ESTABLISHED 1850

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OFFICE OF THE MAYOR

August 2, 2021

TO: Solano County Civil Grand Jury

Re: City of Vacaville Response to 2020-2021 Grand Jury Report Entitled: City Of Vacaville Unfunded Liabilities: Pensions and Other Post-Employment Benefits

Dear Solano County Civil Grand Jury,

The following is the City of Vacaville's response to the Grand Jury Report entitled *City of Vacaville Unfunded Liabilities: Pensions and Other Post-Employment Benefits*

FINDING 1 – *The unfunded portion of the City of Vacaville's CalPERS pension plans liability increased from $126 million in 2011 to $209 million in 2019. This amount is categorized as high-risk by the California State Auditor. The unfunded OPEB liability as of June 30, 2019, exceeded $80 million.*

RECOMMENDATION 1a – *The City of Vacaville establish an annual contribution schedule to retire the unfunded liabilities over a 10- to 15-year period.*

RECOMMENDATION 1b – *The City of Vacaville apply for American Rescue Plan Act funds to make additional contributions towards reducing pension and OPEB liabilities*.

Response to Finding 1 and Recommendations 1a and 1b:

The City of Vacaville disagrees partially with Finding 1, specifically the statement that the OPEB liability exceeded $80 million at June 30, 2019. The OPEB liability was $78.2 per the June 30, 2019, OPEB actuarial valuation.

Recommendation 1a has not been implemented on the pension side. Staff will be presenting a pension funding policy for Council consideration in late summer/early fall of this year.

Recommendation 1b will not be implemented since American Rescue Plan Act funds can not be used to make deposits into a pension fund and contributions to an OPEB trust do not meet the principles of the American Rescue Plan Act funds.

Similar to many other government agencies throughout the state, the City's CalPERS pension unfunded liability has increased over the last decade as CalPERS has implemented a variety of measures since the Great Recession to strengthen the long-term sustainability of the pension fund and stabilize future costs that has resulted in increases in the unfunded liability and agency contributions. CalPERS' measures taken during this timeframe included:

- Changing its unfunded liability amortization policy from a rolling 30-year base – this approach would be like refinancing your mortgage to a new 30-year mortgage every year - to having fixed 30-year bases.
- Lowering the discount rate (what CalPERS expects its investments to earn during the fiscal year) from 7.5% to 7%.
- Updating the actuarial assumptions used in the valuation reports to more closely align with reality; the most significant being greater life expectancies.

While the City's CalPERS unfunded liability increased from $126 million in 2011 to $209 million in 2019 on a dollar basis, on a percentage basis, the City's CalPERS funded status was 66.1% in 2011 and 65.6% in 2019, down only a half of one percent. The City's OPEB unfunded liability was $78.2 million as of June 30, 2019, and has decreased in the last two successive actuarial valuations. At the time of the writing of the Grand Jury's *Survival of "OPEB" Other Post-Employment Benefits City of Vacaville* report, the OPEB unfunded liability per the current actuarial valuation report was $124.6 million.

The City agrees with the Grand Jury that additional contributions should be made toward the unfunded liabilities which is already currently done with OPEB. The City's OPEB funding policy, which was adopted in November 2015, states the City will make additional contributions to the OPEB trust following a fiscal year where General Fund revenues exceeded expenditures. From the fiscal year 2018 through 2020, the City contributed on average $1.5 million or 15% over the annual Actuarially Determined Contribution (ADC). Additionally, the current OPEB unfunded liability is on a fixed amortization schedule and will be retired in the next 17 years.

As presented by staff at the March 2, 2021, Special City Council Study Session on unfunded liabilities, additional steps are needed to help offset the anticipated increases from CalPERS on the pension side. Similar to the steps taken to address OPEB, staff will develop a pension funding policy for Council consideration with the goals of reducing projected pension costs and increasing the funded status of the City's pension plans, and as part of that policy, explore establishing a pension rate stabilization trust to realize greater investment returns than what is currently available through the City's investment portfolio. Establishing a pension rate stabilization trust was one of the recommendations stated in *the League of California Cities Retirement System and Sustainability Study and Findings* report and is a tool currently used by hundreds of government agencies in the state in conjunction with making additional discretionary payments (i.e. principal payments) to CalPERS to save on interest costs. Staff plans to present this policy to the Council late summer/early fall of this year.

Although the City has applied and received American Rescue Plan Act funds, these monies are not allowed to be used to make additional contributions to a pension trust such as CalPERS. While contributions to an OPEB trust are not explicitly disallowed in the current guidance from the US Treasury, it would be difficult for the City to make a case that these contributions would meet the principles of the American Rescue Plan Act funds.

FINDING 2 – *The City of Vacaville's current employment benefits packages are unsustainable and offer benefits exceeding those provided by other California cities with similar population and home values.*

RECOMMENDATION 2a – *The City of Vacaville use an independent facilitator to negotiate all labor contracts.*

RECOMMENDATION 2b – *All labor negotiations should address unfunded pension and OPEB liabilities.*

Response to Finding 2 and Recommendations 2a and 2b:

The City disagrees with Finding 2, specifically that the benefit packages are unsustainable. As will be explained in the response to Finding and Recommendation 3, the City and labor unions have continuously worked over the last 15 years to work toward a sustainable model. Additionally, the City's Five Year General Fund forecast projects the City being able to maintain reserves above policy levels throughout the life of the forecast while fully funding the projected annual contributions towards pension and OPEB.

Recommendations 2a and 2b have been implemented.

The City utilizes independent consultants to study comparable agencies including pay and benefits packages. These studies are utilized as one of several pieces of data presented to Council when entering labor contract negotiations. Council direction is given based on several factors including but not limited to comparison to other agencies, city budget, and recruitment and retention data. An independent labor negotiator is also retained as Chief Negotiator for labor contracts and takes direction from the Council and City Manager throughout the process.

FINDING 3 – *The City of Vacaville has no control over healthcare premium rates set by CalPERS, hindering the city's ability to contain healthcare costs.*

RECOMMENDATION 3 – *In future labor negotiations with Tier 1 and Tier 2 employees, the City of Vacaville convert to a defined contribution healthcare benefits model.*

Response to Finding and Recommendation 3:

The City agrees with Finding 3 that it doesn't control the healthcare premium rates set by CalPERS.

Recommendation 3 has been implemented for all non-safety employees hired on or after December 1, 2018, and safety employee hires on or after January 1, 2020. While the City will continue to monitor and report on its unfunded liabilities, with the progress seen on the OPEB unfunded liability in recent years and total General Fund revenues projected to exceed expenses into the future, attempting to negotiate a reduction in healthcare benefits at this time is not warranted.

The City of Vacaville has provided health insurance for active and retired employees since 1975. During that 45+ years, health premiums have increased exponentially nationwide. Over 300 cities in California contract with CalPERS for group health insurance. CalPERS health is the largest public employer purchaser of health benefits in California and the second largest employer purchaser in the nation after the federal government. CalPERS provides coverage to over 1.5 million members. CalPERS group health offers numerous plan options for employees and includes coverage for early (non-Medicare) retirees.

According to study results by healthaffairs.org, the average national premium for family coverage has risen 20% over the past five years and 55% over the past ten years whereas the CalPERS rate the City bases contributions toward coverage on (Kaiser) has risen only 1.80% and 3.76% on average over the same respective time periods.

In 2005, recognizing the need for addressing the increasing costs and growing unfunded liability of this benefit, the Council directed staff to work with labor unions to find solutions and work toward a sustainable model and has continued that direction over the last 15 years. The City had paid for 100% of the benefit for actives and retirees to that point. After 30 years of providing that level of benefit the approach to make changes has been incremental but deliberate in assuring the City could still attract and retain the high level of talent the council and citizens expect while working toward a more sustainable benefit model. Between 2005 and 2017 the Council, staff, and all City labor unions accomplished:

- Three separate reductions of the City contribution to active and retiree health
    - 2009 – reduced from 100% to 95%
    - 2010 – reduced from 95% to 92%
    - 2016 – reduced from 92% to current 85%
- Establishment of an OPEB trust fund and implementation of active employee contributions directly into that trust
    - 2009 – $25/mo employee contribution
    - 2015 – increase to $50/mo from safety employees
    - 2016 – increase to $75/mo from safety and $50/mo from non-safety employees
    - 2017 – increase to $100/mo from safety employees
    - As of June 30, 2021, the trust fund balance (including City and employee contributions) was $61.5 million.
- Implementation of a vesting schedule - 2009
    - Prior to the vesting schedule, someone could come work for the City for 1 day and retire the next with full retiree medical benefits. The vesting schedule required a minimum of 5 years at the City of Vacaville to receive any level of retiree medical.
- Adoption of an OPEB funding policy – 2015
    - The policy established a goal of increasing the funding of the annual Actuarially Determined Contribution (ADC) in each successive year until reaching full funding of the ADC in 2020. The City was able to reach this goal of fully funding the annual contribution amount in 2018.

In 2018, the council recognized the need for more drastic changes to address OPEB and directed staff to negotiate a new, lower benefit tier for future hires during that year's upcoming round of contract negotiations with labor groups. At the conclusion of those labor negotiations, a new tier of retiree medical was established with a drastically reduced retirement benefit for non-safety employees hired on or after December 1, 2018, and safety employees hired on or after January 1, 2020.

FINDING 4 – *The Vacaville City Council dismissed the OPEB advisory committee, without taking any action, limiting the effectiveness of the oversight process.*

RECOMMENDATION 4 – *The Vacaville City Council re-establish the OPEB advisory committee and act on the recommendations made by the prior committee.*

Response to Finding and Recommendation 4:

The City disagrees with Finding 4 regarding the effectiveness of the oversight process. The process allowed 4 members of the public to study the subject and direct access to internal and external professionals to gain a better understanding of the topic.

Recommendation 4 to reestablish the OPEB advisory committee will not be implemented as the recommendations of the committee have been addressed as explained below.

In 2019 the Solano County Grand Jury report was issued addressing the City of Vacaville's OPEB obligations. The report recommended the formation of an advisory group which the Council agreed with and approved formation of in late 2019.

The advisory group, made up of 4 members of the public appointed by the Council was chaired by the City Treasurer, then met eight times throughout 2020. The advisory group meetings explored many facets of OPEB and took an in depth and critical look into the topic. Many of the presentations and much of the information received was from outside professional resources brought in to present information to the advisory group while other presentations were from staff. The meetings included:

1/16/20: Introduction and overview of City's current OPEB – City staff presentation
1/27/20: Milliman actuary presentation by Erik Goodhart, Enrolled Actuary, Member of the American Academy of Actuaries, Associate of the Society of Actuaries
2/13/20: Alliant Insurance Services presentation and Q&A
3/12/20: PERS Health Program Consultation Services presentation by Shannon McKaughan from PERS Health Account Management Division
8/27/20: Review of 5-year budget forecast – City staff presentation
8/27/20: Review of Grand Jury report and responses – City staff presentation
9/10/20: Keenan and Associates (benefit and insurance broker/consultants) presentation and Q&A
9/10/20: EPIC Insurance Brokers & Consultants presentation and Q&A

The group presented their findings and recommendations to council in late 2020. The group's formation and final recommendations were formed shortly after Council had already directed staff to negotiate and implement a new tier of retiree medical. The advisory committee meetings and recommendations explored many of the same resources staff utilized prior to entering negotiations with labor groups ultimately resulting in establishment of the new tier and addressing the group's two recommendations as follows:

Group Recommendation: **Sustainable Fiscal Plan**
The City agrees with communicating the use of General Fund dollars in an *open and honest manner.* As part of the development of the recently adopted fiscal year 2021-2022 budget, the City held two budget study sessions, a special Budget 101 session, and quarterly updates on the status of the General Fund. As part of these updates, staff provides a five-year General Fund forecast using available data at the time to project revenue and expenditure trends and the General Fund reserve to ensure services are available today and in the future. Regarding the City's General Fund reserves, current projections estimate the reserve to be around 50% over the life of the five-year forecast, much higher than the Government Finance Officers Association minimum recommendation of 15% of expenses. As mentioned in the response to Grand Jury Finding 1, staff will explore taking advantage of this strong reserve to establish a pension rate stabilization trust and making additional discretionary payments on the pension unfunded liability to save on interest costs.

Group Recommendation: **Defined Contribution Plan**
The newly established Tier 3 retiree medical structure for all new hires addresses this recommendation. While defined contribution is not usually a term utilized to describe medical benefits, the concept of having a clearly defined maximum benefit, and therefore cost, is realized with the Tier 3 structure.

FINDING 5 – *Unfunded pension and OPEB liabilities remain a concern for Vacaville citizens because they directly affect the quality of public services provided to residents as well as the future financial stability of the city.*

RECOMMENDATION 5 – *The Vacaville City Council take actions to ensure that issues affecting pensions and OPEB liabilities continue to be reviewed regularly and publicly.*

Response to Finding and Recommendation 5:

While the City agrees that unfunded liabilities are a challenge for many government agencies – the City of Vacaville included – with the potential to affect the financial stability of a city if ignored, the City has and will continue to monitor and address its unfunded liabilities so that services aren't crowded out and the City's General Fund reserves stay within policy.

Recommendation 5 has been implemented and will continue to be presented publicly.

On March 2, 2021, a special study session was held to provide the Council and the public with an update on the City's current Pension and OPEB unfunded liabilities, review what those liabilities are associated with, review steps taken to address those liabilities, and answer any questions the Council and public had on this topic.

As a result of Council actions over the last 15 years, along with favorable investment earnings on the OPEB trust fund assets and in the more recent actuarial valuation results, the City has seen a reduction of $46.5 million in the OPEB unfunded liability since 2015. As with any major reform to a benefit that has been in place this long the favorable impact of the reform is also seen over time. Staff has consulted with the City's third-party, independent actuary regarding the newly established retiree medical tier and have been told it should result in a significant reduction in the growth of future unfunded liability as time passes. While the new tier will not impact the current unfunded liability, the City has made great strides towards keeping that cost contained including all of the aforementioned steps taken and fully funding the ADC or "annual mortgage payment" since 2018.

The City retains the services of a professional actuary to perform a complete study or valuation of OPEB every two years. The next study is scheduled for this year and will utilize updated data as of June 30, 2021. The valuation is expected to be completed in September/October 2021 for presentation to the Council and public. This study will capture over a year of experience under the newly established tier of retiree medical and begin to give the first data on what we can expect the impact of the new tier will be in the years to come. To ensure the OPEB liability is reviewed even more frequently, the City will be moving from the current biennial actuarial valuation to having the actuarial valuation performed annually.

While retiree medical is a benefit the City has the flexibility to make changes to, such as those described in prior responses, public pensions are far more regulated by the State and many changes are outside of the City's control. However, in 2012 the Council did elect to make a change allowed by the State and directed staff to work with safety labor groups to reduce the City's pension benefit for future hires to address the unfunded liability and future costs. These negotiations successfully resulted in a reduced pension tier for any safety employee hired on or after September 1, 2012. During that same year, California adopted AB-340 and AB-197, the Public Employees Pension Reform Act (PEPRA). PEPRA leveled the playing field for all public agencies by implementing statutory pension formulas state-wide for any "new" (meaning no prior public employment) employee hired on or after January 1, 2013. The main goal of PEPRA was to address then current pension models that were determined to be “unsustainable” for all public agencies in California.

PEPRA also eliminated plans deemed to be “supplemental” as of January 1, 2013, for any new hire (not just “new” to the retirement system). The City’s PARS plan was originally implemented on July 1, 2001, for non-safety employees and provides a 0.7% benefit at age 55 to employees as a “supplement” to their PERS benefit of 2.0% at age 55 for a combined benefit of 2.7% at age 55. The City’s PARS plan which is considered a supplemental plan then became a “closed plan” meaning no new entrants into the plan effective with hire date January 1, 2013, and after creating an additional tier for “classic” employees similar to that for safety employees established in 2012.

While the City has seen a reduction in the OPEB unfunded liability over the last several years, the opposite is the case with pension. The City’s pension liability has increased mainly due to lingering impacts of the Great Recession, lower than expected returns on CalPERS investment earnings, and CalPERS gradually reducing that expected return or “discount rate” from 7.5% to 7% in recent years. When expected investment returns aren’t realized or discount rates are lowered, unfunded liabilities and contributions to address them increase. CalPERS continues to work toward a more reasonable return amount in an effort to stabilize costs in the future while keeping in mind how even an incremental change in the discount rate drastically impacts public agencies and their costs. As currently scheduled, CalPERS is expected to discuss the current 7% discount rate in November 2021 as part of its Asset Liability Management (ALM) process conducted every four years. As with OPEB, the impact of pension reform (PEPRA) will take time to be realized. CalPERS currently projects that pension costs will stabilize and begin reducing in about 10 years. Until then the City will continue to see high (and even increasing) pension costs.

At the March 2, 2021, Special City Council Study Session on unfunded liabilities staff committed to providing updates to Council in open session every year upon receipt of updated actuarial information on OPEB and Pension obligations. Prior to that, the City had already implemented a recommendation from the prior Grand Jury Report of bringing the annual PERS health rates to Council in open session. Staff also committed to continuing to monitor industry changes, trends, and options for OPEB as well as development of a Pension Funding Policy and Pension Rate Stabilization Trust in alignment with the City’s Strategic Plan implementation strategy for Goal #4 – Maintain Effective and Efficient Services.

Please let me know if you have any further questions.

Sincerely,

Ron Rowlett
Mayor