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Attachments:	1. Attachment 1 - General Fund Tax Revenue, 2. Attachment 2 - General Fund Expenditures by Department, 3. Attachment 3 - General Fund Expenditures by Type, 4. Attachment 4 - Historical & Projected Pension Contributions, 5. Attachment 5 - CalPERS ROI 1994-95 to 2017-18, 6. Attachment 6 - Schedule of Amortizaton Bases, 7. Attachment 7 - General Fund 10-year Forecast - No Additional Contributions, 8. Attachment 8 - General Fund 10-year Forecast $1M contribution to CalPERS, 9. Attachment 9 - General Fund 10-year Forecast $1M contribution to pension trust, 10. Attachment 10 - PowerPoint Presentation		

Date	Ver.	Action By	Action	Result

Study session regarding a comprehensive financial review of the City of South San Francisco, including pension costs *(Christina Crosby, Interim Director of Finance)*

RECOMMENDATION
Staff recommends that the City Council receive this report. This is an information only item. No action is requested at this time.

BACKGROUND/DISCUSSION
The purpose of this agenda item is to provide the City of South San Francisco City Council and the community in general with financial context to better understand the issue of escalating pension costs.

Like other general law cities of its kind, the City of South San Francisco (City) obtains the majority of its funding through taxes to provide services to the community. The City's primary taxes are property tax, sales tax, and transient occupancy tax (TOT), all of which are accounted for in the City's General Fund. The General Fund serves as the City's primary operating fund, and as such, is the primary focus of the study session.

Major Revenues
Property Tax
Since 1978, the property tax framework has been guided by Proposition 13, which includes the following principal tenets:

1. Annual property tax assessment is limited to one percent (1%) of the assessed value (AV) of land and improvements.
2. Annual increase in assessed value is limited to no more than two percent (2%).
3. Allocation of the 1% property tax between public entities is largely static. In San Mateo County, on

average, school districts receive 43 percent, the County receives 26 percent, and local municipalities receive 18 percent. In other words, for every dollar paid in property tax, local cities receive $0.18.

4. Property is reappraised to current full value immediately upon a change in ownership.

At 30 percent of total General Fund revenues, property tax is the City's top revenue source. In Fiscal Year (FY) 2017-18, the City received $34.1 million in property tax, the majority of which came from current year secured property tax ($17.4 million).

Sales Tax

The State of California began imposing sales tax on retailers for the privilege of selling tangible personal property in 1933. In 1935, the state added "use tax" to protect retailers from then tax-free, out-of-state competitors. Over the course of a decade, 324 local cities established their own sales taxes. In an effort to promote administrative efficiency and uniformity, the Legislature passed the Bradley-Burns Local Sales and Use Tax Law in 1955 (Bradley-Burns). Of the current 9.25 percent sales tax rate in South San Francisco, the City receives 1.0 percent, pursuant to Bradley-Burns, and 0.5 percent, pursuant to Measure W, which was approved by South San Francisco voters in November 2015.

In FY 2017-18, the City received $17.6 million in sales tax revenues, which represented 15 percent of total General Fund revenues. Measure W revenues totaled $11 million. Since inception, the City has received $21.5 million in Measure W revenues.

Transient Occupancy Tax (TOT)

TOT is a general tax imposed on occupants for the privilege of occupying a room in a hotel, motel, inn, etc. The City's current TOT rate is 10 percent per transaction, plus the South San Francisco Conference Center tax of $2.50 per night/room. FY 2017-18 TOT revenues were $14.0 million, or 12 percent of total General Fund revenues.

On November 6, 2018, South San Francisco voters approved Measure FF, which will increase the TOT rate from 10 to 12 percent as of January 1, 2019, 13 percent as of January 1, 2020, and finally, 14 percent as of January 1, 2021.

As illustrated in Attachment 1, tax revenues, including all of the aforementioned taxes, business license taxes, and property transfer taxes, totaled $71.6 million, or 64 percent of total General Fund revenues in FY 2017-18. Due to the reliance upon tax revenues for operational funding, local government entities, such as the City of South San Francisco, are susceptible to the ebb and flow of the local, state, and national economy. Reliance upon tax revenues poses a challenge to service delivery during periods of economic contractions, as employee salaries and benefits comprise 77 percent of the City's General Fund operating costs.

Major Expenditures

As indicated in Attachment 2, in FY 2017-18, excluding transfers, from a department perspective, the City's Fire and Police departments comprised 55 percent of total General Fund expenditures, which is common for full service city government operations. Attachment 3 analyzes General Fund expenditures by type, where employee salaries and benefits cost $74.7 million, or 77 percent of total General Fund expenditures in FY 2017-18. Within that expenditure category, $46.3 million was spent on employee salaries, and the remaining $28.4 million was for employee benefits. Of the $28.4 million in employee benefits in FY 2017-18, $15.3 million, or 20 percent of total employee costs, reflected the City's payment to CalPERS. Attachment 4 provides historical and projected CalPERS pension contributions and the percentage of total General Fund expenditures. As manifest in the data, pensions will continue to take on a greater proportional share of General Fund expenditures each year, which warrants the discussion below to provide a clear understanding of pensions:

1. CalPERS background;
2. Key pension terms;
3. Pension liability primer; and
4. Options to address pension liabilities.

CalPERS Background

In 1932, the State Employees' Retirement System (SERS) was established. In 1939, the State Legislature passed a bill that allowed counties, cities, and school districts to participate in SERS. The City of South San Francisco joined SERS in 1945 to provide pension benefits to its employees. In 1992, SERS changed its name to the California Public Employees' Retirement System (CalPERS). CalPERS is the largest pension trust in the country, with $357 billion in assets and 1.9 million members.

Over the past two decades, CalPERS has endured significant investment return volatility, including the boom and bust of the dot com era and the Great Recession. CalPERS' strategic actions to reduce its exposure to economic fluctuation included changes in actuarial assumptions (discount rate, mortality rate), and changes in how gains and losses were amortized.

CalPERS' Investment Earnings

For every dollar of pension benefits paid to retired annuitants over the past twenty years, 59 cents is funded by CalPERS investment earnings, while 28 cents comes from contributions from CalPERS employers, and the remaining 13 cents comes from contributions from CalPERS members. CalPERS' dependence on its investment earnings to pay pension benefits, when in contrast against the investment volatility it has experienced, has played a major role in escalating pension costs.

The chart in Attachment 5 illustrates CalPERS' historical return on investment (ROI) in comparison to the discount rate, which is the expected rate of return over a long period of time. In CalPERS's case, the time horizon for measuring long term investment returns is 30 years. Over the past 24 years, CalPERS' annual rate of return has been as high as 20 percent in FY 1996-97 to as low as negative 23 percent in FY 2008-09. In order to address the investment volatility while ensuring long term sustainability, CalPERS has implemented a number of significant changes to its policies and actuarial assumptions.

Notable Changes to Policy and Actuarial Assumptions

In 2013, CalPERS shifted from a 30-year open amortization of its pension liabilities to a 30-year closed amortization. In the former, the Unfunded Accrued Liability (UAL) was refinanced each year for another 30-year period. In the latter, the UAL will be fully paid by the end of the amortization period.

Within the 30-year amortization, CalPERS implemented a ramping method to mitigate the impact of investment gains/losses and changes in actuarial assumptions. Within the 30-year period, the amortized cost of the first five years is gradually ramped up, 20 percent each year. If the annual cost of a particular amortization base is $100,000 per year, the then the cost in Year 1 would be $20,000. In Year 2, the cost would increase to $40,000, and so on. While this methodology is favorable in the short term, it is more costly to the employer in the long term, as there is less principal being paid than would be under normal amortization, and the total principal balance to pay off ends up being higher than the actual UAL due to the cost of interest. This phenomenon is known as negative amortization. At the tail end of the 30-year amortization period, the annual payment would go through a "ramp down" process, which is a reverse of the 5-year ramp up process.

In 2015, CalPERS adopted a funding risk mitigation policy, which established investment-related events that would be triggered if certain criteria were met. For example, if actual investment returns exceeded the discount rate by 4.0 percent, the discount rate would be reduced by 5 basis points (0.05 percent). While higher investment returns may be welcome by some, from CalPERS perspective, the deviation from expected outcome is an indication that the investment portfolio's risk profile (i.e. the proportion of CalPERS assets invested in higher risk investment vehicles) is too high.

In December 2016, the CalPERS Board of Administration approved a reduction of the discount rate from 7.5 to 7.0 percent. The reduction reflects the impact of a relatively low interest rate market on CalPERS long-term investment projections. While Governor Brown preferred to implement the accompanying increase in employer contribution rate immediately, the sharp contribution increase would have put several CalPERS member agencies into fiscal duress. As a compromise, CalPERS agreed to phase in the discount rate reduction over a three year period. Factoring in the five-year ramp up method, the full impact of the discount rate reduction will be not felt until seven years after implementation of the first amortization base. The CalPERS Board also temporarily suspended the funding risk mitigation policy discussed above until further notice.

In February 2018, CalPERS reduced the period to amortize gains and losses from 30 to 20 years. While the long-term cost to member agencies will be lower, the contribution rates will be higher in the short term. A similar analogy would be paying off a mortgage over 20 years rather than the traditional 30 years. The long-term cost is lower due to higher principal payments, shorter amortization period, and reduced interest expense.

Key Pension Terms and Concepts

Defined Benefit

Public pensions, such as those available through CalPERS, are defined benefit plans, where an employee's pension earnings are calculated based on the length of service and the highest salary, which typically is at the end of their career. As a general example, the annual pension benefit for a "Classic" member of CalPERS that worked their entire career for the City of South San Francisco for 30 years as a Parks Maintenance Worker and retired at the end of 2018 at the age of 55 would be calculated as follows:

Highest 12-month average salary: $66,414
Number of service years: 30
Pension plan: 2.7% @ 55
Benefit factor: (30 x 0.027) = 0.81
Annual pension benefit = $66,414 x 0.81 = $53,795

Member types

CalPERS members are identified as either "Classic" or "PEPRA". Classic members were a member of CalPERS before January 1, 2013. Any new members hired on or after January 1, 2013 are subject to a less rich pension benefit pursuant to the Public Employees' Pension Reform Act (PEPRA). Prior to PEPRA, the City Council adopted a second Classic tier for both the miscellaneous and safety pension plans to address the City's pension liabilities. As such, pension benefit tiers are as follows in the City of South San Francisco, where the member earns a percent for every year of service, with the latter portion of the formula reflects the retirement age.

Pension Plan	**Tier 1 Classic**	**Tier 2 Classic**	**PEPRA**
Miscellaneous	2.7% @ 55	2.0% @ 60	2.0% @ 62
Safety	3.0% @ 50	3.0% @ 55	2.7% @ 57

Pension Liability Primer

A net pension liability exists when pension plan liabilities exceed pension plan assets. Pension plan assets include investment earnings, employer pension contributions, and employee pension contributions. Pension plan liabilities reflect investment losses and changes in actuarial assumptions. To avoid extreme volatility, the above liabilities are amortized or spread over a long period of time, similar to a mortgage. Each year, any investment deviation from the discount rate, whether a gain or loss, is recognized as an amortization base. Each subsequent year over the 20-year amortization period, CalPERS assesses the annual amortized annual payment for each of the existing amortization bases. Attachment 6 provides the amortization bases as reflected in CalPERS' annual actuarial valuation for the miscellaneous and safety pension plans.

San Mateo County Grand Jury Report

On July 17, 2018 County of San Mateo Civil Grand Jury released a report entitled "Soaring City Pension Costs - Time for Hard Choices." There were multiple recommendations, including scheduling public hearings, posting detailed pension obligations on the City website and have City staff prepare and post a plan to address pension costs by June 30, 2019. The City has addressed the first two recommendations but has not adopted a formal plan as of yet.

Options to Address Pension Liabilities

The City Council already implemented a number of options to address pension liabilities:

- In 2010, the City Council established a second pension tier for classic CalPERS members. Any employee hired on or after April 25, 2010 falls under the second pension tier. For any miscellaneous members (non-public safety), the pension formula is 2.0% @ 60, as opposed to 2.7% @ 55 for tier 1 members. Any safety members earn 3.0% @ 55, as opposed to 3.0% @ 50.
- In FY 2015-16, the City established the CalPERS Stabilization Reserve to address pension contribution volatility.
- In July 2017, the Council approved agreements with public safety employees, which include International Association of Firefighters Local 1507 (IAFF), Police Officers Association (POA), Public Safety Managers (PSM), and Executive Management. These agreements outlined provisions for employee cost-sharing of City contributions to CalPERS as part of a long-term strategy to reduce the City's pension costs. The plan includes an increase in employee contributions to pension by 3% of salary, for a total employee contribution of 12% of salary. This will, in turn, reduce the City's costs by the same amount. The increases are scheduled to occur in 1% increments in each fiscal year from 2017 to 2019.
- In FY 19-20 City Council moved forward with two ballot measures to increase the City's tax base, Measure FF and Measure LL. Measure FF increases hotel Transient Occupancy Tax (TOT) by 2% in 2019. The ballot measure also authorized an additional 1% each year to a maximum TOT rate of 14%. Measure FF first increased the City's TOT rate to 12% effective January 1, 2019. Subsequently, it will then increase the City's TOT rate to 13% effective January 1, 2020. Finally, Measure FF would increase the City's TOT rate to a maximum of 14% effective January 1, 2021. This is estimated to generate approximately $5.9 million of additional revenue annually for the General Fund. In addition to Measure FF, Measure LL set the business license tax for all types of commercial cannabis operations permitted within the City at a minimum rate of 1% for gross receipts. Additionally, it established maximum rates for permitted cannabis uses: a maximum of 2.5% of gross receipts for Testing, a maximum of 4% of gross receipts for Cultivation; a maximum of 3% of gross receipts for Distribution, a maximum of 5% of gross receipts for Manufacturing, and a maximum of 5% of gross receipts for Delivery Only.

There are additional options that the City Council can consider to address pension liabilities, including:

Contribute additional funds to CalPERS

The City could consider paying funds in addition to the required annual contribution to pay down existing amortization bases. The additional funds would reduce the principal balance on the amortization base; shorten the period of time that the amortization base is paid, thus reducing the accompanying interest expense. The City's 10-year financial forecast, included as Attachment 7, depicts the projected outcome with no additional contributions to CalPERS. City staff projects operating outcomes that range from a deficit of $0.5M in FY 2028-29 to a surplus of $3.5M in FY 2021-22. Page 2 of Attachment 7 projects the City's reserves, including General Fund Reserve, Infrastructure Reserve, and the CalPERS Stabilization Reserve, which is projected to end FY 2028-29 with a balance of $13.3 million, and a projected pension liability of $130.0 million.

Attachment 8 provides a similar financial forecast where the City contributes $1.0 million additional funds per year to CalPERS beginning in FY 2022-23. In this scenario, staff projects operating outcomes ranging from a deficit of $0.7 million in FY 2028-29 to a surplus of $3.7 million in FY 2021-22. Page 2 of Attachment 8 notes that the additional contributions to CalPERS reduce the pension liability by $6.8 million, from $130.0 million to $123.2 million in FY 2028-29.

Contribute to a Section 115 Pension Trust Fund
In February 2014, the City Council authorized investment of $13.5 million in funds with the California Employers' Retiree Benefit Trust (CERBT) that had accumulated over a number of years in an internal service fund, intended to address the City's Other Post-Employment Benefits (OPEB) liability. The trust fund assets included in CERBT can be directly netted against the City's OPEB liability on the City's Comprehensive Annual Financial Statement (CAFR). This figure is noted as the Net OPEB liability. Since that time, the City's operating budget has included budget appropriations to ensure ongoing contributions to CERBT. As of September 30, 2018, the City's CERBT balance is $22,526,702.

Similar to the above concept, as one viable option to address pension liabilities, the City Council could invest funds into a Section 115 pension trust fund. However, there is one distinct accounting nuance with pension trust funds. Any assets from a pension trust fund are not directly netted against pension liabilities. Instead, they are reported as a restricted asset on the entity-wide financial statement in the CAFR. While the net position (the bottom line) is still the same, for some agencies, this nuance is a deterrent. If the City invested the current balance of $5.5 million in the CalPERS Stabilization Reserve, then beginning in FY 2022-23, $1.0 million on an annual basis into a Section 115 pension trust fund with a discount rate of 5.0 percent, as illustrated in Attachment 9, the City's net pension liability would be reduced by $19.0 million, from $130.0 million to $111.0 million.

Continue to Use a Multi-Pronged Approach
As stated above the City Council has been proactive in the steps that have already been implemented. Most consultants recommend using a combination of different approaches to address outstanding CalPERS obligations. Below are some of the most recommended:

- Continue to explore ways to raise revenue and increase the tax base. In addition to the above ballot measures the City is currently proactive in cost recovery and analyzes our Master Fee Schedule to ensure that we are charging adequately for service delivery.
- Continue to explore potentially contributing a percentage of General Fund surplus at the end of the fiscal year to the existing CalPERS Stabilization Reserve.
- Continue to work toward employee cost-sharing for the City's contribution to CalPERS with additional labor groups to lower the City's contribution to CalPERS.
- Continue to explore the possibility of creating a 115 pension trust fund with the existing $5.5 million in the CalPERS Stabilization Reserve.

FISCAL IMPACT

The City's pension contributions are projected to increase by $10.2 million, or 59 percent over the next decade. At this time there is no fiscal impact since staff is only seeking direction from City Council for future action.

RELATIONSHIP TO STRATEGIC PLAN

Developing a plan to fund the City's CalPERS pension obligations is part of the Financial Stability priority area of the strategic plan.

CONCLUSION

Staff recommends continuing a multi-pronged approach to address the challenge of escalating pension contributions and liabilities. This includes, continuing to explore increases in the tax base and charges for service, funding the existing CalPERS Stabilization Reserve with potential surpluses in the General Fund at fiscal year-end, and continuing to pursue cost sharing for the City's pension obligation with additional labor groups, and explore the potential of 115 pension trust.

Attachments

1. General Fund Revenues - Taxes
2. General Fund Expenditures by Department
3. General Fund Expenditures by Type
4. Historical and Projected Pension Contributions
5. CalPERS ROI 1994-95 to 2017-18
6. Schedule of Amortization Bases
7. General Fund 10-year Forecast - No Additional Contributions
8. General Fund 10-year Forecast - $1.0M Contribution to CalPERS
9. General Fund 10-year Forecast - $5.5M + $1.0M Contribution to Section 115 Pension Trust Fund
10. PowerPoint Presentation