pp. 47-57.

7 Changes in anticipated career length and duration of retirement also can affect the City's pension obligation. For example, early retirements of City workers can extend the predicted pensions paid out to them, thus increasing the cost of these pensions. During 2015-17, approximately 104 fire fighters took service retirements. This represented an increase from the annual average of 13 service retirements taken over the previous 25 years, suggesting that some of them may have retired sooner than otherwise expected. In a future study, the City's actuary will calculate the impact of these retirements on the City's pension obligation.

I. <u>Background</u>

Providence provides its employees with a "defined benefit" pension, which determines the amount of an employee's pension through a formula based on years of service and salary history, without regard to investment returns or funding levels.[8] The Governmental Accounting Standards Board ("GASB") requires public employers offering a "defined benefit" pension to pre-fund it, by having the employer contribute money into a retirement fund to pay for future obligations at a rate designed (based on expected investment returns and payouts) to allow the fund to pay all obligations as they become due.[9] While the GASB standards are not legally binding, bond rating agencies measure a city's compliance with GASB when assessing its financial stability. As a result, Providence must meet the GASB standards if wishes to retain access to credit at affordable interest rates. Providence needs this capital to maintain its school buildings, streets, sidewalks, City buildings and other infrastructure.

Each year, the City's actuary calculates the "annual required contribution" (or "ARC") needed to amortize the pension fund obligation over a set period of years. As is true for a home mortgage, annual costs can be reduced by extending the length of time needed to pay off the obligation. Providence has adopted a 30-year amortization schedule, which is the longest period allowed by GASB Standard 27.

Providence's pension crisis dates back to 1989. As of June 30 of that year, the Providence Employees Retirement System had $216 million in assets and $343 million in total

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8 In contrast, a "defined contribution" pension system, such as a 401(k) fund, fixes the amount of money that goes *into* the employee's pension account without any guarantee or limitation as to how much will be available for the employee to withdraw at retirement.

9 Providence must meet GASB reporting requirements to qualify for affordable bond financing, which is critical to the City's ability to function.

liabilities, for a deficit of $137 million and a funded ratio of 65.4%.[10] While this was far from complete funding, it exceeded the State's 60% threshold for "critical" status.[11] Disaster followed. At a December 6, 1989 meeting, the employee-controlled Retirement Board dramatically increased cost of living adjustments ("COLA's") and minimum pensions, while reducing required years of service, changes the Director of Administration said "broke the City."[12] Over the next two years, the Retirement Board awarded generous disability pensions to an unprecedented flood of employees, while increasing COLA's to as much as 6% compounded annually, raising the City's required contribution into the pension fund from $12 million to $32 million. *Id.* The courts rejected the City's various legal challenges, but the City did not increase its pension contributions sufficiently to match these increasing obligations.

By 2004, the pension's funded ratio had fallen below 40%. The City formed a Pension Study Committee, which published a report in 2006.[13] The Report proposed reforms to the disability pension approval and verification process, and reforms to early retirement, accidental disability pensions and eligibility for post-retirement health benefits. 2006 Report, pp. 12-18.[14] The City Council enacted legislation to implement many of these reforms, but the pension

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10 Report on the Evaluation of the Employees' Retirement System as of June 30, 1990.

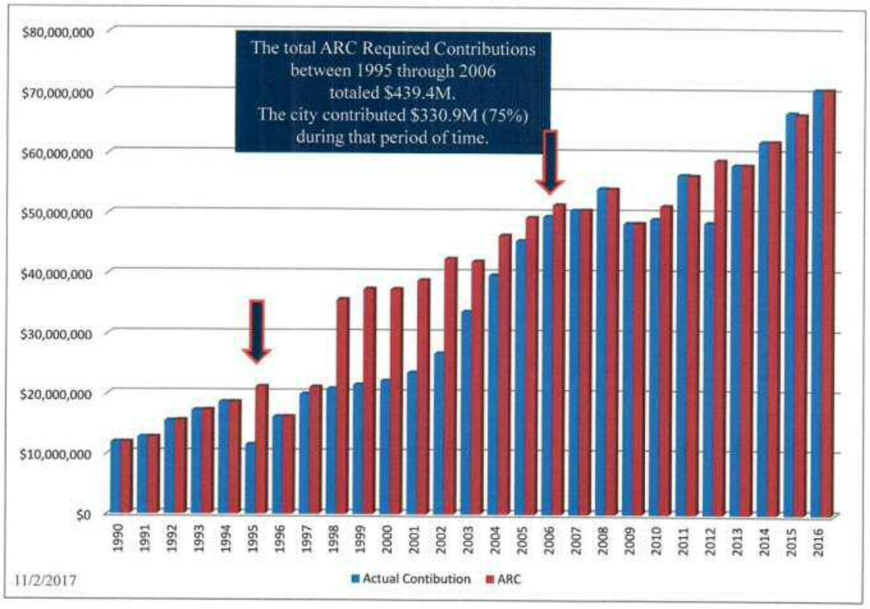
11 *See* R.I.G.L. §45-65-4(3).

12 "Retirement board once dominated by unions compounded Providence pension woes," Providence Journal, June 7, 2011

13 *See* 2006 City of Providence Pension Study Committee Report, viewable at http://clerkshq.com/content/Attachments/Providence-ri/2007_365.pdf.

14 The 2006 Report also recommended the City issue pension obligation bonds, which would allow the City to increase its stock market exposure. Fortunately, the City did not follow this recommendation, which would have increased the City's investment losses during the 2008-09 stock market reversals.

obligation continued to rise, and the City fell further behind, as reflected in the following chart prepared by the Internal Auditor:

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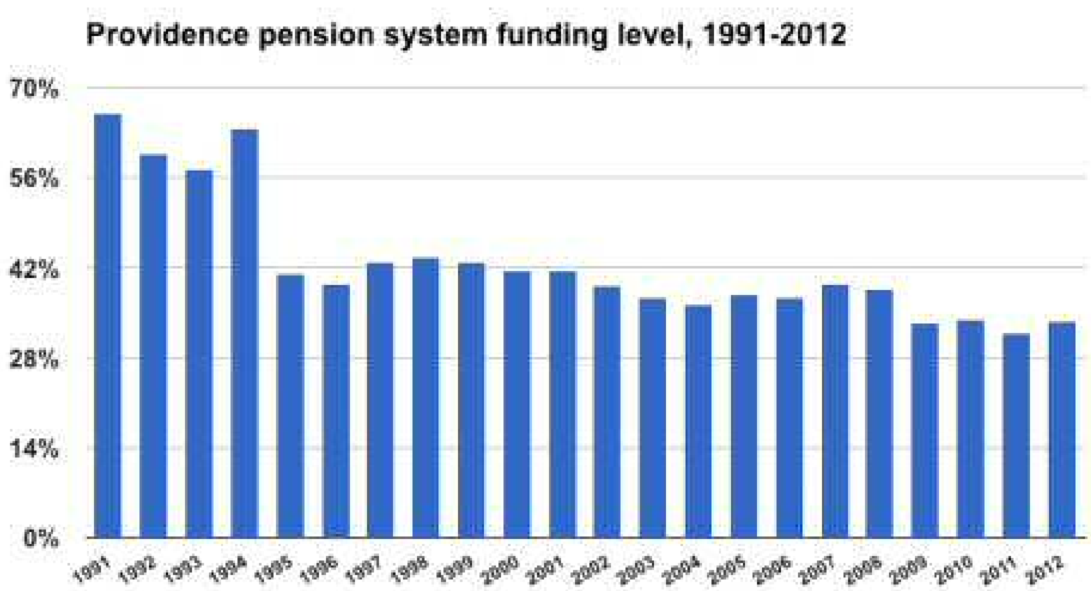
This mismatch of obligations and contributions produced a steady decline in the pension's funding level, as depicted in this chart from WPRI.com:[15]




15 Ted Nesi, "Providence's troubled city pension fund, in three charts", Nesi's Notes, WPRI.com, October 1, 2014.

In 2011, the City Council formed a Subcommittee on Pension Sustainability, which generated a 2012 Report recommending further reforms.[16] Later that year, the City negotiated and enacted a $170 million package of pension fund savings, consisting of reductions in benefits for non-vested employees and new employees, a permanent reduction in the highest COLA's, a suspension of many COLA's for a period of years, and caps on total pension value relative to the salaries paid to active employees.[17] The City Council enacted revisions to the pension ordinance that achieved savings by adjusting such criteria as required years of service and calculations of the final salary on which the pension was based.

Since the 2012 reforms, the City has negotiated modest additional pension savings in subsequent collective bargaining agreements. The City accelerated the timing of its annual contribution to the pension fund so that it can earn a greater return over time. The City adopted a policy of contributing 100% of the ARC, which has risen to $78 million, an increase of more than 600% above the 1989 level of $12 million. Of that $78 million, less than $9 million is needed to pay the "normal cost" of funding retirements for current employees, while the balance is dedicated to paying the "legacy cost" of retired City employees. Today, the pension contribution accounts for roughly 54% of the annual payroll. With these changes; however, the funded ratio remains at an anemic (and virtually comatose) 25.28%.[18]

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16 The 2012 Report is viewable at http://council.providenceri.com/efile/103.

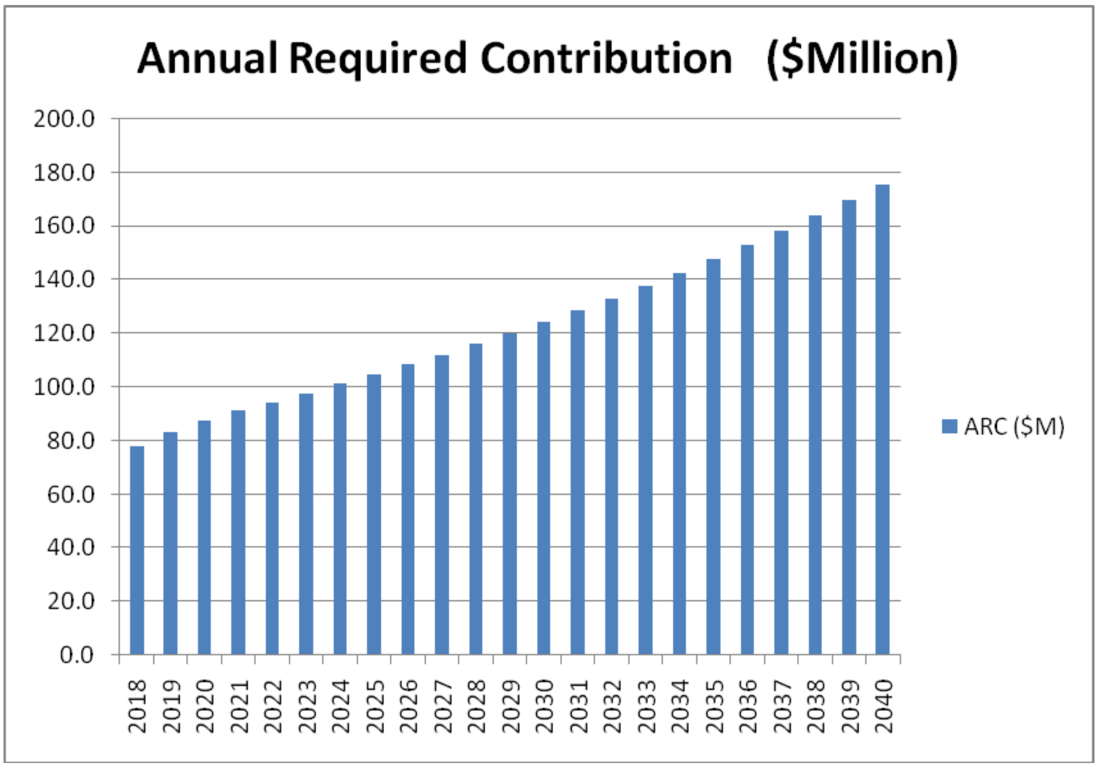
17 Greenberg Traurig, Providence Pension Reform Case Study (Power Point presentation viewable at http://www.bu.edu/ioc/files/2015/05/27-2_3Taveras-Slides.pptx ).

18 The 25.28% funded ratio is stated in the City's 2017-18 Comprehensive Annual Financial Report. *See* n. 3, above. It is based on an assumption the City's investment portfolio will generate an average rate of return of 8%. If the assumed rate of return is reduced, the pension deficit increases, and the funded ratio decreases. *Id.* For example, the 2017-18 Report states (at p. 51) that if one assumed a 7% rate of return, the unfunded liability would increase to $1.15 billion, resulting in a funded ratio of approximately 23.24%.

II. Current conditions and trends

A. Pension contributions

The City's current pension payment schedule is affected by two benchmarks. First, the City began a 30-year amortization in 2007, which means it is on a schedule to fully fund the pension by June 30, 2037.[19] Second, payments are set to increase by 3.5% annually. On its current course, the City's annual required pension contribution will rise on the following schedule:




As the chart indicates, the annual required contribution will increase by more than $38 million (to $116 million) over the next decade. According a report prepared by the Internal Auditor (Exhibit 2), the average homeowner's tax will increase by $350 to cover this single expense over that decade, while the average business property tax bill will increase by more than $1,200. In the five years that follow, the ARC will increase by another $22 million (to $138

19 This is the maximum amortization period permitted by GASB Standard 27.

million). Given the City's current property tax levy of $350 million, the projected ARC in 2033 would consume 40 cents out of each dollar paid by Providence taxpayers today.

Nor will things become any easier if the City somehow makes its pension payments through 2033. On the current schedule, payments after 2033 will increase by more than $5 million annually, ultimately reaching $176 million (or half the current tax levy) in 2040. In fact, given the actuary's current assumed rate of return of 8%, this chart understates the problem. If, for example, the City adopted a 7% rate of return (the target adopted by the State Retirement Board in May, 2017), the current accrued pension liability would increase by more than $150 million, and the 2028 ARC would increase further by approximately $10 million. The City cannot raise an extra $100 million per year to pay its upcoming pension obligations; instead, the current course will "break the City."

B. Anticipated revenues

The City's high commercial tax rate (which also applies to residential apartments of six units or greater) has discouraged new development. Because of the City's precarious fiscal position, it is not possible to implement a dramatic reduction in the commercial tax rate to overcome this hurdle; instead, the City provides incentives to developers that defer payment of full taxes. The largest example is the Providence Place Mall, which is subject to a tax treaty that limits annual payments to the City in lieu of taxes to $500,000 for another decade before full taxation (which at current rates would likely exceed $25 million) goes into effect. While the Providence Place Mall treaty appears to offer some potential future relief, its future taxable value may be subject to changes in the retail and real estate markets.[20]

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[20] *See, e.g.,* "Competitor Buying Providence Place's Chicago Owner At A Discount," Providence Journal, March 28, 2018.

More generally, the City encourages development through a tax stabilization program that provides commercial developers with a "stabilization period" of 10 to 20 years in which to progress from partial to full taxation. According to the Internal Auditor's December, 2017 report,[21] the current inventory of stabilized properties has an aggregate "true" value of approximately $500 million, which would generate $18 million at full taxation, but currently generates $7 million, thus indicating $11 million of tax base growth.[22] In a March, 2018 update, the Internal Auditor included recently approved stabilizations, which are projected to provide a potential addition of more than $63 million by 2037, a promising future, but not sufficiently timely to address the pension crisis. Similarly, the Wexford project on the I-195 land may someday come to fruition, but it will likely be subject to a 20-year tax stabilization agreement, again too far in the future to help the City with the looming pension crisis.

C. Other budgetary stresses

In the meantime, the City will face other significant fiscal challenges beyond the pension, including the School Department, retiree health benefits and infrastructure.

The School Department "local budget" for FYE June 30, 2018 is $382 million, of which the City funds approximately $128 million, with the balance coming from the State ($247 million) and other sources ($7 million).[23] Over the past seven years, the State implemented funding formula increases that added approximately $40 million to the budget, allowing the

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21 Review of Tax Stabilization Agreements, viewable on the Internal Auditor's web page at http://www.providenceri.gov/internal-auditor/ .

22 The City's agreement with Providence Place Mall is a "tax treaty," which is counted separately from the inventory of tax stabilization agreements.

23 It also should be noted that the "local budget" does not include federal funds, which have declined from $40 million in 2011-12 to $30 million currently, and which are targeted for further cuts under the current administration.

Providence Public Schools to maintain its essential program even as the City enacted flat appropriations for six of those years. The State's formula-based education aid increases end this year, and the City will see increased expenditures from charter school enrollment growth (which reduces State aid without corresponding savings in fixed costs) and other natural increases (State pension, health care, utilities, etc.). According to the School Department's current 5-year projection, the gap between non-City revenue increases and overall cost increases will expand by a total of $37 million by 2023.

Providence also faces a major liability in the form of health benefits provided to retirees (also known as "OPEB" or "other post-employment benefits") which it currently satisfies on a "pay as you go" basis, with a cost in FY 2017 of just under $27 million.[24] According to the City's latest annual financial report, the City would require a fund of $956 million to pay off these costs over time, and the current fund holds only $1 million. While the financial standards do not currently mandate the establishment of a reserve fund, GASB Standards 43 and 45 require the City to track the cost of establishing such a fund, which its actuary estimated in 2015 to equal $45 million per year on top of the amounts paid out in benefits. At this point in time, neither Providence nor many other municipalities have the financial capacity to fully fund a retirement benefit reserve; however, the prospect of steadily rising medical costs will continue to be a source of stress on City finances for the foreseeable future.

There also is the issue of the City's infrastructure, which has suffered from years of deferred maintenance. In 2015, the City Council's Bond Study Commission issued a report identifying several hundred million dollars of needed repairs to the City's inventory of streets,

[24] *See* 2017 Annual Financial Report, pp. 58-60.

sewers, parks and sidewalks, before accounting for public buildings or schools.[25] While capital needs can be addressed with bond financing,[26] there also is a need to invest substantial funds in the operating budget to maintain infrastructure both to extend its useful life, and to promote residents' safety and quality of life.

To conclude, the City's current increasing pension obligations will crowd out the essential functions of government, eroding the public schools, public safety and quality of life until the City reaches a point of total failure. We are currently on a course to begin seeing those major stresses within the next decade.

## III. Tools for resolution

While the City's lack of progress in reducing the pension deficit further since the 2012 reforms is regrettable and harmful, the prospect of spending money on this medium-term problem rather than using it on more attractive tangible projects (more police officers, recreation centers, school programs or tax relief, for example) can be understood as a normal reaction of human nature. As will now be described, a realistic solution to a problem of this magnitude will require contributions from many stakeholders who are not inclined to view themselves as responsible for the problem. This section of the Report will evaluate and quantify potential tools to achieve a minimum goal of moving the pension out of "critical status" (i.e. a funding ratio of

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[25] This year, the Governor and Treasurer are supporting an initiative to increase State funding for school repairs by issuing $500 million in bonds. While the State's current reimbursement formula provides Providence with more than 80% State aid for school repairs, the current estimate for all of the City's school buildings exceeds $300 million.

[26] As noted (*see* p. 3, above), Providence must comply with GASB standards (including payment of the annual recommended contribution) in order to retain access to affordable credit in the bond market to maintain its infrastructure.

60% or better) within the next ten years, and a sustainable path to full funding in the years that follow.

A. Bankruptcy

If the City does not solve its pension issue, bankruptcy will follow. With that said, other cities (such as Central Falls and Detroit) have emerged successfully from bankruptcy court to gain a fresh start, leading some to suggest that Providence could use the bankruptcy process as a pre-emptive tool to clear away and/or substantially reduce its pension obligations before it reaches the desperate condition predicted for the coming years. When this working group investigated the bankruptcy option further, however, it learned that (1) the City in its current financial position is unlikely to qualify for receivership or bankruptcy, and (2) even if the City were to qualify, the damage from bankruptcy proceedings likely would exceed the relief they could provide at this point in time.

More specifically, a city seeking protection under Chapter 9 of the federal bankruptcy code must, among other things, meet two requirements that the City of Providence is unlikely to satisfy in the foreseeable future. First, a municipality must have authorization from the State.[27] The Rhode Island Fiscal Stability Act, R.I.G.L. §§45-9-1 *et seq,* prescribes a series of escalating interventions (fiscal overseer, budget review panel and receiver) for municipalities facing fiscal challenges, and confers upon the State-appointed receiver the decision as to whether to seek bankruptcy protection. Because the receiver answers to the director of revenue, and because a municipal bankruptcy would have statewide implications beyond the petitioning city or town, a receiver might be especially reluctant to authorize a bankruptcy for the City of Providence.[28]

27 *See* 11 U.S.C. §109(c)(2).

28 A city or town also could meet Section 9's requirement of state authorization by petitioning the General Assembly directly; however, it is not likely the General Assembly

A second reason that Providence is unlikely to qualify for bankruptcy in the near future is that a petitioning municipality must demonstrate it is "insolvent." (11 U.S.C. §109(c)(3)). In this context, courts look to whether a municipality can make payments as they become due. The City's pension fund currently holds more than $350 million in assets, and the current annual contribution to the pension fund is less than $100 million; therefore, the current fund is at least three years away from insolvency.[29] In the meantime, the City has returned an operating surplus for the past two years, also negating its eligibility for bankruptcy protection. In short, a city or town cannot seek bankruptcy protection until it spends down essentially all its savings in whatever form, and run out of cash flow to pay bills as they become due.

Unless Providence became completely destitute, the cure of bankruptcy is probably worse than the disease that triggered the petition. First, the pension fund itself would probably be reduced to close to zero in order for the City to qualify for bankruptcy protection, creating a deeper hole from which to emerge. Bankruptcy relief from payments of invoices for goods and services provided by vendors and other creditors would cast a cloud over the City that would deter development. Also, any bankruptcy plan likely would include maximal task increases for a period of years (such as five years in the case of Central Falls). Finally, the stigma associated with a bankruptcy in the State's largest and capital city could produce "contagion" effects for both the State and other cities and towns. For these reasons, municipal bankruptcy is not a "trump card" to play at the City's convenience; instead, it is a drastic last resort that becomes available only after the ship strikes the iceberg.

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would favor a city or town's efforts to avoid the orderly process set forth in the Fiscal Stability Act.

29 Because the pension fund currently pays out less than the City contributes each year, this calculation probably understates the number of years the City will maintain a pension fund with a positive net balance under any scenario.

B. Continual re-amortization

GASB Standard 27 requires that municipal employers of defined benefit pension plans create a reserve account that amortizes current and future obligations over a maximum period of 30 years. This requirement is similar to a standard home mortgage, in which a portion of each monthly payment is for interest, while the balance is to "pay down" the remaining amount owed.[30] In 2007, the City re-amortized its pension fund, thus re-starting the 30-year clock based on the amount owed at the time. This provided a reduction in the annual required contribution for several years, as the chart on page 6 would indicate. Some have suggested that Providence could avoid the pain of increasing pension contributions by re-setting the amortization clock every year, which would be the equivalent of paying the interest only on a mortgage without ever reducing the amount owed.

This proposal is an example of what Leo Bloom once described to Max Bialystock as "creative accounting."[31] Rating agencies (such as Fitch which, as noted above, bases borrowing rates on pension funded ratios) would recognize continuous re-amortization (or even frequent re-amortization) as a subterfuge that will lead to future fiscal instability, thereby making the City's ability to borrow money more expensive and, possibly, unattainable. Under such a scenario, Providence would face such difficult choices as scaling back programs, raising taxes or deferring maintenance, which would lead to even greater costs down the road. Also, such a practice might

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30 The analogy is not perfect. While a homeowner pays the same amount every month in a "fixed rate" mortgage, the typical pension amortization schedule builds in steadily increasing payments until the pension is fully funded, at which time they fall dramatically. The Providence pension payment schedule calls for payments to increase at a 3.5% annual rate.

31 *See* "The Producers" (1967), written and directed by Mel Brooks, starring Zero Mostel as Max Bialystock and Gene Wilder as Leo Bloom.

trigger the State's intervention under the Fiscal Stability Act to prevent future harm to the City or the State.

C. Components of a sustainable solution

In the absence of any "simple" or "painless" solution, the City must choose among difficult options to close (or at least substantially reduce) the current pension gap. With the help of a set of scenarios prepared by the City's actuary in March, 2016 (based on the pension valuation of July 1, 2015), the working group has looked at many of these possible difficult choices, and estimated the impact they would have on addressing the City's pension gap. Exhibit 3 provides a baseline "snapshot" of the pension fund as of July 1, 2015. At that time, the pension fund had an unfunded liability of $894 million and a funded ratio of 27.4%. Since that time, the fund's position has declined further (*see* Exhibit 1); however, the March, 2016 collection of pension runs (which is indexed to the "baseline" of Exhibit 3) is useful for comparative purposes, indicating the approximate savings each potential reform can generate. As noted above, the goal is to find possible solutions to a projected increase of $38 million in the ARC over the next decade, and a $60 million increase by 2033.

1. Active employees

a. Increased employee pension contributions

City employees currently contribute 7.5%-8.5% of their pay into the pension fund for an annual total of over $11 million. This amount is governed by collective bargaining agreements, and any change would have to be negotiated in that context. The City's actuary refers to the cost of maintaining the pensions of current employees as the "normal cost". In FYE 2017, the City met its ARC by contributing $8.6 million to fund the "normal cost" pensions of current employees (in addition to the employees' own contributions), and $69.1 million to pay the cost of amortizing the unfunded pension liability.

For those reasons, reducing the City's share of "normal cost" payments can provide at best modest relief. For example, Exhibit 4 calculates the impact of a hypothetical agreement by employees to increase their contribution share from its current range up to 10%. Compared to the status quo (Exhibit 3), this reform could reduce the City's "normal cost" contribution by $4 million annually. This change would represent at most a solution to 10% of the problem, while smaller increases in the employee contribution would provide lesser amounts of relief.

b. Transition to hybrid plan

Through the passage of the Rhode Island Retirement Security Act, the State of Rhode Island implemented a "hybrid" pension plan that combined "defined benefit" and "defined contribution" components. Under the State's plan, employees with extensive years of service retained the "defined benefit" plan (in which their pension amount was guaranteed based on pay levels and years of service) they had at the time of the reform, while new employees were provided a combination of a smaller "defined benefit" plan with a "combined contribution" plan (or what is known in the private sector as a "401(k) plan"). Employees with intermediate years of service were provided a combination that retained the vested defined benefits they had earned at the time of the reform.

The State undertook this transition to stabilize its future obligations. Because the bulk of Providence's current pension contributions are to amortize the unfunded liability rather than to pay for anticipated costs for current employees, a City transition to a hybrid plan would purchase long-term stability at a substantial short-term cost, as the City would be required to create a new 401(k)-type fund for existing employees in addition to continuing legacy obligations. Exhibit 5 provides an actuary's run for a sample hybrid plan, under which employees are moved to a hybrid plan (with a 2% employer contribution), and the City changes its amortization payments from the current 3.5% annual increase to a flat amortization schedule. These changes immediately increase the City's annual contribution by approximately $20 million, but that contribution remains fixed and/or declines slightly in all future years.

2. Retirees

In 2012, the City negotiated with retirees to suspend and reduce COLA's. The negotiations were codified in a consent judgment which would be, at a minimum, very difficult to change absent agreement. With that said, the working group wanted to know how much of the existing problem could be solved by adjustments to current retirement benefits. We found that less-than-severe adjustments would produce only modest savings.

Exhibit 6 provides a run in which the current freeze on COLA's is extended until 2034, when the account is projected to emerge from "critical" status. This produces a $60 million reduction in the accrued liability and a savings of around $6 million in the ARC, again at best a component of a solution.

In Exhibit 7, the actuary produced a scenario where all pensions up to $2,000 per month are preserved, and any excess above that amount is reduced by 5%. This change would reduce the ARC by $4 million -- $6 million annually over that period. A 10% cut (Exhibit 8) reduces the ARC by $10 million - $15 million annually.

3. Increased City contribution

As noted above (p. 6, above), the City failed to meet the actuary's annual recommended contribution into the pension fund on several occasions over the past quarter-century. The City asked its investment advisor to review the known timing and amount of these shortfalls over the past 21 years.[32] The investment advisor's report is attached as Exhibit 9. The advisor added the

[32] As noted above, the City's pension crisis began in December, 1989, and the City failed to make full ARC payments in some of the years prior to the investment advisor's "start date" of July 31, 1996. The earlier underpayments were incorporated by the actuary, who

money in, and assumed it would earn the same rate of return as the rest of the City's investment portfolio. The report tabulated the total amount of under-payments at $111.5 million, and the total loss in value to the portfolio (including the $111.5 million and adding anticipated investment gains) at $305.4 million as of November 1, 2017. In other words, prior under-payments by the City account for approximately 30% of the current pension deficit.

Because of this history, there is an argument that the City should consider making contributions to the pension fund in excess of the ARC going forward, as part of a global solution to resolve the pension problem once and for all. Some of today's taxpayers may have paid less in the past as a result, but there is no easy way to match the underpayments with particular taxpayers; therefore, it will be a general obligation of the City's. With that said, any extra contribution by the City will be constrained by the multiple financial challenges described at pages 7-9 above, and this increased participation will be only part of a solution that will require the involvement of many others.

4. Monetization of Providence Water

Last year, the City presented a proposal to the General Assembly to regionalize Providence Water, which currently provides water directly to customers in four Rhode Island communities,[33] and indirectly (through wholesale purchases) to at least seven more.[34] The City did not propose selling the water system to a private vendor; instead, the proposal contemplated continued ownership and management by a public or quasi-public body. Such a transaction

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adjusted the ongoing payments as of 1996 to include an extra amount for the under-payments of 1989-96.

33 Providence, North Providence, Cranston and parts of Johnston.

34 Greenville Water, the City of East Providence, Town of Smithfield, Lincoln Water, Kent County Water, Bristol Water, City of Warwick, and Town of Johnston.

would allow the City to realize proceeds that could be invested directly into the pension fund. According to a 2017 report by MRV Valuation Consulting, Inc. ("MRV Report"), the physical plant of Providence Water had a replacement value of slightly over $400 million as of March 31, 2017 after taking depreciation into account.

Providence offered the General Assembly different justifications for this transaction. The first is historical. The Providence water supply was originally built and paid for by Providence taxpayers, but it now provides its water to a State-wide customer base at uniform rates set by the Public Utilities Commission. Unlike a private utility, the Public Utilities Commission does not allow Providence to derive a rate of return on its equity in the system. While this arrangement makes sense when the public owner of the water system is identical to the users, the same is not true when one public body (namely Providence) built and paid for the original system, and the system serves a much wider body of users.

The City also argued that regionalization (i.e. combining the Providence water supply customer base with other State water supplies) could lead to more uniform rates, including reductions in some communities.[35] Finally, the City has argued that if the pension problem is not resolved, the water supply may be disposed of in court proceedings in a manner that is not in the best interest either of the City of Providence or the State as a whole.

Representatives from other parts of the State opposed this plan, viewing their current access to the high-quality, cut-rate (*see* n. 33) Providence water as an entitlement. (Also, some Providence residents are concerned about how such a transaction would affect water quality, although there appear to be adequate ways to protect this.) Exhibit 10 contains projections of the

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[35] In a recent survey by MR Value Consulting, the average annual bill for 100 cubic feet of water was $431 in Providence, $545 in Pawtucket, $717 in Kent County and $810 in Newport. *See* MRV Report, p. 15.

impact of a $250 million payment[36] from other water users, which clearly provides a significant "down payment" on the problem provided these objections can be overcome, immediately raising the funded ratio to close to 50% and reducing the ARC by around $20 million to start, savings which more than double in the "out years." With that said, the infusion of $250 million in additional funds from an external source is far from a complete solution to the current deficit.

5. Combinations

The actuary runs presented here measure the benefits from applying one of several possible tools. While combining the tools in a package will close the deficit further than any individual tool, the benefits of combination are not strictly additive. With that said, it is clear that any sustainable solution likely will have to combine some version of many, if not most of the available tools just listed. Each of these components may face strong opposition from an affected group (such as existing employees, retirees, taxpayers) and/or from the State, but this working group is unable to develop a realistic solution if it is limited to what else is available.

6. Other tools

The City's authority to increase its pension contribution is limited by the Paiva-Weed Act, R.I.G.L. §44-5-2(b), which caps the annual growth of the City's tax levy at 4%. For fiscal 2018-19, the Internal Auditor estimated that the increased ARC alone will claim 1.5% of a tax levy increase, almost half of what is permitted under Paiva-Weed. If the City chose to "flatten out" its ARC payments over time by increasing the amount currently paid, the Paiva-Weed tax cap would become a barrier, not just a limitation. For those reasons, the working group recommends the City seek a permanent Paiva-Weed exemption for contributions to the pension

[36] At the time the City requested this run from the actuary (March, 2016), it did not know the actual value of the water supply. Since that time, the City commissioned the MRV Report and learned that the actual value of the water supply is $400 million as of March 31, 2017.

fund. In addition or alternatively, the City currently enters into a number of tax treaties with some property owners (such as National Grid) that are not counted as part of the levy until the expiration of the treaty. It would be helpful if the State law provided room for a transition of these treaties to the tax rolls without imposing an immediate "hit" for revenue the City already receives through the treaty.

## IV. Conclusion and Recommendations

The City's pension fund has been in "critical" condition for decades, and the current schedule of required payments is a recipe for disaster. There are no rabbits to pull out of this hat, and the problem only grows more expensive and painful with each passing year of inaction.

There is a basis for hope. While each stakeholder has a particular, deeply felt reason to deny responsibility for this problem, oppose any solution they believe will balance the pension budget "on their back" and argue that someone else should be asked (or required) to resolve it, all of them hold a stake in the City's well-being, and all of them will suffer from the consequences of the City's financial ruin. For that reason, one can envision a "grand bargain" in which all stakeholders participate on the premises that (a) everyone else is contributing their fair share, and (b) the City will fail without full participation. This Report identifies some important tools that can become part of such a discussion.

This working group proposes that the City Council and administration commit to funding the pension to a minimum level of 60% within ten years, i.e. by June 30, 2028. The working group proposes that the City develop, no later than September 30, 2018, an engagement campaign to solicit stakeholder input, and submit by December 31, 2018, a working plan that will achieve that goal.

The working group invites the Finance Committee, the City Council, all stakeholders and the general public to contribute their ideas to this effort. We have tried to present all the potential solutions we could find, but welcome your suggestions about alternatives we have missed. With that said, the City is past the point of engaging in denying a serious and imminent reality. The members of this working group would be pleased and grateful to provide any assistance we can to advance these fundamental and essential reforms.

Thank you for your consideration.

Exhibits to Pension Working Group Report
(under separate cover)

1. Segal Consulting, Providence Employees Retirement System, July 1, 2016 Valuation, Funding Schedule.

2. Internal Auditor "Funding Pensions in Providence", November 1, 2017.

3. Segal Consulting, Providence Employees Retirement System, July 1, 2015 Valuation, Funding Schedule.

4. Segal Consulting, Providence Employees Retirement System, July 1, 2015 Valuation, Funding Schedule 7.

5. Segal Consulting, Providence Employees Retirement System, July 1, 2015 Valuation, Funding Schedule 5

6. Segal Consulting, Providence Employees Retirement System, July 1, 2015 Valuation, Funding Schedule 1.

7. Segal Consulting, Providence Employees Retirement System, July 1, 2015 Valuation, Funding Schedule 11.

8. Segal Consulting, Providence Employees Retirement System, July 1, 2015 Valuation, Funding Schedule 12.

9. Wainwright Investment Counsel LLC, Analysis of Non-Funded ARC Payments Fiscal Years 1997 through 2016.

10. Segal Consulting, Providence Employees Retirement System, July 1, 2015 Valuation, Funding Schedule 19.