The Civic Federation

Research * Information * Action * Est. 1894

METROPOLITAN WATER RECLAMATION DISTRICT FY2017 TENTATIVE BUDGET:

Analysis and Recommendations

December 1, 2016

****This is a summary of the Civic Federation's analysis and recommendations. The full 57-page report is available at www.civicfed.org.****

The Civic Federation • 10 N. Dearborn Street • Chicago, IL 60602 • civicfed.org

The Civic Federation is an independent, non-partisan government research organization working to maximize the quality and cost-effectiveness of government services in the Chicago region and State of Illinois.

Table of Contents

****This is a summary of the Civic Federation's analysis and recommendations. The full 57-page report is available at www.civicfed.org.****

EXECUTIVE SUMMARY

The Civic Federation **supports** the FY2017 Tentative Budget proposed by the Metropolitan Water Reclamation District of Greater Chicago (MWRD). The FY2017 Tentative Budget of approximately $1.13 billion is 9.0% less than the FY2016 adjusted budget of $1.24 million.[1]

With the FY2017 budget proposal, the MWRD continues to demonstrate a sensible and proactive approach to meeting its financial challenges. In FY2017 the District will continue to maintain substantial reserves and other safeguards to cover shortfalls or financial emergencies. Spending within the District's Corporate Fund, or general operating fund, will remain relatively flat from the prior year, and the District will reduce the cost of health and life insurance for employees by 3.1%. The District also maintains high credit ratings, which the District says enabled it to save $120 million on future debt service costs at its 2016 bond sale.

Over the past several years, the MWRD has committed to increasing contributions to its employee pension fund and contributing to a trust fund for future retiree healthcare benefits. Since 2013 the MWRD has contributed more to the pension fund than the actuarially determined contribution in order to make up for shortfalls in prior years. These additional contributions have begun to reverse the downward trajectory of the pension fund. In FY2017 the District will increase its contribution to the fund by 12.4% from the prior year. The District will also contribute $5.0 million in FY2017 to a trust fund for future retiree health benefits.

These achievements are not to say that the MWRD is free of challenges. As a non-home rule government, the MWRD has limited revenue flexibility and depends heavily on property taxes, including a projected maximum increase in FY2017. The District shares a property tax base with other local governments that have high pension and debt burdens, putting pressure on the tax base as a source of revenue for all the governments that access property taxes in Cook County. Like most governments, the District must control spending to balance rising personnel costs. The MWRD pension fund still has a long way to go to reach full funding. Despite these limitations, however, the MWRD has done a commendable job implementing prudent and thoughtful financial management policies that work to improve the District's long-term stability.

The Civic Federation offers the following **key findings** from the FY2017 Tentative Budget:

- Total proposed spending is $1.13 billion, which is a 9.0%, or $111.7 million, decrease from the FY2016 adjusted budget of $1.24 billion. The decrease is due to lower spending on major capital and infrastructure projects based on normal fluctuations in project scheduling;
- The five-year capital budget for FY2017-FY2021 totals approximately $1.1 billion, with proposed spending in FY2017 at $236.7 million. The request for total capital spending authorization on project costs in FY2017 is $348.0 million;
- The MWRD will decrease position count in FY2017 by 21 full-time equivalent (FTE) positions, eliminating 19 vacant positions in the Corporate Fund and two positions in the Stormwater Management Fund. This is a 1.1% reduction in FTE positions from 1,976

[1] The decrease from FY2016 is due to normal fluctuations in the project schedule for spending on major capital projects.

positions in FY2016 to 1,955 positions in FY2017. However, the District also plans to hire 35 apprentices in FY2017 through a newly proposed apprenticeship program;[2]

- In FY2017 the MWRD's total gross property tax levy will increase by 3.0%, or $17.5 million, to $595.0 million from the FY2016 adjusted budget, including both tax-capped and non-tax-capped funds;
- The MWRD will contribute $79.5 million to its Retirement Fund (pension fund) in FY2017, which is an $8.7 million, or 12.4%, increase from the prior year contribution;
- The pension fund's unfunded actuarial accrued liabilities, or the dollar value of accrued liabilities not covered by the actuarial value of assets, rose over a ten-year period from $515.1 million in FY2006 to $1.06 billion in FY2015;
- The pension fund's actuarial value funded ratio, which is a measure of the pension liabilities covered by assets, declined from 70.0% in FY2006 to 55.2% in FY2015;
- Between FY2011 and FY2015, short-term liabilities increased by $55.9 million, or 46.8%, solely due to an increase in the amount due to the pension fund. All other short-term liabilities decreased over that period; and
- Between FY2011 and FY2015, long-term debt increased by 10.6% from $2.7 billion to $3.0 billion;[3]

The Civic Federation **supports** the following elements of the proposed budget:

- Keeping Corporate Fund spending relatively flat;
- Utilizing prudent fiscal safeguards that include maintaining substantial operating reserve funds, a high level of liquidity to cover short-term liabilities and working cash to cover anticipated property tax revenues rather than using short-term borrowing;
- A transparent and prudent capital planning process;
- Reducing the cost of workers' compensation claims;
- Increasing contributions to the pension fund and continuing pre-funding for healthcare benefits for retirees; and
- Allowing more time between the public budget hearing and the Board of Commissioner's approval of the budget than in past years.

The Civic Federation has the following **concerns** about the FY2017 proposed budget:

- Possible court challenges to the MWRD's 2012 pension funding reform law; and
- Effects of sharing an overlapping property tax base with local governments that have large pension and debt liabilities.

The Civic Federation offers the following **recommendations** to improve MWRD's financial management:

- Evaluate the possible impact of a reversal of the District's pension funding reforms; and
- Continue to maintain generous reserves, control costs, manage long-term debt costs and strengthen the pension fund in order to protect the District's credit rating.

[2] The apprenticeship program expects to hire 70 apprentices by FY2018. The District indicates that the cost of the apprenticeship program will be neutralized through an adjustment of vacant positions.
[3] Long-term debt in this calculation includes general obligation debt, converted bond anticipation notes, deferred premiums, bond anticipation notes and capital leases.

CIVIC FEDERATION POSITION

The Civic Federation **supports** the FY2017 Tentative Budget proposed by the Metropolitan Water Reclamation District of Greater Chicago (MWRD). The FY2017 Tentative Budget of approximately $1.13 billion is 9.0% less than the FY2016 adjusted budget of $1.24 million.[4]

With the FY2017 budget proposal, the MWRD continues to demonstrate a sensible and proactive approach to meeting its financial challenges. In FY2017 the District will continue to maintain substantial reserves and other safeguards to cover shortfalls or financial emergencies. Spending within the District's Corporate Fund, or general operating fund, will remain relatively flat from the prior year, and the District will reduce the cost of health and life insurance for employees by 3.1%. The District also maintains high credit ratings, which the District says enabled it to save $120 million on future debt service costs at its 2016 bond sale.

Over the past several years, the MWRD has committed to increasing contributions to its employee pension fund and contributing to a trust fund for future retiree healthcare benefits. Since 2013 the MWRD has contributed more to the pension fund than the actuarially determined contribution in order to make up for shortfalls in prior years. These additional contributions have begun to reverse the downward trajectory of the pension fund. In FY2017 the District will increase its contribution to the fund by 12.4% from the prior year. The District will also contribute $5.0 million in FY2017 to a trust fund for future retiree health benefits.

These achievements are not to say that the MWRD is free of challenges. As a non-home rule government, the MWRD has limited revenue flexibility and depends heavily on property taxes, including a projected maximum increase in FY2017. The District shares a property tax base with other local governments that have high pension and debt burdens, putting pressure on the tax base as a source of revenue for all the governments that access property taxes in Cook County. Like most governments, the District must control spending to balance rising personnel costs. The MWRD pension fund still has a long way to go to reach full funding. Despite these limitations, however, the MWRD has done a commendable job implementing prudent and thoughtful financial management policies that work to improve the District's long-term stability.

Issues the Civic Federation Supports

The Civic Federation **supports** the following initiatives contained in the MWRD FY2017 Tentative Budget.

Controlling Corporate Fund Costs

The Corporate Fund is the MWRD's general operating fund, which accounts for revenue and expenditures for general administration, monitoring and research, procurement, information technology, human resources, maintenance and operations, law, finance and engineering. The Corporate Fund makes up the largest portion of the District's overall expenditures at 32.4%. The FY2017 budget proposes Corporate Fund spending of $367.1 million, an increase of 0.2%, or $801,000 compared to the FY2016 adjusted budget. This is a minimal increase, and over the past

[4] The decrease from FY2016 is due to normal fluctuations in the project schedule for spending on major capital projects.

five years Corporate Fund appropriations have decreased by 4.3% from $383.6 million in FY2013.

The District is eliminating 19 vacant positions within the Corporate Fund to balance rising personnel costs,[5] and the cost of employee health benefits will decrease by 3.1% from the previous year due to cost containment strategies. We are encouraged by the District's intent to keep its Corporate Fund expenditures level and its exploration of alternative revenue sources such as the sale of its waste products in concert with its projected property tax increase.

Prudent Fiscal Safeguards

As a special purpose government with capital-intensive operations, it is important for the MWRD to maintain financial safeguards. As in the past, the District again is taking prudent steps to protect its operations and enable it to maintain its infrastructure in the context of stagnant revenue growth and increasing expenditures.

The MWRD has consistently maintained a high level of operating reserves within the Corporate Fund, the District's general operating fund. The District is budgeting to set aside $91.0 million of Corporate Fund appropriations as reserves in FY2017, which is 24.8% of operating expenditures. The District's policy is to maintain reserves of at least 12-15% of Corporate Fund expenditures, which it has adhered to over the past six years. The level of reserves is also well above the best practice standard recommended by the Government Finance Officers Association of two months of operating expenditures. The District has noted it will maintain a fund balance higher than its policy over the next several years in order to minimize increases in the property tax levy and provide for unexpected shortfalls.[6] This is prudent, given recent instability in State funding and a reduction in Personal Property Replacement Tax (PPRT) revenue due to an allocation error made by the State of Illinois. The State will recoup PPRT revenue from local governments over the next two years through lower PPRT payments.

The MWRD maintains more than sufficient liquidity to cover short-term liabilities such as short-term debt and payments owed to vendors or employees within one year. As of FY2015, the most recent audited data available, the District had enough short-term assets to cover short-term liabilities more than seven-fold. The best practice standard is a ratio of assets to liabilities of 2.0. The MWRD's ratio in FY2015 was 7.7, which demonstrates that the District held a healthy level of liquidity to cover expenses.

The MWRD also maintains a Working Cash Fund financed through transfers of surpluses in other funds, which enables the District to cover Corporate Fund expenses during periods when anticipated property tax revenues have not yet been collected. This Working Cash Fund allows the District to avoid short-term borrowing through tax anticipation notes (TANs), which is a costly practice utilized by other local governments.

---

[5] While FTE count is decreasing by 21 total positions – 19 in the Corporate Fund and 2 in the Stormwater Management Fund – it is also important to note that the District is proposing a new apprenticeship program, which would add 70 apprentice positions and is estimated to cost $1.8 million in FY2017 and $3.7 million in FY2018. The program cost would be neutralized through an adjustment of vacant positions.
[6] MWRD FY2017 Executive Director's Recommendations, p. 18.

These safeguards provide the MWRD and taxpayers with protection in the event of financial shortfalls and uncertainties.

Continued Exemplary Capital Budgeting and Planning Processes

The MWRD has long been a leader among local governments in northeastern Illinois with its long-term planning processes. There are several aspects of the District's capital and long-term planning process that the Civic Federation believes are praiseworthy:

- The District develops a best-practice five-year Capital Improvement Program (CIP), which is updated on an annual basis and includes project detail and five-year projections of anticipated expenditures;
- The District is one of the few area local governments that holds a public hearing specific to the capital plan in order for members of the public to comment on the plan;
- The District produces a Strategic Business Plan that serves as a guiding document for policy decisions and budgetary priorities and is updated annually; and
- The District publishes a five-year financial forecast for all funds within each annual budget, which includes strong narrative detail on assumptions and projections.

The Civic Federation commends the District for its consistently superior planning efforts.

Reducing Spending on Workers' Compensation Claims

The MWRD states in the FY2017 budget proposal that it is making ongoing efforts to reduce costs associated with workers' compensation claims by implementing safety training programs. Expenditures within the Reserve Claim Fund, which is the District's self-insurance fund to provide coverage for employee and general claims, are expected to decrease in FY2017 from $5.4 million in FY2016 to $5.0 million in FY2017. With the exception of a large $44.7 million settlement in 2014 unrelated to workers' compensation, the trend over the past ten years has been a reduction in claim expenditures from $7.6 million in FY2008 to $5.0 million projected in FY2017.[7] The District credits an active safety education and enforcement program with the low and stable expenditures related to Workers' Compensation claims.

Increasing Pension Contribution and Pre-Funding Other Post Employment Benefits

The District adopted a pension funding policy in October 2014 with the goal of making annual contributions to the fund large enough to increase the funded ratio of the pension fund to 100% by 2050, instead of the statutory 90% funded ratio by 2050 that was imposed by a 2012 pension funding law. The 2012 law increased both the District's employer and Tier 1 employee contributions to the fund. The FY2017 appropriation to the Retirement Fund is $79.5 million, which is an increase of $8.7 million, or 12.3% from the FY2016 adjusted budget.[8] In contrast to some other governments, the MWRD is allowed to contribute more than the statutory limit to its pension fund.

[7] MWRD FY2017 Executive Director's Budget Recommendations, p. 523.
[8] MWRD FY2017 Executive Director's Budget Recommendations, p. 530.

Additionally, the District consistently contributes to an Other Post Employment Benefits (OPEB) Trust Fund established in 2007. When fully funded, the OPEB Trust Fund will subsidize healthcare for retirees. By December 31, 2016 the fund's contributions will total $122.4 million and the actuarial value of assets will be $149.3 million, compared to an unfunded obligation of $137.3 as of December 31, 2015.[9] The District is planning to contribute $5.0 million to the OPEB Trust Fund from the Corporate Fund in FY2017 and will make a $5.0 million contribution each year until the trust is fully funded. Pre-funding retiree health benefits is a prudent move given uncertainty in the degree to which such benefits are protected by the Illinois Constitution.

The District's pension funding policy and contributions to the OPEB Trust Fund demonstrate a proactive effort to improve the funding levels for employees' retirement benefits and reduce some of the uncertainty that has contributed to other governments' low bond ratings.

Allowing Additional Time for Consideration of Public Comments on the Budget

During the FY2016 budget process in fall of 2015 and continuing for the FY2017 budget process in 2016, the District has allowed more time between the public hearing on the budget proposal and the Board of Commissioners meeting when the Board votes on the proposed budget. Previously, the hearing was held the day before the Board vote, whereas last year and again this year, the hearing was held a week before the vote on the budget. This allows the Board more time to consider comments made by members of the public before adoption of the budget.

[9] MWRD FY2017 Executive Director's Budget Recommendations, p. 13.

Civic Federation Concerns

The Civic Federation has the following **concerns** about issues contained in the MWRD's FY2017 Tentative Budget.

Possibility of Challenges to the MWRD Pension Reform Law

Earlier this year, pension funding and benefit reform legislation for the City of Chicago's Municipal and Laborers' Funds (Public Act 98-0641) was struck down as unconstitutional by the Illinois Supreme Court. In 2015 the Court also struck down the State of Illinois' pension funding and benefit reforms[10] (Public Act 98-0599). Funding and benefit reforms that were passed in 2014 for the Chicago Park District Pension Fund are being litigated in the Cook County Circuit Court.[11] Given all this litigation, there is a possibility that the District's 2012 pension funding reforms (Public Act 97-0894) might be challenged in court.

It is important to note here that there are large differences in the scope of the changes made by the Illinois, Chicago and the Chicago Park District pension reform bills and the MWRD's. The former changed pension benefits in addition to changing funding, while the District's reforms increased employee and employer contributions only, without adjusting pension benefit accruals or automatic annual increases to annuities. However, a footnote in the Illinois Supreme Court's ruling on *Jones v. Municipal Employees' Annuity and Benefit Fund of Chicago,* 2016 IL 119618, makes note of the fact that under Public Act 98-0641, City of Chicago employees who participate in the Municipal and Laborers' Funds were required to contribute more for their reduced benefits. The Court decided it did not need to consider the additional impact of the increased contributions, but it did make a point of raising the issue.[12]

Given that the District has been following rating agencies' guidance in focusing on stabilizing the financial condition of its post-employment benefits in order to maintain its high bond ratings and minimize borrowing costs, ongoing uncertainty with regard to the legal status of the MWRD's funding schedule could be harmful.

Effect of Overlapping Property Tax Base with Other Chicago Area Local Governments

The MWRD maintains high credit ratings, with a AAA rating from Fitch Ratings since 2001, which is the highest rating possible, and an AA+ rating from Standard & Poor's (S&P) since May 2016. The District credits its solid ratings with saving $120 million on future debt service costs at the District's 2016 bond sale, which allowed the District to take advantage of low interest rates.[13]

However, the MWRD shares an overlapping tax base with several other local governments – including the City of Chicago, Cook County, Chicago Public Schools, Chicago Park District and the Cook County Forest Preserve District. This means that decisions made by those governments

---

[10] *In re Pension Reform Litigation*, 2015 IL 118585. Available at http://www.illinoiscourts.gov/opinions/supremecourt/2015/118585.pdf

[11] *Biedron et al. v. Park Employees' and Retirement Board Employees' Annuity and Benefit Fund et al.* Case No. 2015 CH 14869.

[12] *Jones v. Municipal Employees' Annuity and Benefit Fund of Chicago,* 2016 IL 119618, Footnote number 5, p. 9.

[13] MWRD FY2017 Executive Director's Recommendations, p. 1.

related to property taxation and long-term debt that increase the burden on taxpayers also impacts the MWRD's ability to access its property tax base. For example, the City of Chicago and Chicago Public Schools have implemented substantial property tax increases over the past two years and all of the major Cook County property tax funded governments have high levels of unfunded pension obligations.

Moody's Investors Services downgraded the MWRD's credit rating in August 2013 from Aaa to Aa1, and again in July 2015 from Aa1 to Aa2 with a stable outlook. Moody's cited concerns over growing unfunded pension obligations and the debt burden placed on the entire Cook County tax base by several major governmental entities.[14] In May 2016 Standard & Poor's downgraded the MWRD from AAA to AA+ with a stable outlook. The reason given for the downgrade was the potential impact of the combined pension liabilities and debt of the overlapping governmental entities on the District's property tax base.[15]

Even after these downgrades the MWRD remains one of the highest-rated large government entities in Cook County. However, the downgrades to the District's credit rating reflect the challenges facing the MWRD, with debt and pension liabilities serving as the main drivers of concern. Further downgrades would cause the cost of the District's long-term debt to increase. The MWRD should work to avoid reductions to its credit rating from any of the rating agencies and possibly earn an upgrade by continuing to improve the funding level of the MWRD Retirement Fund and moderating its debt burden.

Civic Federation Recommendations

The Civic Federation has the following **recommendations** to the MWRD.

Evaluate the Possible Impact of a Reversal of the District's Pension Funding Reforms

Given the MWRD's focus on long-term planning, the Civic Federation believes that it would be helpful to employees, retirees and the public if the District were to commission an evaluation of the possible impact of a reversal of its 2012 pension funding law and release the results of the study publicly. It is crucial for all stakeholders to understand the effect that the pension funding reforms are having on the fund's future and the probable impact of an ill-considered challenge to the law.

The District's 2012 pension funding reform law included increased employee and employer contributions, which were developed to improve the MWRD Retirement Fund's fiscal sustainability. Since increased employer and employee contributions began in FY2012 and FY2013, the actuarial funded ratio of the Fund has increased steadily from 50.4% in FY2012 to 55.2% in FY2015, the most recent data available. The Fund's actuary projects that under the current funding schedule, the unfunded liability will begin to be reduced in FY2021 and the fund

[14] Moody's Investors Service, "Rating Action: Moody's downgrades Met Water Reclamation District, IL to Aa2 from Aa1; outlook stable," July 6, 2015. Available at https://www.moodys.com/research/Moodys-downgrades-Met-Water-Reclamation-District-IL-to-Aa2-from--PR_329579

[15] S&P Global RatingsDirect, "Summary: Metropolitan Water Reclamation District of Greater Chicago; General Obligation," May 26, 2016. Available at https://www.mwrd.org/irj/go/km/docs/documents/MWRD/internet/Departments/Treasury/docs/Ratings/SP.pdf.

will achieve 100% funding in FY2049.[16] However, if the funding reforms are challenged in court and repealed, the District's plan to increase funding to 100% by 2050 would be in jeopardy.

Continue Working to Maintain High Credit Rating

As noted above, the MWRD has some of the highest credit ratings of the large governments in Cook County. But the Federation does caution that the District may need to mitigate the effects of other local governments' taxing decisions and fiscal instability on the District's credit rating.

In its July 2015 statement, Moody's cited several steps the MWRD could take to improve its credit rating, which include moderation of the District's overlapping debt burden, reducing fixed costs including debt service and retirement liabilities and improving the financial health of District's employee pension plan.[17] In its May 2016 downgrade report, Standard & Poor's noted positive aspects of the District's financial management such as maintaining high reserves, as well as the diverse economy of the Chicago metropolitan region. S&P stated that it would consider a higher rating if the District shows improvement in its pension funding level and if the combined debt and pension liabilities of overlapping governments are contained.[18]

The Federation commends the District for taking a proactive approach to funding its retirement system, maintaining generous reserves and controlling costs. The Federation encourages the District to continue these practices as well as limiting property tax increases, managing long-term debt costs and continuing strengthen the pension fund in order to protect its credit rating.

---

[16] Presentation provided during Study Session of the Committee on Finance, June 2, 2016. Available at http://mwrd.legistar.com/gateway.aspx?M=F&ID=5039b30c-ede7-4d3c-b137-2d562b36509d.pdf.
[17] Moody's Investors Service, "Rating Action: Moody's downgrades Met Water Reclamation District, IL to Aa2 from Aa1; outlook stable," July 6, 2015. Available at https://www.moodys.com/research/Moodys-downgrades-Met-Water-Reclamation-District-IL-to-Aa2-from--PR_329579
[18] S&P Global RatingsDirect, "Summary: Metropolitan Water Reclamation District of Greater Chicago; General Obligation," May 26, 2016. Available at https://www.mwrd.org/irj/go/km/docs/documents/MWRD/internet/Departments/Treasury/docs/Ratings/SP.pdf.

ACKNOWLEDGEMENTS

The Civic Federation would like to express our appreciation to Executive Director David St. Pierre, Budget Officer Shellie Riedle, Administrative Services Manager Eileen McElligott and Supervising Budget and Management Analyst Sylvia Lopatka and for their hard work in preparing this budget. We greatly appreciate their willingness to provide a budget briefing and to answer our questions.

****This is a summary of the Civic Federation's analysis and recommendations. The full 57-page report is available at www.civicfed.org.****