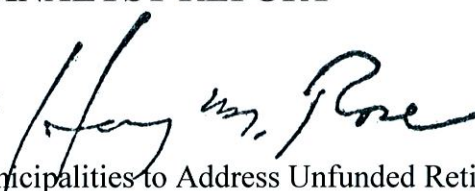


**CITY AND COUNTY OF SAN FRANCISCO
BOARD OF SUPERVISORS**

BUDGET AND LEGISLATIVE ANALYST

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(415) 552-9292 FAX (415) 252-0461

LEGISLATIVE ANALYST REPORT

To: Supervisor Farrell
From: Budget and Legislative Analyst 
Date: January 10, 2013
Re: Efforts by Other California Municipalities to Address Unfunded Retiree
Healthcare Liabilities

SUMMARY OF REQUESTED ACTION

Your office requested that the Budget and Legislative Analyst prepare a report on what other municipalities are doing to address the future costs of unfunded retiree health-care benefits.

As noted in your request, in November 2008, San Francisco voters passed Proposition B, a Charter amendment increasing the years of service required for new City employees to qualify for employer-funded retiree healthcare benefits and setting up minimum contribution requirements for the prefunding of those benefits. While Proposition B will slow the rate of growth of the City's unfunded liability over time, the City and County of San Francisco still needs to address its \$4.4 billion unfunded liability for employee benefits that were earned prior to July 1, 2010.

EXECUTIVE SUMMARY

In addition to pensions, public employees often receive other forms of post-retirement compensation such as healthcare, life insurance and access to legal services. Non-pension benefits for retirees are formally referred to as Other Post-Employment Benefits (OPEB). An important distinction between OPEB benefits and traditional retirement benefits is that OPEB benefits are generally provided to each retiree equally without regard to salary or position during employment. In addition, while pensions are largely pre-funded, most local government jurisdictions in California do not put funds aside each year toward their future OPEB costs.

As with pensions, if a city or county were to set aside and invest funds each year to cover future OPEB costs, the burden of covering those costs in the future would be significantly reduced due to the effects of compounded interest earned over time. For many pension systems, it is common for interest earned over multiple years to fund the majority of pension costs.

Public sector entities were not required to report OPEB liabilities until the implementation of Government Accounting Standards Board (GASB) Statements 43 and 45 (adopted in 2004 and implemented by December 2008). These new reporting standards have drawn attention not only to the substantial long-term OPEB liabilities for many local government entities but also to the fact that most of these local government jurisdictions do not fully fund their actuarially

determined Annual Required Contribution (ARC)¹ related to OPEB benefits. Full ARC payments on a regular basis such as annually allows for systematic funding of a jurisdiction's OPEB liability.

For City and County of San Francisco employees, Other Post-Employment Benefits consist of retiree healthcare benefits for employees and their spouses or domestic partners. These benefits are authorized by the Charter² and have been incorporated into memorandums of understanding between the City and County and its employee organizations.

The Charter does not specify a required level of funding that the City and County must contribute toward future OPEB costs. Like many California local government jurisdictions, the City and County's approach to funding its OPEB obligations has been to cover OPEB costs on a "pay-as-you-go" basis, covering only current benefits costs each year but not setting funds aside to earn interest and pre-fund future benefits costs, as is done for employee pensions.

For FY 2010-11, the City and County's Annual Required Contribution for Other Post-Employment Benefits was \$392,151,000, according to the FY 2010-11 Comprehensive Annual Financial Report (CAFR). However, the City and County of San Francisco contributed only \$145,756,000, or 37.2 percent, of the total required amount of \$392,151,000, which covered only current benefits costs for the year.

As a result of not making full contributions in FY 2010-11 and past years towards future OPEB costs, the City and County's estimated cumulative unfunded portion of its Annual Required Contributions for OPEB was approximately \$1.1 billion as of June 30, 2011.

The City and County's actuarially determined present value of projected total future OPEB costs for benefits already earned and for which no assets have been set aside (or the Unfunded Actuarially Accrued Liability (UAAL)), was \$4,420,145,827 as of FY 2010-11, according to the most recent OPEB valuation prepared for the Controller's Office.³ This significant Unfunded Actuarially Accrued Liability (which incorporates the approximately \$1.1 billion in unfunded Annual Required Contributions as of June 30, 2011) will continue to increase each year that the City and County of San Francisco does not provide the full Annual Required Contribution.

Until the adoption of Proposition B in 2008, all OPEB costs were paid for entirely by the City and County as employer, with no contributions required of employees. The FY 2010-11 CAFR reported a "zero percent (0%) funded status" for the City and County's OPEB liability, meaning that no funds had been set aside as of June 30, 2011 to fund future liabilities. However, a small amount of the City and County's Actuarially Accrued Liability for OPEB costs has been pre-funded since the FY 2010-11 CAFR was released, as a result of the mandatory employee and employer contributions required pursuant to Proposition B. Additional employee contributions to

¹ The Annual Required Contribution is the amount needed to cover: 1) current OPEB benefits; and 2) an amortized payment for actuarially determined unfunded future OPEB benefits due to current employees for past years of service. GASB Statements 43 and 45 require disclosure of OPEB payment and liability information by local government entities but do not mandate contribution levels.

² See Charter Sections A8.420 through A8.428.

³ *Postretirement Health Plan Actuarial Valuation Report*, dated November 12, 2012

pre-fund OPEB costs will be required starting in 2016 as a result of the voters' approval of Proposition C in 2011.

Proposition B increased the years of service required for more recently hired City and County employees to qualify for retiree healthcare benefits. Proposition B also required that the City and County of San Francisco, as employer, contribute one percent of salaries per year for employees hired on or after January 10, 2009 and that those employees contribute two percent of their salaries per year (for a total contribution of three percent of salaries per year). Proposition B further requires that these contributions be deposited into a newly created Retiree Health Care Trust Fund (RHCTF). Pursuant to Proposition B, assets in the RHCTF cannot be accessed by the City to pay for OPEB costs until 2020.

The City and County's most recent OPEB valuation reported \$3,194,672 in assets in the Retiree Health Care Trust Fund as of FY 2010-11. This amounts to only 0.07 percent of the City and County OPEB Unfunded Actuarially Accrued Liability of \$4,420,145,827. While the \$3,194,672 in assets represent a first step in pre-funding the City and County's OPEB liability, this amounts to less than one percent of the liability and is wholly inadequate relative to the total Unfunded Actuarially Accrued Liability of \$4,420,145,827. Even with compounded interest earnings on these assets, a significant UAAL will continue unless the City and County modifies its current OPEB funding strategy.

To further reduce the City and County's OPEB unfunded liability, Proposition C, approved by the voters in November 2011, requires that employees hired on or before January 9, 2009 contribute .25 percent of their salary to OPEB costs starting in January 2016. This contribution percentage will increase every year by 0.25 percent until it reaches a maximum of 1 percent of employee salaries.

Like the City and County of San Francisco, other local government entities throughout the State have taken steps to address their unfunded OPEB liabilities. However, overwhelmingly, most jurisdictions continue to fund OPEB on a pay-as-you-go basis. Some of the changes implemented by those jurisdictions that have chosen to pre-fund benefits or restructure their OPEB plans are presented in Exhibit 1, below. Since OPEB benefits are protected by law and defined in collective bargaining agreements, some of the changes implemented were only possible as the result of successful negotiations for changes in agreements with employee bargaining units.

Exhibit 1: Actions Taken by Selected California Jurisdictions and the City and County of San Francisco to Reduce their OPEB Liability

Jurisdiction	More restrictive qualifying requirements	Capping benefits	Increasing employee cost-sharing	Establishing separate trust fund	Converting to Defined Contribution Plan
Beverly Hills					✓
City of Los Angeles		✓	✓		
Palo Alto			✓	✓	
City of San Diego	✓	✓	✓	✓	✓
County of Sonoma	✓			✓	✓
City & County of SF	✓		✓	✓	

Sources: Comprehensive Annual Financial Reports and websites for each jurisdiction

While there are many potential strategies for local governments to reduce unfunded OPEB liabilities, one of the most effective approaches appears to be pre-funding these liabilities. Funds that are set-aside, invested and earn interest that compounds over time can significantly reduce the level of employee and employer direct funding to pay for OPEB costs. Similar to traditional pensions, for which funds are set aside and invested in the present to cover benefit costs in the future, compounded interest earnings would most likely end up covering the majority of OPEB costs.

While there are numerous variables affecting increases in healthcare costs, many of them beyond the City and County of San Francisco’s control, any steps that the City and County of San Francisco can take to control healthcare costs for its employees and retirees could also help lower the OPEB liability.

BACKGROUND

In addition to salary, public employees often receive other forms of compensation for their services, which accumulate over the term of employment. These benefits can include traditional pensions as well as non-pension benefits such as healthcare, life insurance and access to legal services. Collectively, non-pension benefits for retirees are commonly referred to as Other Post-Employment Benefits (OPEB). In California, some form of OPEB benefits are offered⁴ by 86 percent of cities, 91 percent of counties and 89 percent of school districts.

Typically, retiree healthcare benefits are structured as either defined benefit or defined contribution plans. Defined benefit plans stipulate the amount of benefit to be provided to the employee after retirement. Defined contribution plans specify the amount to be contributed by the employer on behalf of the employee throughout employment, without specifying how much the employee will receive upon retirement.

Although not received until employment ends, qualifying employees earn OPEB benefits each year while employed. Unlike traditional retirement benefits, OPEB generally offers the same benefit to each retiree, without relation to salary or rank during employment. A review of Fiscal Year 2010-11 audited financial statements for 34 of California's larger cities and counties showed that the majority of these jurisdictions are covering their OPEB costs on a pay-as-you-go basis, so that only the current benefits that are due in a given year are paid, despite the long term benefits and contribution savings created by setting aside current funds for future costs since investment returns relieve the pressure of future funding. In order to pre-fund OPEB benefits for current employees, restrict the access to and use of these monies and maximize return on investments, some local governments have established irrevocable trust funds in order to accumulate and invest current contributions to finance future costs.

In 2004, the Governmental Accounting Standards Board (GASB) issued two statements, GASB 43 and GASB 45, to standardize the way in which local governments report on OPEB liabilities. Previously, most governments only reported on the annual cash outlays for OPEB, which failed to illustrate the actual employer OPEB cost, including future liabilities. These two amounts are often quite different. Under GASB 43 and 45, local governments are now obligated to disclose a description of their plans, annual OPEB costs, details regarding how these payments will be financed, and the total Unfunded Actuarial Accrued Liability (UAAL), or the actuarially determined present value of projected future benefits already earned by employees. Across the country, the disclosure of this information has led to increased scrutiny by the public, redesigned plans in some jurisdictions, and revised approaches regarding funding future benefit obligations. The GASB standards themselves, however, address only financial reporting and accounting issues; determinations regarding OPEB funding policies remain the purview of local jurisdictions.

With the heightened focus on OPEB costs and liabilities, local governments have focused on ways to calculate and present the amount that should be set aside on an annual basis in order to ensure sufficient funding. GASB 45 defines this measure as the Annual Required Contribution

⁴ "Funding Pensions and Health Care for Public Employees", Public Employees Benefits Commission, January 2008.

(ARC), which is actuarially determined to provide sufficient resources to fund both the normal cost⁵ each year and the amortized unfunded liability⁶, if paid on an ongoing basis. Actual payments made by governments may or may not equal the ARC – and in fact are often less.

Even when employers do not contribute an annual amount on behalf of retirees, there are circumstances under which the local government would be required to report OPEB information. For example, some local governments allow retirees to continue participating in the employer’s group health insurance plan that is also available to active employees. Retirees typically pay the same group premium that is charged to active employees. However, according to GASB 45, this creates an OPEB liability because retirees theoretically have higher utilization rates of healthcare benefits than active employees. Therefore, the premium for retirees generally understates costs, creating an implicit rate subsidy from active employees that must be disclosed in financial statements.

GASB 45 created standards that require greater financial reporting transparency, which in turn created strong incentives to fund liabilities, particularly with regard to bond rating agency evaluations. Because GASB 45 requires the full liabilities to be reported, bond rating agencies contend that a government’s decision not to fund OPEB indicates that management has not recognized the depth of a major liability. This lack of recognition may weigh heavily in a rating decision and eventually could result in the jurisdiction paying higher interest expenses on future debt issuances.

Over the past decade, unfunded retiree healthcare liabilities have become an increasingly common and complex problem facing local governments around the country. As healthcare costs continue to rise and the number of public employee retirements grows, local governments are facing increased pressure to find solutions to address unfunded OPEB liabilities – or make other budget cuts and service reductions.

OPEB BENEFITS FOR SAN FRANCISCO PUBLIC EMPLOYEES

Employees of the City and County of San Francisco are eligible to receive retirement benefits through a defined benefit retirement plan, optional defined contribution plan, and other post-employment healthcare benefits. The defined benefit retirement and a deferred compensation plan are administered by the San Francisco Employees Retirement System (SFERS). The Other Post-Employment Benefits (OPEB) plan is administered by the City and County of San Francisco Health Services System, which also administers health benefit plans for active employees.

Unlike San Francisco’s traditional retirement benefits, its OPEB benefits have historically not been pre-funded; the City and County has instead employed a “pay-as-you-go” approach in which current costs are covered each year, but no funds are set aside for future costs. However, with the passage of Proposition B in 2008 and Proposition C in 2011, City and County employees are now, or will be in future years, required to make contributions to pre-fund a

⁵ “Normal cost” refers to the portion of the present value of estimated total benefits attributable to services received during the current year.

⁶ The amortization portion represents the amount to be paid in the current year as part of a twenty to thirty year amortization schedule to ensure sufficient funding is available to cover already earned OPEB costs in the future..

portion of the City and County's future OPEB costs. The contributions are placed in a Retiree Health Care Trust Fund (RHCTF) that was established pursuant to Proposition B specifically to hold assets to pre-fund OPEB costs. The City and County of San Francisco, as employer, is also required to make annual contributions to cover future OPEB costs for employees covered under the terms of Proposition B.

City and County of San Francisco employees (and their dependents) hired on or before January 9, 2009⁷ are eligible to receive OPEB benefits after five years of service, regardless of how long before retirement the employee stopped working for the City and County. The City and County currently pays 100 percent of the costs of this defined benefit plan for these retirees. However, pursuant to Proposition C, which was approved by the voters in 2011, City and County employees hired on or before January 9, 2009 will be required to contribute 0.25 percent of their salary to OPEB costs starting in January 2016. This amount will increase every year by 0.25 percent until it reaches 1 percent of salary.

Pursuant to Proposition B, the City and County provides varying levels of OPEB cost subsidies for employees hired on or after January 10, 2009, depending on when they were hired and their length of employment. The City and County subsidy levels for these employees in accordance with Proposition B are: 50 percent for employees with at least 10 but less than 15 years of credited service; 75 percent for those with at least 15 but less than 20 years of credited service; and, 100 percent for those who have 20 or more years of credited service.

The City and County's Comprehensive Annual Financial Report (CAFR) for FY 2010-11 reports that the pay-as-you-go OPEB plan had a 0% funded status, with an Actuarial Valuation of Assets of \$0. The Unfunded Actuarial Accrued Liability in FY 2010-11 was \$4,420,145,827 according to the biennial OPEB valuation released in November 2012.⁸ This amount represents the present value of the City and County's actuarially determined obligations for all future benefits already earned as of FY 2010-11.

The actuarially determined Annual Required Contribution (ARC) for FY 2010-11 was reported in that year's CAFR as \$392,151,000. Of this amount, the City and County contribution on behalf of retirees was only \$145,756,000, or 37.2 percent of the total amount actuarially determined to be needed to meet current and future OPEB costs for current employees.

The City and County's \$145,756,000 OPEB contribution in FY 2010-11 covered current costs but did not include the \$246,395,000 (the difference between the \$392,151,000 ARC and the \$145,756,000 actually paid) required to meet the actuarially determined share of amortized future OPEB costs that had already been earned as of FY 2010-11. At the time, contributing to only current costs had been the regular practice in the City and County. Had San Francisco also been making contributions that were sufficient to fund the future cost component of the Annual Required Contribution in FY 2010-11 and prior years, rather than using the "pay-as-you-go"

⁷ This date is the demarcation between two tiers of OPEB benefits provided by the City and County; one for employees hired on or before January 9, 2009 and a second for employees hired January 10, 2009 or after, The second tier was created with the passage of Proposition B in November 2008.

⁸ Postretirement Health Plan Actuarial Valuation Report, dated November 12, 2012, with information effective July 2010.

approach, the OPEB plan would be fully funded to date and would be benefitting from earning investment income on the assets set aside for this purpose.

Estimated Covered Payroll for OPEB for FY 2010-11, according to the November 2012 valuation report, was \$2,500,000,000 and the ratio of the \$4,420,145,827 UAAL to the Covered Payroll was 176.8%. The number of “inactive participants” for the fiscal year ended June 30, 2011 was 23,511, including retirees and their beneficiaries. These statistics provide broad indicators of the ability of a jurisdiction to fund benefit costs: (a) the higher the ratio of UAAL to covered payroll, the more difficult it will be for a jurisdiction to fund its obligations; and, (b) the higher the number of inactive participants, the greater the annual cost of benefits per active employee.

Exhibit 2 presents a summary of key facts pertaining to the City and County’s OPEB liability for FY 2010-11.

Exhibit 2: OPEB Liabilities and Funding Status, FY 2010-11

Number of Inactive participants + beneficiaries	23,511
Unfunded Actuarial Accrued Liability (present value of projected future benefit costs already earned but unfunded) ¹	\$4,420,145,827
OPEB Cost (accumulated contribution deficiencies as of FY 2010-11 as a result of City & County of SF not making full Annual Required Contributions in prior years)	\$1,099,177,000
OPEB Assets ²	\$0
Annual Required Contribution ³	\$392,151,000
Actual City Contribution ⁴	\$145,756,000
% Annual Required Contribution Paid	37.2%

Sources: FY 2010-11 Comprehensive Annual Financial Report and July 1, 2010 Postretirement Health Plan Actuarial Valuation Report, dated November 2012.

¹ Amount reported in *Postretirement Health Plan Actuarial Valuation Report*, dated November 12, 2012.

² This is the amount reported in the City and County’s Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2011. However, approximately \$3.2 million in assets were allocated later that year in the newly created Retiree Health Care Trust Fund, established in December, 2010.

³ This is the actuarially determined amount that the City and County should have paid in FY 2010-11 to cover its current year obligations (normal cost) and its amortized annual contribution toward future costs.

⁴ This is the amount the City and County actually paid during the year to cover current costs only. A contribution to cover future costs was not made.

Though the City and County’s FY 2010-11 CAFR reported \$0 in OPEB assets, that financial statement was based on the 2008 OPEB valuation, which was the most current at the time. Since then a new valuation has been completed, based on 2010 data, and assets are now recognized in the Retirement Health Care Trust Fund, which was created in December 2010 pursuant to Proposition B. As a result, there were reportable OPEB assets of \$3,194,672 in the Retiree Health Care Trust Fund as of June 30, 2011(though not reported in the CAFR due to timing differences). This \$3.2 million in assets represents only 0.07 percent of the City and County’s Unfunded Actuarial Accrued Liability of \$4.4 billion. The OPEB valuation released in 2012 projected that assets in the Retirement Health Care Trust Fund will increase to \$17.8 million by July 1, 2012 as more employee contributions are made, pursuant to Proposition B, and as those funds earn investment income.

COMPARISON WITH OTHER CALIFORNIA JURISDICTIONS

A comparison with the 14 cities with the highest Covered Payrolls reported in their FY 2010-11 CAFRs out of 21 cities reviewed by the Budget and Legislative Analyst shows that, at \$4.4 billion, the City and County of San Francisco had the largest Unfunded Actuarial Accrued Liability in absolute terms. Though the City of Los Angeles has a higher total Actuarial Accrued Liability than the City and County of San Francisco (approximately \$6.1 billion for Los Angeles vs. \$4.4 billion for San Francisco), approximately \$3.6 billion of the City of Los Angeles liability was funded in FY 2010-11 whereas the City and County of San Francisco's CAFR reported that it had not funded any of its Actuarial Accrued Liability during that reporting period.⁹

As shown in Exhibit 3, the City and County of San Francisco has the third highest ratio of Unfunded Actuarial Accrued Liability relative to Covered Payroll for the 15 jurisdictions shown in the table. Only the cities of San Jose and San Diego have higher Unfunded Actuarial Liabilities relative to their Covered Payrolls.

To provide additional context for the relative impact of each jurisdiction's liability and cost of benefits, it is useful to consider the ratio of the Unfunded Actuarial Accrued Liability¹⁰ (UAAL) relative to Covered Payroll (i.e., Unfunded Actuarial Accrued Liability/Covered Payroll). This measure is shown for each jurisdiction presented in Exhibits 3 and 4. The measure allows for a comparative assessment of the size of the unfunded liability relative to a common and related measure. The higher the ratio of Unfunded Liability to Covered Payroll, the weaker the plan's position (e.g., if a jurisdiction has a liability 2.5 times its covered payroll it will be in a weaker position than a jurisdiction with a liability 1.25 times its covered payroll).

⁹ The comparisons with other jurisdictions are based on FY 2010-11 CAFRs. Therefore, for consistency between jurisdictions, the information presented does not incorporate the contributions made by City and County of San Francisco employees toward the Unfunded Actuarial Accrued Liability starting in FY 2010-11, pursuant to Proposition B, since those amounts were not reported in the City and County of San Francisco's FY 2010-11 CAFR.

¹⁰ Unfunded Actuarial Accrued Liability represents the difference between the present value of the projected future benefits earned by employees by that date and the value of assets.

**Exhibit 3:
Unfunded OPEB Liabilities for California Cities as Reported in their Audited Financial
Statements for Fiscal Year 2010-11**

City	Year ¹	Covered Payroll	Actuarial Accrued Liability (AAL)	Unfunded Actuarial Accrued Liability	Funded Actuarial Accrued Liability	AAL % Funded	UAAL/Cvrd Pyrl ²	Funding Plan ³
San Francisco ⁴	2008	\$2,296,336,000	\$4,364,273,000	\$4,364,273,000	\$0	0.00%	1.90	PAYG
Los Angeles	2011	\$2,397,558,000	\$6,077,211,000	\$2,514,508,000	\$3,562,703,000	59%	1.05	FPF
San Jose	2010	\$498,568,000	\$1,872,679,000	\$1,706,082,000	\$166,597,000	9%	3.42	PPF
San Diego	2011	\$455,537,000	\$1,248,151,000	\$1,131,543,000	\$116,608,000	9%	2.48	PPF
Oakland	2010	\$310,155,000	\$520,882,000	\$520,882,000	\$0	0%	1.68	PAYG
Sacramento	2009	\$284,198,000	\$376,417,000	\$376,417,000	\$0	0%	1.32	PAYG
Anaheim	2010	\$177,229,000	\$211,914,000	\$147,994,000	\$63,920,000	30%	0.84	FPF
Long Beach	2010	\$328,107,000	\$130,252,000	\$130,252,000	\$0	0%	0.40	PAYG
Santa Ana	2011	\$157,564,000	\$122,720,000	\$122,720,000	\$0	0%	0.78	PAYG
Glendale	2009	\$140,934,000	\$103,947,000	\$103,947,000	\$0	0%	0.74	PAYG
Fresno	2011	\$246,461,400	\$84,252,383	\$84,252,383	\$0	0%	0.34	PAYG
Pasadena	2011	\$153,898,526	\$31,678,052	\$31,678,052	\$0	0%	0.21	PAYG
Burbank	2010	\$205,123,000	\$60,685,000	\$29,943,000	\$30,742,000	51%	0.15	FPF
Santa Clara	2010	\$101,739,000	\$30,886,000	\$23,855,000	\$7,031,000	23%	0.23	FPF
Santa Monica	2010	\$161,290,000	\$20,173,000	\$20,173,000	\$0	0%	0.13	PAYG

Source: FY 2010-11 CAFRs for each city.

¹ Year of most recent actuarial valuation used for CAFR reporting.

² Ratio of Unfunded Actuarial Accrued Liability to Covered Payroll.

³ PPF = partially pre-funded; FPF = fully pre-funded; PAYG = pay-as-you-go

⁴ For consistency with other jurisdictions, amounts shown for San Francisco are taken from the 2008 valuation reported in the FY 2010-11 CAFR. These amounts vary from those reported in the November 2012 Valuation Report (and elsewhere in this report) because the CAFR was based on the 2008 valuation. San Francisco's Funding Plan is listed as pay-as-you-go in this table, consistent with the City and County of San Francisco's FY 2010-11 CAFR.

Similarly, a comparison of the City and County of San Francisco's unfunded OPEB liabilities with those of the eight California counties with the largest¹¹ Covered Payrolls out of 13 counties reviewed by the Budget and Legislative Analyst is shown in Table 2. As can be seen, the City and County of San Francisco's Unfunded Actuarial Accrued Liability and Covered Payroll are second only to Los Angeles County.

Exhibit 4 also presents the ratios of Unfunded Actuarial Accrued Liability relative to Covered Payroll for the jurisdictions included in the table. Only the County of Los Angeles has a higher Unfunded Actuarial Liability relative to its Covered Payroll.

¹¹ Despite having large covered payroll, Alameda, San Diego, Fresno and San Bernardino counties are not reflected in this table because their OPEB plans do not provide relevant comparisons.

**Exhibit 4:
California Counties with the Largest Covered Payroll as Reported in their Audited Financial
Statements for Fiscal Year 2010-11**

County	Year ¹	Covered Payroll	Actuarial Accrued Liability (AAL)	Unfunded Actuarial Accrued Liability	Funded Actuarial Accrued Liability	AAL % Funded	UAAL/ Cvrd Pyrll ²	Funding Plan ³
Los Angeles	2010	\$6,700,000,000	\$22,900,000,000	\$22,900,000,000	\$0	0%	3.42	PAYG
San Francisco ⁴	2008	\$2,296,336,000	\$4,364,273,000	\$4,364,273,000	\$0	0%	1.90	PAYG
Santa Clara	2011	\$1,201,539,000	\$2,035,456,000	\$1,783,667,000	\$251,789,000	12%	1.48	PAYG
Contra Costa	2010	\$599,734,000	\$1,078,000,000	\$1,016,280,000	\$61,720,000	6%	1.69	PAYG
Orange	2009	\$1,267,427,000	\$456,005,000	\$361,895,000	\$94,110,000	21%	0.29	PPF
Sonoma	2011	\$314,045,000	\$316,737,000	\$297,691,000	\$19,046,000	6%	0.95	PPF
Kern	2010	\$487,323,000	\$149,962,000	\$149,962,000	\$0	0%	0.31	PAYG
Sacramento	2009	\$869,898,000	\$144,804,000	\$144,804,000	\$0	0%	0.17	PAYG
Riverside	2010	\$1,030,030,000	\$43,158,000	\$28,886,000	\$14,272,000	33%	0.03	PPF

Source: FY 2010-11 CAFRs for each county.

¹ Year of most recent actuarial valuation used for CAFR reporting.

² Ratio of Unfunded Actuarial Accrued Liability to Covered Payroll.

³ PPF = partially pre-funded; FPF = fully pre-funded; PAYG = pay-as-you-go

⁴ For consistency with other jurisdictions, amounts shown for San Francisco are taken from the 2008 valuation reported in the FY 2010-11 CAFR. These amounts vary from those reported in the November 2012 Valuation Report (and elsewhere in this report) because the CAFR was based on the 2008 valuation. San Francisco's Funding Plan is listed as pay-as-you-go in this table, consistent with the City and County of San Francisco's FY 2010-11 CAFR.

While the City and County of San Francisco is not the only local government with a 0% funded ratio reported in their FY 2010-11 CAFRs, the City and County's total liability amount, in absolute terms, is comparatively high.

Exhibit 5 shows how San Francisco compares to the 16 California cities and counties with the highest ratios of Unfunded Actuarial Accrued Liabilities to Covered Payrolls out of 34 jurisdictions reviewed by the Budget and Legislative Analyst. As can be seen, there are three other cities with greater ratios of Unfunded Actuarial Accrued Liability (UAAL) relative to their Covered Payrolls than the City and County of San Francisco. Compared to other California counties, the City and County of San Francisco is second only to Los Angeles County in terms of the comparison of its Unfunded Actuarial Accrued Liability relative to Covered Payroll.

**Exhibit 5:
Unfunded Actuarial Accrued Liability (UAAL) as a Percentage of Covered Payroll**

City	Covered Payroll	Unfunded Liability	Unfunded Liability/Covered Payroll
San Jose	\$498,568,000	\$1,706,082,000	3.42
Redding	\$50,300,000	\$125,500,000	2.50
San Diego	\$455,537,000	\$1,131,543,000	2.48
San Francisco	\$2,296,336,000	\$4,364,273,000	1.90
Roseville	\$80,664,000	\$146,097,000	1.81
Oakland	\$310,155,000	\$520,882,000	1.68
Palo Alto	\$83,285,000	\$139,701,000	1.68
Bakersfield	\$63,685,205	\$101,430,667	1.59
Sacramento	\$284,198,000	\$376,417,000	1.32
Los Angeles	\$2,397,558,000	\$2,514,508,000	1.05
County	Covered Payroll	Unfunded Liability	Unfunded Liability/Covered Payroll
Los Angeles	\$6,700,000,000	\$22,900,000,000	3.42
San Francisco	\$2,296,336,000	\$4,364,273,000	1.90
Contra Costa	\$599,734,000	\$1,016,280,000	1.69
Santa Clara	\$1,207,539,000	\$1,783,667,000	1.48
Sonoma	\$314,045,000	\$297,691,000	0.95
Kern	\$487,323,000	\$149,962,000	0.31
Orange	\$1,267,427,000	\$361,895,000	0.29
Sacramento	\$787,970,000	\$144,804,000	0.18

Source: 2011 CAFRs

Note: For consistency with other jurisdictions, amounts shown for San Francisco are taken from the 2008 valuation reported in the FY 2010-11 CAFR. These amounts vary from those reported in the November 2012 Valuation Report (and elsewhere in this report) because the CAFR was based on the 2008 valuation.

WHAT CAN LOCAL GOVERNMENTS DO TO ADDRESS UNFUNDED OPEB LIABILITIES?

As healthcare costs continue to rise, and greater numbers of public employees enter retirement, state and local governments face mounting pressure to address unfunded OPEB liabilities. In general, local governments can do two things: reduce the obligation or set aside a greater amount of funding now to cover future costs. While there are various ways to achieve these objectives, implementation can be complicated, particularly in the context of financial and legal constraints, including those related to collective bargaining agreements. The policy choices embedded in the options shown below involve balancing the escalating costs for future retiree benefits with other local government costs and needs.

Options include:

Pre-Funding Benefits

Options for employers to set aside funding for future costs are fairly straightforward. Basically, by investing more now, employers can significantly reduce the future costs of retiree benefits. Creating a trust fund and making annual contributions to that fund, which can then be invested, is a standard approach to pre-funding. Employers, however, use various methods for determining annual contributions – either using the actuarially determined Annual Required Contribution (ARC) as a standard, or by making lump sum contributions according to the availability of their funds.

Restricting Eligibility

A tool that is commonly used to reduce OPEB obligations is restricting eligibility for benefits. Because the total benefit amounts are largely driven by the number of people receiving them, the benefits provided and the number of years of coverage, employers can take steps to restrict those variables. Benefits are typically structured so that employees can receive them if they retire at a certain age, having completed a certain number of years of service. Employers can increase the retirement age for future employees, and/or require those employees to work a greater number of years before retirement benefits become available in order to shorten the number of years for which employees would receive retiree healthcare benefits.

Also, some employers provide benefit coverage for the spouses and dependents of retirees. Limiting benefit coverage to retirees only can provide significant cost savings. Like the restrictions noted above, OPEB plans can also be amended to limit coverage to retirees-only for future employees.

Introducing Cost Sharing Measures

Another way to reduce the employer obligation is to establish or increase the employee contribution to OPEB costs. Where cost-sharing already exists, raising the employee contribution rate can help relieve the burden on employers. If employees don't presently contribute to the benefit plan, it can be difficult to introduce contribution requirements for current employees – particularly where benefit packages have been negotiated under the terms of collective bargaining agreements. In those cases, employers can implement changes that will impact future employees – such as requiring the annual contribution of a specified percentage of salary from active employees into the OPEB fund or attempting to renegotiate collective bargaining agreements.

Using Multiple Sources to Fund Benefits

Some jurisdictions find added value in using multiple sources for funding. One option is to issue OPEB obligation bonds in order to fund an established trust. This helps reduce the UAAL, lowers the long term cost of OPEB liabilities and can potentially have a positive effect on a jurisdiction's credit rating. A possible disadvantage of OPEB obligation bonds is the concentration of investment risk in lump-sum deposits, such as when governments make large one-time contributions of tens of millions of dollars, as opposed to spreading the risk through annual ARC payments.

Placing Caps on Benefits

There are several ways that local governments can cap retiree healthcare benefits: establish a ceiling on the maximum dollar amount that can be received; placing a limit on the average annual increase allowed for all health plans; or, requiring additional contributions from retirees and active members.

Installing Narrow Network HMOs

Governments can also reduce the costs of retiree health benefits by installing a narrow network, of health maintenance organizations (HMOs) as the primary healthcare provider for employees so that more expensive medical providers are excluded and premium costs can be reduced. This tool has recently been adopted by public employers and the private sector to address rising costs of healthcare for active employees, and can be employed for retiree benefits, as well.

Changing the Benefit Structure

Another option to reduce OPEB liabilities for governments that offer a defined benefit plan is to change the structure of the plan. Defined contribution plans for retiree healthcare are more cost-effective, provide the employer with certainty about their costs in succeeding years, and have been widely accepted throughout the private sector. These plans can offer employees a plan more similar to a 401(k), whereby both employees and employers contribute to a health savings account throughout the term of employment. This interest-bearing account then becomes available upon retirement. While restructuring the benefit plan can be a difficult change to implement for current employees, it can be a very effective policy for reducing the benefit costs of future employees. Defined contribution plans can protect governments from the effects of rising costs of healthcare.

One related option that has had some success in California is offering current employees a hybrid option which includes transferring some of the value of the defined benefit into a defined contribution retiree health plan and a lump-sum payment of some percentage of the actuarial value of the OPEB benefit (see discussion regarding the City of Beverly Hills, below).

Public benefits are overwhelmingly of the defined benefit type. While some private sector companies continue to offer defined benefits, the clear trend in the private sector is to transition away from defined benefits in favor of defined contributions, thereby transferring the risks associated with market performance from the employer to the employee. An additional advantage of the defined contribution is that it leads to less volatile City budgets over time because the cost of providing benefits is constant, not varying over time to compensate for market performance. However, actuarially determined ARC payments, if made in full, are designed to smooth the effects of market volatility over time.

WHAT HAS SAN FRANCISCO DONE TO ADDRESS UNFUNDED OPEB LIABILITIES?

San Francisco has taken steps in recent years to address its unfunded OPEB liabilities. In 2008, San Francisco voters passed Proposition B to increase the years of service required for employees hired on or after January 10, 2009 to qualify for subsidized health benefits at retirement, and adjusted the formula for calculating retiree health benefits for new employees. For employees hired on or after January 10, 2009, the City and County is required to pay a percentage of the employee's retiree health costs but only after a minimum of 10 years of service. The contribution level of the City and County increases the longer the employee works, as follows: 0% for employees with 5 to 10 years of service; 50% for employees with more than 10 and up to 15 years of service; 75% for employees with more than 15 and up to 20 years of service; and 100% for employees with 20 or more years of service.

Proposition B also created the Retiree Health Care Trust Fund (RHCTF) to separately account for funds set aside for future retiree health benefits. The measure established a defined employee and employer contribution to future retiree healthcare costs, so that employees hired on or after January 10, 2009 must pay 2 percent and the City and County must pay 1 percent of their gross salary into the new trust fund, until the trust fund is fully funded.

The RHCTF receives employer and employee OPEB contributions, which will earn interest and will serve as the funding source for future OPEB costs. The trust fund will be the source for distributions for retiree healthcare benefits. The trust fund was created to pay for the City and County's future costs related to retiree healthcare and any other postemployment benefits. Though not formally established until December, 2010, \$3,194,672 in net assets were set aside for deposit into the RHCTF as of July 1, 2010. No disbursements from the RHCTF, other than to pay reasonable expenses of administering the trust, will be made before January 2020. The City and County expects that contributions to the Trust Fund will eventually fully fund future retiree health costs, but this will be many years in the future.

Proposition C, passed in November 2011, requires employees hired on or before January 9, 2009 to contribute 0.25 percent of salary to the RHCTF, beginning July 1, 2016. This contribution amount will increase annually by 0.25 percent per year to a maximum of 1.0 percent of salary.

WHAT HAVE OTHER CALIFORNIA JURISDICTIONS DONE?

The Budget and Legislative Analyst has reviewed actions taken by a number of cities and counties throughout California to reduce their OPEB liabilities. The following represents some of the more significant actions taken to address OPEB liabilities by jurisdictions for which such information was available.

City of San Diego

In January 2008, San Diego's City Council voted to invest a lump-sum amount of \$30 million in a trust fund in order to begin reducing that city's \$1.1 billion unfunded OPEB liability.

In 2011, following negotiations with the City's six labor unions, the City took additional steps to cap retiree healthcare benefits by negotiating three options for employees hired before July 1, 2005: (1) a guaranteed benefit of \$8,880 per year with an annual escalator of 2 percent, which requires a \$100 monthly contribution by participating employees; (2) a guaranteed benefit of

\$5,500 with no annual escalator and a \$50 monthly contribution from the retiree; or (3) a defined contribution that aims to provide an annual benefit of \$8,500, with no cost to the employee. All retiree healthcare benefit options have been eliminated for new employees. Employees hired after July 2005 are not eligible to receive retiree healthcare benefits.

City of Beverly Hills

In 2010, facing a \$58 million unfunded OPEB liability, the City of Beverly Hills designed a multi-pronged approach to reduce costs. First, the City established a defined contribution OPEB plan for new employees. It then issued pension obligation bonds, using the proceeds to fund a voluntary exchange program that was offered to current employees (hired before 1/1/10). Employees could opt out of their defined benefit healthcare plan in exchange for a one-time payment equivalent to the plan's actuarially-determined present value. Part of the payment went into a defined contribution retiree healthcare savings account, and employees then had the option to take the remainder in cash or for it to be deposited into the defined contribution plan. Approximately 58% of employees took the option. Through this offer, Beverly Hills reduced its OPEB liability by \$6.4 million in 2009-10, and by \$12.8 million in 2010-11 (approximately 33 percent of the 2010 unfunded liability).

City of Los Angeles

Since 2006, the City of Los Angeles has fully funded its actuarially determined Annual Required Contribution to the Los Angeles City Employees Retirement System (LACERS) and was at least partially funding it in previous years. In 2011, after successful negotiations between the Mayor and employee unions, the city capped its subsidy at \$1,190 per month per person for all employees who retire after that year. If future retirees want to exempt their benefits from the cap, they now must contribute 4 percent of annual pay.

Sonoma County

Like many other jurisdictions, Sonoma County established an OPEB trust in 2008 to begin pre-funding retiree healthcare benefits. Following extended discussions and negotiations with the county's Joint Labor Management Benefits Committee, the County also created three tiers of employees to restrict OPEB eligibility and reduce costs. For employees hired before 1990, the County provides full benefits to retirees and their dependents. For employees hired between 1990 and 2009, the County provides OPEB benefits to retirees but only after 10 years of service, and to retirees plus one dependent after 20 years of service.

Employees hired after June 2009 are no longer eligible for the defined benefit plan. In its place, the County has established a defined contribution plan in the form of a Health Reimbursement Account. When a full-time employee becomes eligible, Sonoma County will make a one-time, lump sum contribution of \$2,400. The contribution for eligible part-time employees will be pro-rated. Each pay period following the initial contribution, Sonoma County will contribute \$.58 for every hour the eligible employee is in pay status, up to 80 hours per biweekly pay period (excluding overtime hours).

City of Palo Alto

This city established an OPEB trust in 2008, into which it contributes more than its ARC every year, moving towards an eventual contribution rate of 100% of ARC. Additionally, the City placed a cap on healthcare premiums for employees hired after February 2007, who are no longer eligible to participate in the most expensive plan. The City of Palo Alto took another step to reduce its OPEB liability when it introduced cost-sharing. This was accomplished through successful collective bargaining agreement negotiations between the City and the Service Employees International Union, whereby employees hired on or after January 1, 2004 share the cost of annual increases in medical premium costs, up to a maximum of 5 percent increase per year, not to exceed 10 percent. For employees hired before 2004, the City pays for 100 percent of the cost of retiree health benefits for their lifetimes.

CONCLUSION

As the costs of healthcare change and the number and lifespans of retirees increase, local governments must take action to address the rising liabilities associated with retiree healthcare benefits. Failure to do so jeopardizes the government's bond ratings, ability to provide essential services, and overall fiscal stability.

Although many of these obligations are protected by law and collective bargaining agreements, there are several options for governments facing growing unfunded liabilities. These include pre-funding benefit plans through the establishment of a trust fund and reducing the OPEB obligation through steps such as restricting the eligibility of future members, requiring higher employee contributions, capping maximum benefits, and changing the benefit structure. Pre-funding can be very beneficial because it shifts a significant portion of growing future costs from the employer and employees current contributions to compounded interest earnings on the set-aside funds.

The City and County of San Francisco maintains one of the highest unfunded OPEB liabilities in the state of California, both in absolute terms and relative to Covered Payroll. The City and County of San Francisco has taken steps in recent years to reduce this burden by restricting eligibility of employees hired on or after January 10, 2009 and requiring all employees to pre-fund a portion of the plan. A review of actions by other California jurisdictions offers additional considerations for San Francisco that include capping benefits, eliminating benefits for new employees, and requiring higher annual contributions into retiree healthcare trust funds.

While there are numerous variables affecting increases in healthcare costs, many of them beyond the City and County of San Francisco's control, any steps that the City and County of San Francisco can take to control healthcare costs for its employees and retirees could also help lower the OPEB liability.