County Connection

INTER OFFICE MEMO

To: Administration & Finance Committee
Date: 11/25/2022

From: Amber Johnson, Chief Financial Officer
Reviewed by: W.C.

SUBJECT: Pension Funding Discussion

Background:

The Authority contracts with the California Public Employees' Retirement System (CalPERS) for its employee defined-benefit pension plans. As such, the Authority is subject to the fluctuations of CalPERS funding policies, investment projections, investment performance, and actuarial assumptions – each of which impacts the level of funding commitment that is required on an annual basis and the level of unfunded liability that is carried by the Authority.

The Authority has long recognized the importance of controlling pension costs. Prior to the 2008 recession, CalPERS was over-funded for a period of time. Many public agencies saw this as an opportunity to contract with CalPERS for more enhanced benefits, either increasing the percentage of pay in retirement, and/or decreasing the age at which retirees can collect benefits. However, the Authority sensibly resisted these changes and did not enhance retiree benefits, keeping the original "2% at 60" formula. This prudent decision has been key in helping the Authority control pension costs as compared to its peers. However, the Authority is not immune from economic conditions that contribute to rising pension costs.

At the November 2022 Administration and Finance (A&F) Committee meeting, the Committee directed staff to review the Authority's current pension funding policy and recommend improvements, specifically the potential creation of a 115 trust for pensions to help mitigate future impacts of rising pension costs.

Current Pension Funding Policy:

<u>Required Contributions</u>:

The Authority is required to make certain contributions to CalPERS as part of its contract: normal cost and Unfunded Accrued Liability ("UAL") payments. In the current fiscal year (FY 2023), the required contributions to CalPERS are as follows:

Employer Normal Cost Rate:	9% of covered earnings
Unfunded Accrued Liability Payment:	$890,950

Employees are also required to contribute to the plan by means of a payroll deduction, using a predetermined percentage of their covered earnings. This rate can vary depending on when the employee entered the CalPERS system and the employee's classification at the Authority.

Discretionary Contributions:

In 2019, the Board authorized reducing County Connection's pension liability by making smaller direct payments to CalPERS to achieve interest saving over time. The following was the framework of how those additional payments could be made:

1. If the estimates for pension related costs are under budget as of the May budget presentation, and would not require a draw on the contingency, nor additional TDA allocations; the General Manager is allowed to authorize additional payments to CalPERS up to $100,000.
2. Additional payment amounts over $100,000 could be recommended by staff and approved by the A&F and Board as part of the May budget review.
3. Any additional payments made by the Authority to CalPERS would be adjusted for in the Wage Increase determination performed by the auditors each year. In the auditors Agreed Upon Procedure report, that additional payment amount will be reduced from total pension expense for that fiscal year. This amount shall not be included as part of the increase of additional pension costs of $1,000,000 for that fiscal year which might cause a reduction of wage increases.

No additional payments towards the pension liability have been made since this framework was adopted.

Pension Funding Vehicles:

There are 3 primary avenues by which the agencies typically set aside additional funds to pay down unfunded pension liabilities:

- Set aside reserves for pensions on the balance sheet.
- Make additional payments to CalPERS to reduce the UAL.
- Make payments to a Section 115 Plan established to fund future pension liabilities.

Because of the unique way the Authority's reserve funds are held by the Metropolitan Transportation Commission (MTC), the Authority does not have typical reserve funds set aside on its balance sheet, except for the Safe Harbor Lease Fund (which is discussed later in this report). This leaves two options for setting aside pension funds, the pros and cons of which are summarized in the following table:

	PROS	**CONS**
Additional payments to CalPERS	Lower fees	No investment diversification from CalPERS
	Reduces UAL on balance sheet	Additional funds in CalPERS system increase investment risk
		CalPERS will not refund overfunding

	PROS	CONS
Payments to a Section 115 Plan	Maximum flexibility on types of investments	Funds must be used for pension payments
	Does not reduce UAL on balance sheet, however the funds are disclosed in pension footnotes	Annual investment and plan oversight costs
	Investment diversification from CalPERS	
	Rate stabilization tool (in lean budget years)	

<u>Additional Payments to CalPERS</u>:

The Authority can make voluntary payments to CalPERS at any time to reduce its UAL, and this is the focus of the current pension funding policy. Such payments will reduce the year-end UAL of the Authority as of the year-end of the fiscal year in which such payments are made. Payments to CalPERS to pay down the UAL will be credited with a pro rata portion of the ultimate actual CalPERS investment return for that year.

If the Authority were to reach a fully funded level (due to voluntary UAL payments and investment returns in excess of the CalPERS projections), the Authority cannot obtain a refund of the amount of overfunded. Any such surplus would be amortized over 20 years and be used as a credit to reduce future losses. The amount of overfunding will be allocated a proportionate share of future investment gains and losses.

Many CalPERS employers are not entirely comfortable surrendering their surplus funds to the vagaries of CalPERS investments and funding policies.

<u>Section 115 Trust for Pensions:</u>

A Section 115 trust (named after Internal Revenue Code Section 115) is a vehicle for segregating agency funds from general assets for the purpose of funding essential governmental functions. For example, a 115 trust can be used to set aside monies to meet future pension or Other Post Employment Benefit ("OPEB") contributions or liabilities. Funds placed in a 115 trust are irrevocably committed for the essential government function(s) specified in the applicable trust agreement (e.g., pension obligations). The Authority currently has a 115 trust for its OPEB plan, which was created in June 2010.

Historically, 115 trusts were primarily used by government agencies OPEB plans. However, in 2015 the IRS ruled that Section 115 trusts can also be used for prefunding pension obligations.

A 115 trust can be used as a rate stabilization fund. Monies set aside in a 115 trust can be used to ease budgetary pressures resulting from unanticipated spikes in employer contribution rates. Assets in the trust can be invested in a diversified manner and can be used to pay out directly to CalPERS or reimburse the Authority for pension-related costs. In addition, funds in a 115 trust can be applied to pay down specific portions of the Authority's UAL.

Other considerations of a 115 trust for pensions are:

- *Investment Options*: Section 115 Plans are not subject to the investment restrictions governing assets held directly by California public agencies.

- *Financial Reporting*: GASB reporting guidelines for our financial statements does not allow for funds in a Section 115 pension trust to reduce the UAL of the Authority on its balance sheet. However, the amount of secured pension funding in a Section 115 plan can be disclosed in the footnotes describing the Authority's pension obligations.

- *Major Providers*: The three major private providers of Section 115 trusts are PARS, PFM, and CalPERS. The Authority's OPEB 115 trust is currently with PARS. For administrative ease, PARS would be the likely choice for a pension 115 trust as well.

Pension Funding Sources:

<u>Ongoing Revenue Sources</u>:

The precise source of funding used to pay the Authority's normal cost and UAL payments is not plainly stated, since this use of funds is part of its normal operations costs and permitted by all its revenue sources. However, if the Authority were to set aside additional funds for pensions – whether by a 115 for pensions or by sending additional funds to CalPERS, the source of funds would be limited. Transportation Development Act (TDA) and COVID-related federal stimulus funds, for example, explicitly prohibit use of these funds for pension obligations beyond the basic CalPERS requirements.

However, the Authority does have discretion over how to allocate fare revenue. Passenger fares would be the safest source of pension funding for the Authority. In the year just ended (FY 2022), the Authority collected $2.2 million in passenger fares. Measure J sales tax revenue is another potential source; staff is consulting with Contra Costa Transportation Authority (CCTA) on any restrictions applicable to this source.

<u>One-Time Source – Safe Harbor Reserve:</u>

The Authority maintains a reserve fund consisting of proceeds from the sale of federal income tax benefits under the safe harbor lease provisions of the Tax Equity and Fiscal Responsibility Act of 1982. The funds held are designated by the Authority's Board as a reserve against future funding shortfalls. As of June 30, 2022, this fund totaled approximately $1.5 million.

Staff is working with legal counsel to determine whether or not there are any additional legal restrictions on the use of these funds beyond the Board's designation. If no other legal restrictions exist, all or a portion of these funds could be considered as a one-time pension funding contribution.

Pension Funding Methods:

<u>Current Policy – Budgetary Savings Method</u>:

The current pension funding policy for discretionary payments compares actual pension costs to budgeted pension costs and permits staff to contribute any budgetary savings up to $100,000 in a given year as an additional payment directly to CalPERS. Additionally, payments greater than $100,000 can be approved during the budget approval process. Should the Authority decide to open a 115 trust for pensions, this same formula could be applied to funding the trust.

<u>One Time Savings – Budget Forecast</u>:

When creating the current year (FY 2023) budget and accompanying financial *forecast* for pension costs, staff relied on the 2021 CalPERS valuation report to model the expenses. At the time of this report, the required annual UAL payment for FY 2024 was projected to be $1 million. While not the focus of the FY 2023 budget, staff did plan to expend $1 million on the required UAL payment in FY 2024 in the 10-year financial forecast model.

However, the following year, the required UAL payment for FY 2024 was reduced to zero, due to the unusually high return on investment (ROI) that year. Using the CalPERS pension outlook tool, staff estimates that the required UAL will return in FY 2025. This one-year reprieve from sending a UAL payment to CalPERS in FY 2024 presents a unique opportunity for one-time forecasted savings to be redirected to pension funding.

The following table illustrates how the annual UAL payment requirement has changed with recent valuation reports and estimates.

	Required UAL Payment		
Year	**2021 Valuation FY20 ROI 4.7%**	**2022 Valuation FY21 ROI 21.3%**	**2023 Estimates FY22 ROI <6.1%>**
FY 2023	$ 890,950	N/A	N/A
FY 2024	$ 1,000,000	$ -	N/A
FY 2025	$ 1,149,000	$ -	$ 330,000
FY 2026	$ 1,246,000	$ -	$ 660,000
FY 2027	$ 1,331,000	$ -	$ 990,000

<u>Other Formulaic Methods</u>:

Additional or alternative funding formulas could also be considered, such as a set percentage of fare revenue collected in a given year, or fare revenues that exceed a certain threshold, etc. Many public agencies use other formulas to fund their 115 trusts, such as allocating a percentage of realized year-end surplus to the pension fund. However, since the Authority does not hold its own reserve funds, it never has a year-end surplus on which to apply this type of formula.

Next Steps:

Depending on the direction of the Committee, staff is prepared to draft a new pension funding policy for consideration, and/or bring additional information to the next Committee meeting. Additionally, should the Committee desire to pursue a pension 115 trust with PARS, staff could request that a PARS representative attend a future Committee meeting to answer any additional questions.

Financial Implications:

None at this time, discussion only.

Recommendation:

Staff recommends that the Committee discuss the Authority's pension funding options and provide direction to staff.

Attachments:

None.