**CITY OF SOUTH SAN FRANCISCO**
**STAFF REPORT**

Staff Report for Discussion on Pension Funding Policy and update on pension and OPEB liabilities (*Karen Chang, Director of Finance*)

## RECOMMENDATION

Staff recommends that the Finance/Budget Committee review and provide feedback on the proposed Pension Funding policies.

## BACKGROUND

A primary City Council priority is ensuring long-term fiscal sustainability for City of South San Francisco. One component for achieving this goal is reducing the City's unfunded liabilities related to employee benefits (i.e. retiree health care and retirement pensions). An unfunded liability is the monetary difference between the estimated future costs of future benefits and the assets set aside to pay those benefits.

City unfunded liabilities fall into two categories –

1) **Other Post-Employment Benefits (OPEB)-** OPEB refers to healthcare benefits for employees who have retired from the city. The city provides its employees with a retiree healthcare plan for employees that were hired before April 25, 2010. Employees hired after that date cannot participate in City medical plans at retirement.

   The City has participated in the California Employers' Retiree Benefit Trust (CERBT), which is a Section 115 irrevocable trust administered by the California Public Employees Retirement System (CalPERS). The City has been pre-funding the OPEB since Fiscal Year (FY) 2013-14. Contributions in that FY were approximately $4.2 million, followed by $11.2 million in FY 2014-15, $1.2 million in 2015-16, and have been contributed $802,000 annually since. The CERBT account has since grown to $38.2 million. The plan was 37.9% funded on June 30, 2023 valuation date.

   Projected Unfunded Liability as of June 30, 2024 was $51.7M.

2) **Pension** refers to the City employees' pension plans that are administered by CalPERS. As of June 30, 2024, unfunded liability was projected to be approximately $264 million.

   The City currently has approximately $6 million in the pension stabilization reserve. It is currently invested in a short-term investment pool with the City's investment advisor, Chandler Asset Management. The yield from inception for this investment is about 4.5%.

## ANALYSIS

**OPEB** – The city has continued to pay benefits directly to retirees annually without drawing down on the CERBT. According to the actuarial valuation statement as of June 30, 2023, the Actuarial Determined Contribution (ADC) for FY 2025-26 is $6.4 million. As the benefit payments escalate, the funding policy is expected to exceed the ADC in FY 2027-28. If this trend continues, we can contribute less than the standard $802,000 to the Trust to offset the benefit payment and still be able to fully fund the OPEB liability by approximately FY 2036-37 according to the 30-year projection.

## 10-Year Projection Illustration

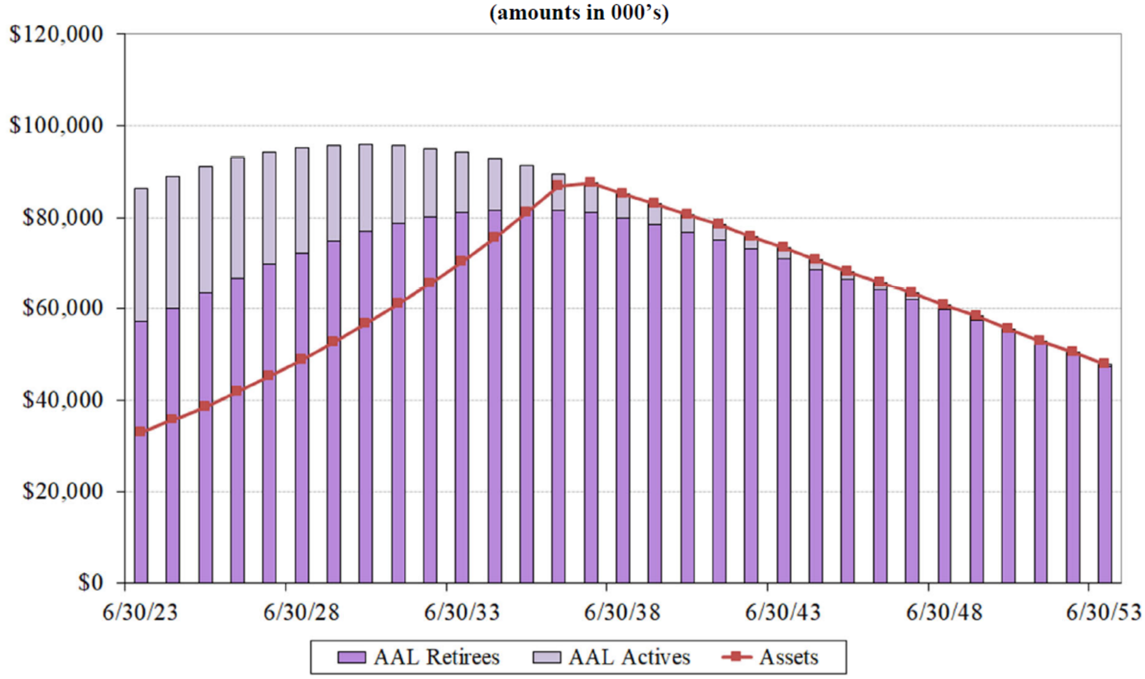
**(amounts in 000's)**

| Fiscal Year | ADC | Contribution: Cash Benefit Payments | Implicit Benefit Payments | Pre-Funding | Total |
|---|---|---|---|---|---|
| 2024/25 | $6,355 | $4,448 | $ 51 | $802 | $5,301 |
| 2025/26 | 6,394 | 4,809 | 58 | 802 | 5,669 |
| 2026/27 | 6,388 | 5,282 | 66 | 802 | 6,150 |
| 2027/28[11] | 5,396 | 5,678 | 75 | 802 | 6,555 |
| 2028/29 | 5,172 | 6,076 | 81 | 802 | 6,959 |
| 2029/30 | 6,912 | 6,343 | 90 | 802 | 7,235 |
| 2030/31 | 6,793 | 6,613 | 102 | 802 | 7,517 |
| 2031/32 | 7,505 | 6,892 | 110 | 802 | 7,804 |
| 2032/33 | 7,386 | 7,073 | 117 | 802 | 7,992 |
| 2033/34 | 7,204 | 7,238 | 127 | 802 | 8,167 |

[11] First year contribution policy expected to exceed ADC.
Projections assume $802k contributions continue until plan 100% funded.

## 30-Year Projection Illustration

**(amounts in 000's)**



**Pension -**

The City has two retirement plans (Miscellaneous and Safety) and three benefit tiers for each plan (Classic Tier 1, Classic Tier 2, and PEPRA—Public Employees' Pension Reform Act, which took effect in January 2013):

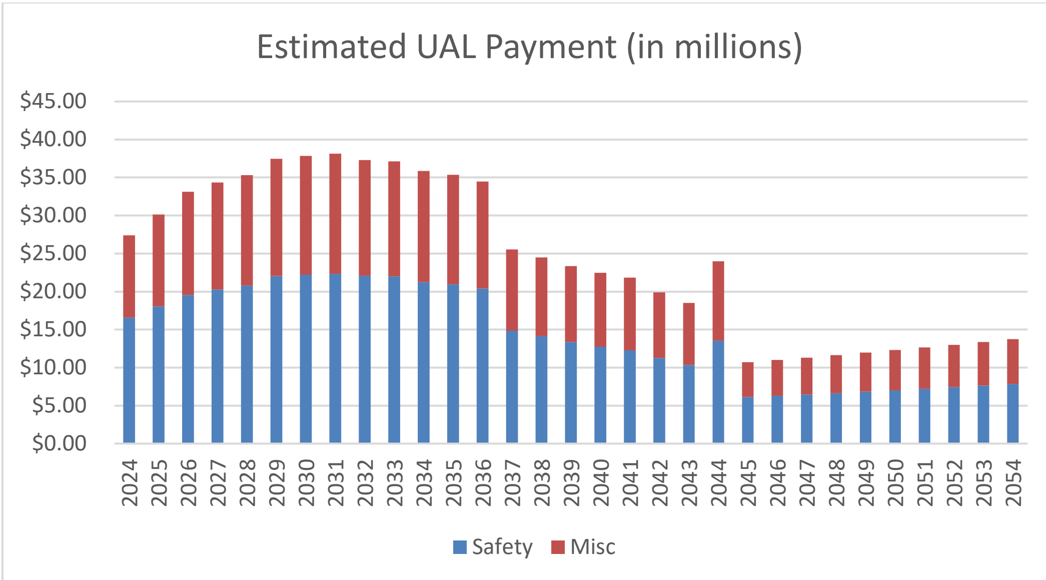
1) **Miscellaneous**
    a. Classic Tier 1: 2.7% @ 55
    b. Classic Tier 2: 2.0% @ 60
    c. PEPRA: 2.0% @ 62
2) **Safety**
    a. Classic Tier 1: 3.0% @ 50
    b. Classic Tier 2: 3.0% @ 55
    c. PEPRA: 2.7% @ 57

The City is a contracting member of CalPERS and, as such, the City is obligated to make certain payments to CalPERS each year. The City's annual pension obligations are comprised of two primary components: 1) Normal Costs and 2) Unfunded Accrued Liability ("UAL") Payments. Normal Costs represent the pension benefits earned by employees during the current fiscal year and are set by CalPERS as a percentage of payroll.

The UAL represents pension benefits that have already been earned with past service but not yet funded. It is a past due payment that is equal to the shortfall between the accrued liability and the current market value of assets in the pension fund. The creation of this liability stems back to the late 1990's when CalPERS was super funded and believed that investment returns would conservatively average 8.25% into the foreseeable future. As a result, State and local governments enhanced pension benefits (some retroactively) and did not keep up with normal cost payments. The Dot.com crash ensued shortly thereafter, followed by the Great Recession, and the CalPERS fund has been underfunded ever since.

CalPERS recalculates the UAL balance every year, and a number of factors impact the accrued liability (i.e., changes in actuarial assumptions or methodology, actual experience deviating from assumptions, demographic changes, wage growth, turnover, etc.). Additionally, the market value of assets can change dramatically from year to year depending on investment performance. As of the most recent Actuarial Valuation (dated as of June 30, 2023), the City's UAL was equal to approximately $264million.

CalPERS allows member agencies to pay off this liability over time. Each year, CalPERS releases a report for each member agency's pension plans that includes a fixed dollar UAL payment schedule. The City's UAL payment for Fiscal Year 2024-25 was about $27 million. Annual UAL payments are projected to increase until peaking at an estimated $39 million in Fiscal Year 2030-31, after which the UAL payments are projected to decline until the current UAL balance is paid off in Fiscal Year 2044-45. When calculating the accrued liability, CalPERS assumes a 2.75% annual wage growth; actual annual wage growth above this assumption increases the UAL payments. The chart below is a current projection of the City's UAL payment schedule incorporating the most recent investment gain of 9.3%.




For the City to pay off its UAL with the fixed dollar payment schedule illustrated in the chart above, CalPERS would need to achieve its assumed annual investment rate of return, or Discount Rate, which is currently 6.80%, and the actuarial assumptions would need to hold constant. However, actuarial assumptions change, and investment returns will not be exactly 6.80% every year. That is why the UAL payment schedule changes every year; and unlike a fixed-rate mortgage, it is not possible to know the exact repayment schedule (public agencies can only be certain of the payments that are due in the upcoming budget year). The UAL is a dynamic liability, and the City should anticipate that its UAL payment schedule will fluctuate as a result of everchanging variables. The existing aggregate funded ratio for both CalPERS plans is about 65.5%.

Despite this uncertainty, staff believe it is important to provide periodic updates to Council regarding the general trajectory of UAL payments, so that policies and plans can be implemented to meet pension obligations while maintaining desired service levels.

The City is currently projected to face a challenging UAL payment schedule through Fiscal Year 2036. As illustrated in the table below, from Fiscal Year 2024-25 through Fiscal Year 2030-31, UAL Payments will continue to increase by two to three million each year and slowly return to the FY 2023-24 level in 2036-37. The cumulative increase through FY 2030-31 will amount to about $12 million. If the City does not implement a plan to lower or smooth out these payments, the growing UAL payments will continue to crowd out future budgets.

| Fiscal Year | UAL Payments | Increase in UAL Above FY 2025 Baseline | Cumulative Increase |
|---|---|---|---|
| 2024 | $ 27.39 | | |
| 2025 | $ 30.15 | $ 2.76 | $ 2.76 |
| 2026 | $ 33.12 | $ 2.97 | $ 5.73 |
| 2027 | $ 34.33 | $ 1.21 | $ 6.94 |
| 2028 | $ 35.31 | $ 0.98 | $ 7.92 |
| 2029 | $ 37.46 | $ 2.15 | $ 10.07 |
| 2030 | $ 37.84 | $ 0.38 | $ 10.45 |
| 2031 | $ 38.15 | $ 0.31 | $ 10.76 |
| 2032 | $ 37.28 | $ (0.87) | $ 9.89 |
| 2033 | $ 37.14 | $ (0.14) | $ 9.75 |
| 2034 | $ 35.85 | $ (1.29) | $ 8.46 |
| 2035 | $ 35.34 | $ (0.51) | $ 7.95 |
| 2036 | $ 34.49 | $ (0.85) | $ 7.10 |
| 2037 | $ 25.56 | $ (8.93) | $ (1.83) |

**Proposed Pension Funding Policy**

**Policy Objectives and Goals**

- Maintain the City's sound financial position;
- Ensure the City has the flexibility to respond to changes in future service priorities, revenue levels, and operating expenditures;
- Provide guidance in making annual budget decisions;
- Protect the City's creditworthiness;
- Ensure that all pension funding decisions are structured to protect both current and future taxpayers, ratepayers, employees, and residents of the City; and
- Ensure that the structure of Pension Obligation Bonds, if authorized and issued, is consistent with the City's strategic planning goals, objectives, capital improvement program, budget, and Debt Management Policy.

***Additional Discretionary Payments (ADPs) to CalPERS.*** Although "resetting the table" by making a large payment to CalPERS with POB proceeds is not currently a feasible strategy, the City can make smaller Additional Discretionary Payments (ADPs)—payments above and beyond the annually required contributions (ARC) calculated by CalPERS. These payments can be used to prepay small amounts of "principal" on the UAL, thereby saving the 6.80% associated "interest" that is charged to the City. "Slow and steady" ADPs chip away at the City's pension obligations; and over time, this strategy can result in significant savings. Although this strategy requires long-term budgetary discipline and prioritization, it is less risky compared to POBs since the City would not be borrowing funds to pay CalPERS. Additionally, making smaller ADPs to CalPERS on a regular basis (i.e., dollar cost averaging) mitigates the market timing risk of a large lump sum deposit with CalPERS that is invested in the market all at once.

There is some associated investment risk if making a big lump sum payment. However, making periodic payments over time can limit this risk.

***Pension Stabilization Reserve Fund.*** The City currently has $6 million in a Council-designated Pension Stabilization Reserve Fund. The goal of this reserve fund is to set aside additional funds to supplement pension costs, including normal costs, offset future unexpected contribution rate increases, or use as a rainy-day fund when revenues are impaired based on economic or other conditions. Monies in this reserve fund are subject to California Government Code investment restrictions and the City's Investment Policy. These investment restrictions, while resulting in lower anticipated investment returns, carry lower risk; therefore, the monies can be invested in a manner that doesn't risk significant investment losses. Since last discussion, staff have taken advantage of the higher interest rate environment. As such, the reserve has grown from $5.5 million to $6 million. However, the interest rate is likely to come down in the next year or so as the Federal Reserve gradually lowers the federal funds rate. The committee might consider an alternative investment strategy such as a Section 115 Trust.

***Section 115 Trust.*** The timing of when funds are available may not line up with the timing and amounts of ADPs that the City desires to make to CalPERS. This should not prevent the City from accumulating funds it has allocated towards paying down its pension obligations, and the City may consider setting up a Section 115 Trust. Money placed into the trust is irrevocable/legally restricted, meaning it cannot be withdrawn and used for another type of expenditure of the City other than pension costs (and OPEB costs if selecting a "combination trust"). Funds in the Section 115 Trust are not subject to California Government Code investment restrictions and therefore have the opportunity for greater investment returns (albeit with higher risk) than its General Fund reserves. The Section 115 Trust allows the City to prefund its pension obligations over time while maintaining oversight of investment management and control over the risk tolerance of the portfolio (i.e., conservative, moderate, aggressive).

The benefits of a Section 115 Trust include:

1. Assets in the trust will offset liabilities on the City's balance sheet.
2. Assets held in trust will allow for greater investment flexibility and risk diversification compared to the City's investment portfolio.
3. The City will control the risk tolerance of the portfolio. The City should hire an investment advisor to manage the Section 115 Trust.
4. City will have the flexibility to access trust assets any time, as long as they are used to pay employer pension obligations (including normal costs).
5. Assets can be used to make "slow and steady" ADPs to achieve UAL savings over time or pay for additional UAL above and beyond what was projected due to any actuarial or investment deviations to offset the impact to the General Fund.

The risk associated with a Section 115 Trust is that the investments can be in a negative position at a time when the City may need to make a large withdrawal to offset pension costs when the City's revenues are impaired (i.e., during a recession). Over time, however, if selecting a moderate investment strategy, the trust should earn more than the City's General Fund reserves while not incurring as much risk as CalPERS' investment strategy. And as mentioned previously, a Section 115 Trust is a good vehicle for accumulating funds while making regular ADPs to CalPERS.

***Potential Funding Sources.*** Having a plan to make ADPs to CalPERS on a regular basis, retaining a Pension Stabilization Reserve Fund, and setting up a Section 115 Trust are prudent and straightforward strategies for chipping away at the City's UAL and for setting aside funds to offset future pension costs during recessionary periods. The challenge is in identifying funding sources for the ADPs, Pension Stabilization Reserve Fund, and Section 115 Trust. The City can explore, and if feasible, pursue the funding sources identified below:

**A. CalPERS Prepayment Savings**

Each year, CalPERS gives its member agencies two options for making its UAL payment: 1) make monthly payments to CalPERS; or 2) make a lower (approximately 3% savings) lump sum payment for the entire year by July 31$^{st}$ to CalPERS. The City has been implementing the second option to take advantage of the savings offered by CalPERS. The City could consider budgeting for the full UAL, continuing to make the annual prepayment every July to CalPERS, and allocate the savings to the Pension Stabilization Reserve, contribute to a Section 115 Trust, or to make an ADP to CalPERS.

**B. Use of Reserves and One-Time Monies**

The City could also annually allocate a percentage of operating surplus or one-time monies to the Pension Stabilization Reserve, contribute to a Section 115 Trust, or to make an ADP to CalPERS.

## FISCAL IMPACT

The recommended pension policy would help to formalize the strategy that City would like to utilize to address long-term unfunded pension liabilities.

## RELATIONSHIP TO STRATEGIC PLAN

The approval would meet the City's Strategic Plan Priority Area 3 – Financial Stability.

## CONCLUSION

Staff are seeking the Budget Committee's input to formalize a pension liability management policy to address the long-term unfunded liability.