Ballot Simplification Committee - DRAFT for Consideration on Monday, July 29, 2013
Retiree Health Care Trust Fund Charter Amendment *(working title only, subject to change)*
The Way It Is Now:

"Currently, the City pays for health care benefits of retired employees on a "pay-as-you-go" basis, with the City's "General Fund" paying for health care of retirees."

"In November 2012, the Controller's office issued a City report, which bench-marked San Francisco's current unfunded retiree healthcare liability at $4.4 Billion. The $4.4 Billion liability represents the future cost of providing retiree health care benefits earned by current employees and retirees."

"San Francisco's current retiree healthcare costs are estimated to increase from $150 million in 2013, to over $500 million in the next 20 years."

In January 2009, the City and County of San Francisco ("City") established the Retiree Health Care Trust Fund ("Fund") to pay for future retiree healthcare costs. A five-member Trust Fund Board ("Trust Board" administers the fund."

"The fund was created to save for future retiree healthcare costs – funds which will continue to grow annually through investment returns and contributions from current employees."

"The City and its employees make contributions into the Fund. The Trust Board may not use the Fund to pay for retiree health care costs until January 1, 2020."

"Currently, anytime after January 1, 2020, the Fund can be 100% depleted at any time, resulting in no savings to address the City's $4.4 billion unfunded retiree healthcare liability."

"In 2011, voters approved increasing employee contributions to the Fund, among other changes to the City Charter."

"The San Francisco Unified School District, San Francisco Superior Court, and the San Francisco Community College District can also choose to participate in the Fund. Currently, the Community College District is the only agency, besides the City, that participates in the Fund. The Fund places contributions from each agency into separate accounts."

"The Proposal"
"Restricting the City from making payments from depleting the Fund before it is fully-funded will allow invested funds to grow quicker, and result in the RHCTF assets being able to fully-fund retiree healthcare costs without any contribution from the City's General Fund. These limitations would not result in less funding for retiree health care, because of certain exceptions:

- For any fiscal year during which the City's account is fully funded – which means that the balance in the account is large enough to pay then projected, accrued retiree health care costs as they will come due;

- For any fiscal year before the account is fully funded when the City's retiree health care costs exceed 10% of the City's total payroll costs, and the Controller, the Mayor, a majority of the Board of Supervisors, and the Trust Board all agree to allow payments from the Fund for that year, but only to the extent necessary to cover the City's retiree health care costs exceeding 10% of the City's total payroll costs; or

- If the Controller, the Mayor, two-thirds of the Board of Supervisors, and the Trust Board approve changes to the expenditure limitation. Similarly, the proposed Charter amendment would prohibit other agencies from spending money in their Fund accounts until either:

- The agency's Fund account is fully funded; or Two-thirds of the agency's governing board and a majority of the Trust Board all approve the earlier payments.

- A "YES" vote means: If you vote "yes," you want to change the Charter to prohibit the City from depleting the Retiree Health Care Trust Fund until the RHCTF is fully funded, or under the listed specified circumstances."

- **A "NO" Vote Means:** If you vote "no," you do not want to make these changes to the Charter.

CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER

Ben Rosenfield
Controller

Monique Zmuda
Deputy Controller

June 19, 2013

Ms. Angela Calvillo
Clerk of the Board of Supervisors
1 Dr. Carlton B. Goodlett Place Room 244
San Francisco, CA 94102-4689

RE: File 130481- Charter amendment - City Retiree Health Care Trust Fund

Dear Ms. Calvillo,

Should the proposed Charter amendment be approved by the voters, in my opinion, the City's ability to withdraw from the Retiree Health Care Trust Fund (the "Trust Fund") to offset short term budgetary costs would be limited. As a result, the Trust Fund will more rapidly accumulate a balance that, when combined with investment income and required City and employee contributions, will provide significant operating budget savings to the City in the longer term.

The City currently pays for the health care benefits of retired employees on a "pay-as-you-go" basis essentially paying for the cost of these benefits as they come due each year. These expenses currently total approximately $150 million annually, or approximately 6 percent of payroll expenditures, but are expected to grow over time to approximately 10 percent of payroll expenses, or approximately $250 million in current dollars.

As a sound financial management practice, employers can instead set-aside funds as retiree health benefits are earned during an employee's active career and use investment income to reduce the future budgetary cost of the provided benefits.

The most recent actuarial analysis estimates that the cost of future retiree health care costs earned by current and future retirees as of July 1, 2010 is $4.4 billion, of which only $3.2 million has been set-aside. As a result of previous voter-adopted Charter provisions, the City has established a Retiree Health Care Trust Fund into which both the City and employees are required to contribute funds as retiree health care benefits are earned. Currently, these Trust deposits are only required on behalf of employees hired after 2009, and are therefore limited, but will grow as the workforce retires and this requirement is extended to all employees in 2016. While no withdrawals are currently permitted from the Trust Fund until 2020, ensuring that the balance will grow until that time, no such prohibitions are in place following that date.

The proposed Charter measure prohibits withdrawals from the Trust Fund following 2020 until sufficient funds are set-aside to equal future retiree health care costs, as determined by an actuarial study. Limited withdrawals prior to accumulating sufficient funds are permitted if City retiree health care costs rise above 10 percent of payroll expenses, with these withdrawals limited to no more than 10 percent of the Trust Fund balance. The City's external actuary has estimated that given these provisions, the Trust Fund will be fully-funded in approximately 30 years, at which time City costs will decline to approximately 2 percent of payroll expenses, or approximately $50 million in current dollars. These projections are dependent on assumptions of future medical inflation, investment returns, and other future trends, which will likely differ from those assumed. Higher rates of medical inflation or lower rates of investment returns will delay the shift to a fully-funded plan. The proposed Charter measure allows for revisions to these funding limitations and requirements on the recommendation of the Controller and an external actuary, and if approved by the Retiree Health Care Trust Fund Board, 2/3rds of the Board of Supervisors, and the Mayor.

The proposed Charter measure also (1) further clarifies the required segregation of moneys within the Trust Fund for other participating employers, (2) limits withdrawals from these sub-trusts by other participating government employers until their governing board has adopted a funding strategy by a 2/3rds vote, and (2) allows the Treasurer, Controller, and General Manager of the Retirement System to serve on the Trust Fund Board, rather than appoint members to the Board.

Sincerely,

Ben Rosenfield
Controller

Note: This analysis reflects our understanding of the proposal as of the date shown. At times further information is provided to us which may result in revisions being made to this analysis before the final Controller's statement appears in the Voter Information Pamphlet.

CITY AND COUNTY OF SAN FRANCISCO
BOARD OF SUPERVISORS

BUDGET AND LEGISLATIVE ANALYST

1390 Market Street, Suite 1150, San Francisco, CA 94102
(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 Charter[2] 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 (RHTCF). 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 offered[4] 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

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[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 cost[5] each year and the amortized unfunded liability[6], 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, 2009[7] 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.

Ben Rosenfield
Controller

Monique Zmuda
Deputy Controller

MEMORANDUM

TO: Mayor Edwin Lee
Members of the Board of Supervisors

FROM: Ben Rosenfield, Controller

DATE: November 20, 2012

SUBJECT: Report on Retiree (Postemployment) Medical Benefit Costs

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I am providing with this letter an updated valuation of the City's retiree (or postemployment) medical benefits liability as required by Governmental Accounting Standards Board Statement Number 45 (GASB-45), *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. The actuarial and analytical work was performed by Cheiron, Inc., the actuarial consulting firm that also provides services to the San Francisco Employee Retirement System. This letter briefly summarizes the analysis and the attached package includes Cheiron's July 1, 2010 Postretirement Health Plan Actuarial Valuation Report and a slide presentation illustrating the findings.

Executive Summary

- The City's unfunded actuarial liability for other post-employment health benefits (OPEB) reported in the July 1, 2010 valuation report is $4.42 billion. This number represents the future cost of providing retiree health benefits earned by employees and retirees as of that date, net of a modest balance of $3.2 million in the Retiree Health Care Trust Fund.

- This unfunded liability estimate is largely unchanged from the prior study performed two years ago, despite inflationary impacts that would otherwise be expected to increase it. This is largely due to lower than expected medical inflation during this past two years, a long-term assumption that medical inflation will be marginally lower in future years, and some reductions from steps the City has taken in recent years to reduce costs for new employees.

- Until recently, the City paid strictly for retiree medical benefits on a 'pay-as-you-go' basis, which means paying the cost of the retiree health benefits as they become due each year. As a sound financial management practice, it would be preferable to set-aside funds for these benefits as they are earned, investing those funds in an interest bearing account. It is assumed that over time, pre-funded assets will earn investment income that will be used to pay a portion of future benefit costs, reducing costs to future taxpayers and employees accordingly.

- As a result of Proposition B (2008) and Proposition C (2011), the City has taken important steps in this direction in recent years, which will slow the rate of growth of the City's unfunded liability in coming years. Beginning in 2009, the City and newly-hired employees contribute to a Retiree Health Care Trust Fund, which will be used to pay for future costs of a lower retiree health benefit level. Beginning in 2016, additional contributions to this fund on behalf of pre-2009 hires will also be required by both employees and the City.

- Given the scale of the overall benefit costs and previously accumulated liability, these pre-funded contributions are modest and will phase in gradually, as the workforce changes over many years. For fiscal year 2012, the City's pay-as-you-go expense was $151 million and contributions to the Retiree Health Care Trust Fund were $4.8 million. The City's unfunded liability will continue to grow for many years, albeit at a slower rate, given that the City's and employees' prefunding contributions are less than the interest due on the accumulated liability. The Controller's Office is available to work on a broader prefunding strategy that builds on these important steps from the past several years.

- As with all long-term projections, the City's unfunded actuarial liability for OPEB reported in the valuation report incorporates assumptions about the probability of events far into the future including the rate of return on investments, employee counts and wage rates, mortality rates and healthcare cost trends. The most significant driver of these projections is the future medical inflation assumption. To the extent that medical inflation exceeds these assumptions, the unfunded liability will increase, while to the extent that the City can control future inflationary increases, future costs will be lower than projected.

If you have any questions, please feel free to contact me at (415) 554-7500.

cc: Department Heads
Labor Organizations