CITY OF OAKLAND

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AGENDA REPORT

TO: Sabrina B. Landreth
City Administrator

FROM: Katano Kasaine
Director of Finance

SUBJECT: OPEB Obligations Funding Policy

DATE: May 14, 2018

City Administrator Approval

Date: 5/17/18

RECOMMENDATION

Staff Recommends That The City Council Adopt A Resolution Directing The City Administrator To Bring A Recommended Funding Policy For Other Post-Employment Benefits (OPEB) Developed In Conjunction With Industry Experts And Stakeholders To City Council No Later Than January 2019.

EXECUTIVE SUMMARY

The City of Oakland (the "City") provides medical benefits to retirees, also referred to as other post-employment benefits (OPEB). The City has historically chosen to pay its OPEB expenses as they come due (as monthly reimbursements to retirees) rather than as they are earned. Payment of OPEB expenses as they come due, rather than as they are earned, results in the accumulation of an unfunded liability for future benefits. As of July 1, 2015, the Unfunded Actuarial Accrued Liability (the "UAAL"), was $859.99 million. As of June 30, 2017, the City's projected net OPEB obligation was $359.98 million. In 2014, the City began investing into the California Employer's Retiree Benefit Trust ("CERBT"), an Internal Revenue Code (IRC) Section 115 Trust, with a balance of approximately $16.1 million as of May 14, 2018.

In recent years, the City was faced with mounting underfunded liabilities for pension plans, but there is an even more pernicious fiscal challenge that needs to be addressed. New updates to the accounting standards will bring OPEB obligations onto the City's books. **Beginning in the fiscal year ending June 30, 2018, the City must recognize the unfunded liabilities of OPEB on its balance sheets, which will impact the City's net position.** It is crucial that the city develop a plan and policy to address the problem of rising OPEB liabilities because pay-as-you-go is not a sustainable option long-term. Additionally, bringing unfunded OPEB liabilities to the forefront has the potential of dragging down the City's credit rating if there is no plan in place to sufficiently address the growing OPEB obligations. A lower credit rating could result in higher borrowing costs to the City and limits the access to the credit market.

In order to properly address and develop a comprehensive plan to tackle the OPEB unfunded liabilities, the City needs to engage all prospective stakeholders such as labor unions, employees, management and City Council, etc. Included as a request in the Mid-Cycle Budget Fiscal Year (FY) 2018-19 is $150,000 to engage industry experts to assist the City explore the various funding options and cost reductions strategies (such as restructuring of the current program) and develop a funding policy to address the OPEB obligations no later than January 2019.

BACKGROUND / LEGISLATIVE HISTORY

The City pays partial costs of health insurance premiums for certain classes of retirees. Retirees meeting certain requirements relating to age and years of service are eligible for health benefits. The health benefits are extended to retirees pursuant to labor agreements between the City and its employee labor unions and in resolutions adopted by the City.

The City implemented Governmental Accounting Standards Board (GASB) No. 45 in Fiscal Year 2007-08. As of July 1, 2015, the Actuarial Accrued Liability (the "AAL"), which is equal to that portion of the Actuarial Present Value of Benefits deemed to have been earned to date, was \$862.89 million, and the Unfunded Actuarial Accrued Liability (the "UAAL"), which is the AAL less actuarial value of assets, was \$859.99 million. As of June 30, 2017, the City's projected net OPEB obligation (defined, in terms of balance sheet liability, as the cumulative difference between the annual OPEB cost and the City's contribution to plan since 2008) was \$359.98 million after a pay-as-you-go amount of approximately \$20.42 million for Fiscal Year 2016-17.

GASB No. 45 required the City to book the shortfall between its annual required contribution (ARC) and actual payments, which is a relatively small amount compared to the full unfunded liability. With the implementation of GASB No. 74 and GASB No. 75 which replace GASB No. 45 (beginning the fiscal year ending June 30, 2018), the City is required to recognize and report all unfunded OPEB liabilities as an expense on the financial statements. Because of this change, the City will see a significant reduction in its net position and is required to recognize the unfunded liabilities of those plans on its balance sheets.

In addition to making annual payments on a pay-as-you go basis, the City has begun investing into the California Employer's Retiree Benefit Trust ("CERBT"), an agent multi-employer defined benefit post-employment healthcare funding plan administered by CalPERS. The CERBT is an IRC Section 115 Trust and an investment vehicle that can be used by all California public employers to prefund future retiree health and OPEB costs. The City has budgeted \$10 million in FY 2017-18 and an additional \$10 million in FY 2018-19 to fund OPEB obligations. As of May 14, 2018, the City has deposited approximately \$16.1 million into CERBT for its OPEB obligations. **Table 1** sets forth the contribution rates for retirees. **Table 2** sets forth certain information with respect to the City's OPEB obligations for the Fiscal Years ended June 30, 2013, through June 30, 2017.

Table 1
Monthly Contribution Rates for Retirees
(Calendar Year 2018)

	Miscellaneous [1]	Fire	Police
Single	\$558.42	\$ 779.86	\$ 779.86
Two-party	\$558.42	\$1,534.90	\$1,471.01
Multi-party	\$558.42	\$1,664.14	\$1,583.80

[1] Includes \$425.42 retiree medical reimbursement

Table 2
City of Oakland
Post-Employment Benefits Other than Pensions
Fiscal Years 2012-13 through 2016-17

Fiscal Year Ended June 30	Accrued Liability	Unfunded Liability	Annual OPEB Cost	Employer Contribution	Net OPEB Obligation
2013	$553,530,074(1)	$553,530,074(1)	$46,291,000	$17,622,000	$215,252,000
2014(2)	463,850,944	463,850,944	40,476,000	20,633,000	235,095,000
2015	463,850,944(1)	463,850,944(1)	41,585,000	19,758,000	256,922,000
2016	862,891,642	859,990,296	68,584,000	20,482,000	305,024,000
2017	862,891,642(1)	859,990,296(1)	75,386,000	20,425,000	359,985,000

(1) Assumed amount, based on prior year's valuation.
(2) The City began to partially pre-fund the annual required contribution in the year ended June 30, 2014 by participating in the CERBT sponsored by CalPERS, which increased the discount rate to 5.59%.

ANALYSIS AND POLICY ALTERNATIVES

Challenge and Impacts

A major challenge for the City that must be addressed is OPEB. The City has been paying the current year's premiums on a "pay as you go" basis and reporting them in financial statement notes. The City has not made the ARC to fund liabilities incurred. With the change in accounting standards and the increased financing reporting (GASB No. 74 and GASB No. 75), the City can no longer ignore the full funding of OPEB. As of July 1, 2015, the UAAL is approximately $862.9 million. The City is partially funded with CERBT with an asset of only $16.1 million as of May 2018. Therefore, the City's net OPEB obligation has totaled to approximately $360 million and growing as shown **Table 2**. The City is currently engaging Cheiron, Inc., an actuarial consulting firm, to prepare the actuarial valuation report as of July 1, 2017.

Reducing OPEB liabilities and providing health benefits to active employees and retirees is a challenge, and there is a need for solutions to the ongoing pressure the City is facing for the following reasons:

- The liabilities will continue to grow with compounding interest and eventually must be paid

- GASB No. 74 and GASB No. 75 make OPEB a long-term liability, which must be reported in the annual financial report

- Multiple outside entities use the annual report to assess the creditworthiness and financial soundness
    1. Ratings Agencies
    2. Investors and Creditors

- Funding liabilities now avoids pushing the funding problem onto future generations

Credit ratings agencies (Moody's, Standard and Poor's and Fitch Ratings) have indicated that they will consider OPEB funding status in their evaluations of a government's current financial status. OPEB funding policy and progress are becoming increasingly important among the factors that they use to evaluate a city's credit ratings. A large OPEB obligation and no plan in place to sufficiently address the UAAL is view as a credit weakness to the rating agencies. With the implementation of GASB No. 74 and GASB No. 75, these changes may have an impact on the City's credit rating. A lower credit rating could result in higher borrowing costs to the City and lack of access to the credit market.

Next Steps

While the retiree health benefit has been historically funded on a pay-as-you-go (Pay-Go) basis, i.e., paying only the actual cost of the benefit for retirees in the current fiscal year, financial accounting standards require the City to account for the benefit as if it were actuarially funded. Even though, the City is paying Pay-Go combined with a minimal contribution to CERBT, if the City does not address the UAAL, the City's Pay-Go obligation will continue to grow, consuming resources that would otherwise pay for vital programs and services. With increasing lifespans and rising healthcare costs, the magnitude of OPEB cannot be ignored. In order to properly address and develop a comprehensive funding policy to strategically tackle the OPEB unfunded liabilities, staff recommends engaging professional consultants with the expertise and experience to assist the City in developing funding options and policy best suited for the City. Below are some options that can be explored:

- ***Modifications to the City's existing plans*** - benefit reductions, cost constraints strategies for current employees vs retirees, changes to vendor contracts, cost-sharing, etc.

- ***Pay as you go (or "pay-go")*** – pays retiree benefits as they come due. Continue "Pay-As-You-Go" Funding. While making annual payments towards annual OPEB costs is the simplest method in the short run, the "pay-as-you-go" method in the long run may result in annually increasing Net OPEB Obligation. This may occur because the investment return assumptions used in the OPEB calculation for the "pay-as-you-go" method likely will be based on the public agency's general operating fund investments, which usually are based on a shorter investment horizon (and thereby, generally lower rates of return) than the investment horizon for certain trust funds.

- ***Pre-funding OPEB Liability*** - Pre-funding an account (e.g., making annual payments consistent with the ARC) will allow the City to allocate funds for the express purpose of funding future OPEB costs. The investment returns can be used to reduce the ARC and can result in lower long-term costs. Pre-funding amounts may be deposited in either:

    1) *Internal Fund "Reserve".* This fund is a separate fund set up within the City treasury. However, in order for funds to be counted towards the ARC for GASB purposes, they must meet certain conditions. Therefore, revenues deposited in internal funds will still be treated as "pay-as-you-go" funding for GASB accounting purposes.

2) *Trust Fund.* GASB does not require liabilities to be funded through an irrevocable contribution; however, the rules applied under GASB make the use of an irrevocable trust beneficial to the public agency

Table 3 sets some general advantages and disadvantage of the funding options:

Table 3

	Advantages	Disadvantages
Pay-as-you-go	• Current year expenditures are lower • Minimal outside professional assistant (actuary every other year, using a roll forward technique) • Convenient, requires no change to current process	• Creates largest liability • Does not address rising costs • No assets to invest so no mitigation of future liabilities • Actuarial valuation must use lower discount rate
Internal Fund "Reserve"	• Begins to address funding • Asset can revert to General Fund • Can use funds if needed	• No GASB benefits: so, structure does not improve UAAL or ARC • More expensive • Funds are not guaranteed for OPEB benefits • Lower investments return (invested in pool cash)
Trust Fund	• Provide funding for future benefits in a formal, segregated manner • Allow investment in higher return securities • GASB reporting benefits, improves UAAL and ARC reporting using higher discount rate and assets directly offset liabilities on balance sheet • Funds are dedicated to only OPEB benefits and are irrevocable • Intergenerational equity	• Requires higher budget commitment upfront • Ongoing budgetary commitment • Requires outside assistant

Like most cities and states, one significant fiscal challenge facing local governments is funding and accounting for OPEBs for current and retired employees, particularly in light of the new accounting standard GASB No. 74 and GASB No. 75. Below outline samples of other local government addressing the continued growing OPEB obligations:

- City of Alameda
  - 2014 Created OPEB Trust (initial deposit of $300,000)
  - April 2015, through negotiated labor contracts with Public Safety to help pay for the retirement benefit in return for salary increases
  - January 2016, City contributed $5.0 million and $250,000/annually for ten years
  - Public Safety employees annually contribute up to 4% of their salary (depending of date of hire)

- City and County of San Francisco
  - Contribution includes employee contributions and employer contributions, with limits on disbursements from fund until certain thresholds are met
    - Beginning in July 2016, employees hired prior to January 9, 2009 will also contribute a share of their salary to the fund with an equal matching contribution from the City, starting at 0.25% of salary each (employee and City) in Fiscal Year 2015-16, and rising by 0.25% of salary each fiscal year until it reaches 1% of salary each in Fiscal Year 2018-19.
    - No withdrawals from the Fund other than for reasonable administrative expenses are allowed prior to January 2020

- County of Los Angeles
  - Utilize a multi-year strategy to phase-in the prefunding portion, while continuing to make the Pay-Go contribution, limited by the ARC

Recommendation

Pay-Go is an unsustainable option. As a sound, financial management practice, it is preferable to set aside funds for these benefits as they are earned, investing those funds in an interest-bearing account. Over time, pre-fund assets will earn investment income that will be used to pay a portion of or all of future benefits costs, reducing the costs to the City. In addition to pre-funding, the City should explore cost containment strategies in order bring the OPEB obligations to a manageable level long-term. Staff recommends the City Council set-aside funding in an amount of $150,000 in the Mid-Cycle Budget FY 2018-19 to engage professional consultants with expertise to provide:

- Provide Benchmarks and comparative analysis (City's current benefit vs other agencies)
- Identify potential solutions to lower OPEB costs through policies and labor relations strategies
- Research and provide strategies to address/restructure OPEB program
- Analysis of the benefits, costs and timing of funding options
- Recommend and prepare a funding policy with the objective to:
  1. Demonstrates prudent financial management practices;
  2. Promotes long-term and strategic thinking;
  3. Provides guidance in making annual budget decisions; and
  4. Reassures bond rating agencies

Staff will return to Council no later than January 2019 to present a recommended funding policy to address the OPEB obligations including various funding options and cost reductions strategies.

FISCAL IMPACT

Staff is requesting for the City Council to allocate an amount not-to-exceed one hundred fifty thousand ($150,000) in the Mid-Cycle Budget FY 2018-19 for services contract related to the OPEB funding options and policy.

PUBLIC OUTREACH / INTEREST

This item did not require public outreach other than the required posting on the City's website.

COORDINATION

This report has been prepared by the Treasury Bureau in coordination with the Finance Department, City Attorney's Office and Budget Bureau.

SUSTAINABLE OPPORTUNITIES

Economic: There are no economic opportunities associated with this report.

Environmental: There are no environmental opportunities associated with this report.

Social Equity: There are no social equity opportunities associated with this report.

ACTION REQUESTED OF THE CITY COUNCIL

Staff Recommends That The City Council Adopt A Resolution Directing The City Administrator To Bring A Recommended Funding Policy For Other Post-Employment Benefits (OPEB) Developed In Conjunction With Industry Experts And Stakeholders To City Council No Later Than January 2019.

For questions regarding this report, please contact Katano Kasaine, Director of Finance, at (510) 238-2989.

Respectfully submitted,

Katano Kasaine

KATANO KASAINE
Director of Finance, Finance Department

Reviewed by:
David Jones, Treasury Administrator
Treasury Bureau

Prepared by:
Dawn Hort, Principal Financial Analyst
Treasury Bureau

FILED
OFFICE OF THE CITY CLERK
OAKLAND

2018 MAY 17 PM 2:51

Approved as to Form and Legality

City Attorney

OAKLAND CITY COUNCIL

RESOLUTION NO.________________C.M.S.

A RESOLUTION DIRECTING THE CITY ADMINISTRATOR TO BRING A RECOMMENDED FUNDING POLICY FOR OTHER POST-EMPLOYMENT BENEFITS (OPEB) DEVELOPED IN CONJUNCTION WITH INDUSTRY EXPERTS AND STAKEHOLDERS TO CITY COUNCIL NO LATER THAN JANUARY 2019

WHEREAS, the City has three programs in place to partially pay health insurance premiums for certain classes of retirees from City employment meeting certain requirements relating to age and service pursuant to labor agreements between the City and local unions and in City resolutions; and

WHEREAS, in August 2004, GASB issued Statement No. 45 ("*GASB 45*"), "Accounting and Financial Reporting by Employers for Post-Employment Benefits Other than Pensions" ("*OPEB*"), which addresses how state and local governments should account for and report the annual cost; and

WHEREAS, in 2014, the City began to partially pre-fund the annual required contribution (ARC) to the California Employer's Retiree Benefit Trust (CERBT), an agent multiple-employer defined benefit postemployment healthcare plan administered by CalPERS and CERBT is an Internal Revenue Code (IRC) Section 115 Trust and an investment vehicle that can be used by all California public employers to prefund future retiree health and OPEB costs; and

WHEREAS, the City's OPEB Actuarial Accrued Liability (the "AAL") which is equal to that portion of the Actuarial Present Value of Benefits deemed to have been earned to date was $862.89 million and the Unfunded Actuarial Accrued Liability (the "UAAL"), which is the AAL less actuarial value of assets, was $859.99 million as of July 1, 2015; and

WHEREAS, as of June 30, 2017, the City's projected net OPEB obligation (defined, in terms of balance sheet liability, as the cumulative difference between the annual OPEB cost and the City's contribution to plan since 2008) was $359.98 million after a pay-as-you-go amount of approximately $20.42 million for Fiscal Year 2016-17.

WHEREAS, beginning in the fiscal year ending June 30, 2018, the City must recognize the OPEB unfunded liabilities as an expense on the City's balance sheets due to the implementation of GASB 74 and 75 which replace GASB 45, which will impact the City's net position; and

WHEREAS, after further research, staff has determined Pay-As-You-Go is an unsustainable option, in addition to the pre-funding option, the City should explore cost containment strategies in order bring the OPEB obligations to a manageable level long-term; and

WHEREAS, the Mid-Cycle Budget Fiscal Year 2018-19 allocates an amount of $150,000 for consulting services related to OPEB fund policy and funding options; now, therefore be it

RESOLVED, that the City Council finds and determines that the foregoing recitals are true and correct; and be it

FURTHER RESOLVED, that the City Council hereby direct the City Administrator to bring a recommended funding policy for other post-employment benefits (OPEB) developed in conjunction with industry experts and stakeholders no later than January 2019.

IN COUNCIL, OAKLAND, CALIFORNIA, ______________________________

PASSED BY THE FOLLOWING VOTE:

AYES - BROOKS, CAMPBELL WASHINGTON, GALLO, GIBSON MCELHANEY, GUILLEN, KALB, KAPLAN, AND PRESIDENT REID

NOES -

ABSENT -

ABSTENTION -

ATTEST: ______________________________

LaTonda Simmons
City Clerk and Clerk of the Council
of the City of Oakland, California