



Agenda Item No. 5

To: Finance-Auditing Committee/Committee of the Whole
Meeting of April 12, 2007

From: Alice Ng, Business Process Analyst
Joseph M. Wire, Auditor-Controller
Celia G. Kupersmith, General Manager

Subject: **AUTHORIZE EXECUTION OF A PROFESSIONAL SERVICES AGREEMENT WITH PFM ASSET MANAGEMENT LLC, RELATIVE TO REQUEST FOR PROPOSALS (RFP) NO. 2007-D-7, TRUST AND INVESTMENT MANAGEMENT SERVICES FOR GASB 45 (OPEB) TRUST**

Recommendation

The Finance-Auditing Committee recommends that the Board of Directors authorize the execution of a Professional Services Agreement with PFM Asset Management LLC, of Philadelphia, PA, for Trust Administrator and Investment Advisor services relative to Request for Proposals (RFP) 2007-D-7, *Trust and Investment Management Services for GASB 45 (OPEB) Trust*, in an amount not to exceed \$24,000 for Phase I, with the understanding that sufficient funds are available in the District's FY 06/07 Operating Budget.

Summary

At the Finance-Auditing Committee Meeting of July 27, 2006, the Board directed staff to investigate options and prepare documents for the Board's approval to create a trust to fund retiree health care and other post-employment (OPEB) liabilities (July 27, 2006, staff report attached). Options for financing the trust and the fiscal impact of those financing options will be brought to the Board during the yearly strategic planning and budget processes under the principle that the Board would move to fund the trust and away from funding retiree benefit costs on a pay- as-you-go basis.

An RFP was issued on October 23, 2006, to seek proposals from firms with experience in OPEB trusts and investment management of trust assets, to explore options to create a trust to fund retiree health care and OPEB liabilities in accordance with GASB Statements 43 and 45 (Phase I) and investment management of those assets in the OPEB trust, subject to the specific funding approval by the Board (Phase II). The RFP was posted on the District's website and mailed to 5 potential proposers. The following proposals were received:

1. ICMA-RC Services
2. Keenan & Associates
3. Nationwide Life Insurance Company of America
4. PFM Advisors (a division of PFM Asset Management LLC)
5. Union Bank of California

An Evaluation Committee, comprised of District staff, evaluated each proposal based on the following criteria set forth in the proposal documents:

1. Firm qualifications and experience (15%)
2. Project team qualifications and experience (30%)
3. Product and investment services (20%)
4. Proposed cost for each Phase of the project (35%)

PFM Advisors and Union Bank of California, the two highest ranked firms, were interviewed by the committee. Based on the evaluation of both the written proposals and the results of the oral interviews, staff recommends award of RFP No. 2007-D-7 to PFM Asset Management LLC, Philadelphia, PA.

PFM Advisors, a division of PFM Asset Management LLC, has been engaged in pension fund investment consulting and advisory services since 1992 for approximately 80 clients, managing total assets exceeding \$7.5 billion, of which approximately \$4 billion is in equity securities. PFM Asset Management LLC has been the District's investment advisor since 1993, managing over \$130 million of District assets in fixed income securities.

By leveraging its scale with investment managers and with its proposed custodial bank for this trust, PFM Advisors has a program that is institutionally priced and offers a solution for the District to begin setting aside funds for its long term OPEB liability. PFM Advisors uses U.S. Bank to provide custodian and trustee services to its OPEB accounts. U.S. Bank is the sixth largest bank and one of the largest custodial banks in the U.S. and has been offering trust and custody services since the early 1900's. The District also has had a long standing relationship with U.S. Bank as the Trustee of the District's Commercial Program since 2000.

Of importance to the evaluation committee was PFM Advisors' demonstrated seamless integration of trustee and investment advisory services that will create a direct and responsive one-to-one communication relationship with the District for this trust. OPEB regulations and compliance are relatively new, and public agencies such as the District will need to rely heavily on firms such as PFM Advisors to guide the District step by step to ensure compliance with all the nuances of the requirements and to also relieve the burden on District staffing.

Of equal importance was PFM Advisors' investment performance record which has shown strong returns in both the equity and fixed income markets. PFM Advisors has been managing numerous discretionary funds which have consistently outperformed the market benchmarks.

Lastly, PFM Advisors' fee structure was highly competitive and offers the lowest short-term and long-term savings for the District without sacrificing sound investment advisory services.

In summary, staff is recommending award to PFM Asset Management LLC as Trust Administrator and Investment Advisor and U.S. Bank as Trustee and Custodian, in recognition of the following:

- Availability and quality of the OPEB trust products and investment services
- Strong investment performance track record in equity as well as fixed income securities
- Familiarity with District guidelines and procedures
- Lowest short term and long term pricing for services requested in the RFP

Next Steps

It is expected that in the summer of 2007, two separate items will be ready to be brought to the Board:

1. Board action to establish the OPEB trust.
2. Board action to consider funding the newly created trust with reserves previously designated for that purpose.

At that time, the Attorney will also discuss in more detail certain legal issues associated with establishing the OPEB trust as summarized below.

Legal Issues

One of the underlying purposes of creating the 115 trust is to broaden the range of permissible investments to obtain a higher rate of return. There are statutory provisions in the California Government Code that clearly permit public agencies to have this broader investment flexibility for the payment of employee retiree health benefits. However, the California Constitution contains a general prohibition against public agencies investing in equities. To date, no courts have interpreted this constitutional prohibition to apply to trust assets invested for the purpose of paying the cost of retiree health benefits. Staff and the Attorney have discussed this issue with PFM and PFM's legal advisor, Orrick, in order to evaluate how to protect trust investments in equities from challenge. This evaluation will continue as PFM proceeds to develop the trust documents, investment policy and further define the role of the District in overseeing the trust. When the Board considers taking action to establish and fund the trust later this year, staff and the Attorney will brief the Board on the potential risks of investing in a broader array of investments and recommend the steps to be taken to minimize those risks. We have reason to believe that ultimately a structure can be developed that will minimize risks for the District, and other public agencies that determine to fund retiree health benefit liabilities that are reported under GASB 45 through the establishment of an OPEB trust.

Fiscal Impact

Phase I of the professional services relative to RFP No. 2007-D-7 will not exceed \$24,000, consisting of a \$20,000 fee to PFM, \$3,000 fee to PFM's legal advisor, Orrick, for the trust documents, and a \$1,000 annual custodial maintenance fee to U.S. Bank. PFM will waive its

\$20,000 fee if the District funds the trust with at least \$3,000,000 during FY 07/08. Full funding for Phase I will be found in the District's FY 06/07 Operating Budget. In addition to the Consultant's fee to establish the trust, it is anticipated that an IRS private letter ruling will be obtained to confirm the tax exempt status of the trust assets. The additional cost of the private letter ruling, including IRS fees, is estimated at \$20,000 plus the IRS filing fee of \$10,000. It is anticipated that Hanson Bridgett will undertake this work.

If the Board chooses to fund the trust, the compensation structure for the investment management of the OPEB trust assets will be all inclusive, incorporating total cost of investing such as asset manager(s)' fees, expense ratios and trading fees, and will be calculated based on the amount of assets managed as follows:

- 1.00% annum for the first \$5 million
- 0.85% annum for the next \$5 million
- 0.70% annum for the next \$10 million
- 0.55% annum above \$20 million

PFM Advisors will not receive compensation from any other source relating to the management of the District's assets.

Attachment - July 27, 2006, Finance-Auditing Committee staff report



Agenda Item No. 4

To: Finance-Auditing Committee/Committee of the Whole
Meeting of July 27, 2006

From: Joseph M. Wire, Auditor-Controller
Celia G. Kupersmith, General Manager

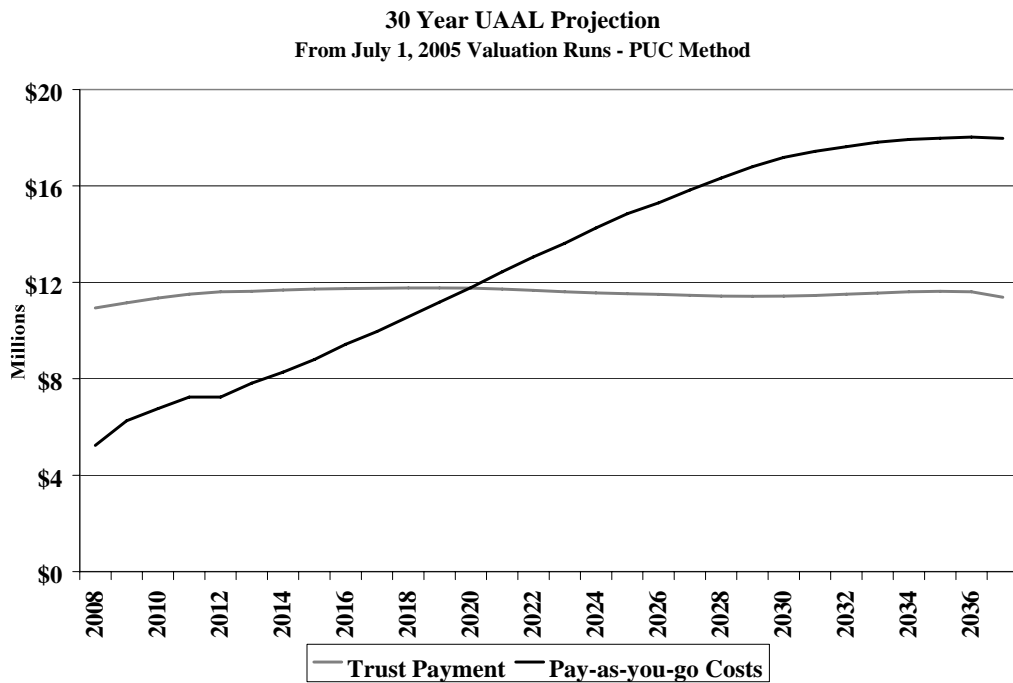
Subject: **APPROVE ACTIONS RELATIVE TO GASB GUIDELINES ON
ACCOUNTING AND REPORTING RETIREE HEALTH BENEFIT
LIABILITIES**

Recommendation

The Finance-Auditing Committee recommends that the Board direct staff to investigate options and prepare documents for the Board's approval to create a trust to fund retiree health care and other post-employment liabilities. Options for financing the trust and the fiscal impact of those financing options will be brought to the Board during the yearly strategic planning and budget processes under the principle that the Board would move away from funding retiree benefit costs on a pay-as-you-go basis.

Executive Summary Bullets

- GASB guidelines require District to report liability for retiree benefits and are structured to encourage level yearly pre-funding through a trust. Recommendation is to begin process to create a trust.
- The District has an estimated actuarial liability of \$110 million for the future cost of retiree benefits already earned by current and past employees.
- The District follows a pay-as-you-go practice for paying the cost of retiree health benefits, i.e., only expensing the cost of retiree health benefits actually paid out each year. The pay-as-you-go practice has potential explosive cost impact in the next decades (see graph on following page).



- \$4 million is the average yearly additional contribution needed in the first 5 years to fund the District’s liability for retiree benefits (assuming 30 year amortization), including the cost of future benefits earned by active employees.

Average yearly cost of liability during first 5 years of 30 year amortization	\$11.6M
Average yearly pay-as-you-go retiree benefit cost during first 5 years – currently in projection	-\$5.9M
Yearly amount included in projection for each of the next five years for contribution to retiree benefit reserve – currently in projection	-\$1.0M
Annual allocation from Retiree Benefit Cost Reserve over next 5 years – currently in reserve	-\$0.7M
<hr/>	
Yearly Average Additional Contribution needed to fully fund the 30 year amortization of the liability for retiree benefits in each of the next 5 years	\$4.0M

- Options for financing the trust and the fiscal impact of those financing options will be brought to the Board during the yearly strategic planning and budget processes.

Summary

Introduction

This report outlines the options given the Board by several new Government Accounting Standards Board (GASB) requirements. Central to that is whether or not to fund the District's retiree healthcare liability and, if so, whether to use a trust as a vehicle to fund that liability. This report provides information on how much the Board would have to contribute to the fund, but does not seek action from the Board on whether to contribute the full amount or some lesser amount at this time. That funding decision will be brought to the Board in the following months and yearly thereafter as part of the annual budget process.

This report discusses the following issues in sections:

- The requirements of GASB guidelines, amount of unfunded liability, and how that amount was derived.

Sections: I. The New GASB Requirements on Post-employment Benefits
 II. The District's Actuarial Liability for Post-employment Benefits

- The benefits of moving from the pay-as-you-go method to a trust for funding post-employment benefits.

Sections: III. Decision to Fund the District's Liability
 IV. Operation of the Trust and Future Actuarial Reports

- The feasibility of paying into a trust during the next five years.

Section: V. Feasibility of Funding the GASB Requirement

- The next steps which are that the options for financing the trust and the fiscal impact of those financing options will be brought to the Board during the yearly strategic planning and budget processes.

Section: VI. Next Steps

I. The New GASB Requirements on Post-employment Benefits

The Government Accounting Standards Board now requires that all public agencies accrue the cost of the retiree health benefits they provide their employees and show that on their balance sheet. The requirement includes those costs for all current and qualified retired employees and their covered spouses and dependents. It is very similar to reporting for pension costs (liabilities).

Deadline to Implement GASB Requirement

There are two GASB guidelines that govern retiree health benefits:

- GASB 43** Financial Reporting for Post-employment Benefit Plans Other Than Pension Plans.
- GASB 45** Accounting and Financial Reporting by Employers for Post-employment Benefit Plans Other Than Pensions.

The official GASB guideline for agencies with annual revenues of \$100 million or more is that the District has to implement GASB 45 for financial reporting by June 30, 2008, for FY 07/08. However, if the District elects to set up a trust (staff recommendation discussed later), GASB 43 must be implemented the year before, i.e., June 30, 2007, for FY 06/07. Thus, the deadline for GASB 43 is driving this report to the Board and the staff's request for Board action. The process required to meet GASB 43 requirements will take several months to accomplish, including future action by the Board.

II. The District's Actuarial Liability for Post-employment Benefits

Actuarial Report Development

The first step in meeting the GASB requirements is to determine the District's liability for retiree health benefits. To this end, the District undertook an actuarial study to determine its liability for post-employment benefits. There are several GASB approved methods for calculating unfunded liability and a number of different assumptions that can be used within each method that influences the overall amount of the unfunded liability. Staff worked with the actuary to develop an estimate that minimized the total amount of the unfunded liability. The reason for this approach is not to understate the liability, which it does not, but to recognize that the unfunded liability is a long-term liability that will be paid out over the next 30 plus years. Since the District is required to undertake new actuarial studies at least every other year, there will be plenty of opportunities to adjust the assumptions to actual results. In fact, GASB requires that another actuarial report be completed prior to implementation on FY 07/08, so the first opportunity to examine the assumptions made will be next year.

The District's liability for post-employment benefits is made up of two parts:

1. Cost of benefits that have already been earned by either qualified retired employees or current employees; and,
2. The future cost of retiree medical benefits that current working employees are earning during the current fiscal year, in this case FY 06/07.

1. Cost of Previously Earned Retiree Health Benefits

The cost of the previously earned retiree health benefits is the unfunded liability of the District. It would not be an *unfunded* liability if the District had been setting aside funds to pay those benefits in the years they were earned, as it does with pension benefits. The total unfunded liability is attributed to two groups of employees: retirees and actives. As the Board has been advised, the unfunded liability is large; \$110 million (see Attachment A), but it will be amortized

over the next 30 years. Of that, \$70 million is the projected cost of future benefits promised to retirees and \$40 million is the projected cost of future retiree benefits already earned by current employees. If the District elects, for the next 5 years, to contribute the amortized amount needed – on a 30 year funding schedule – to fully fund the benefits earned to date, the contribution would average \$7.9 million a year.

2. Cost of Retiree Health Benefits Earned in Current Year

In addition to the \$7.9 million per year cost of the 30 year amortization of the \$110 million for benefits already earned, there is a cost of benefits earned by current employees in the current year. That cost is referred to as the normal cost and is projected to average \$3.7 million over the next five years. No matter what funding choice the District makes for the unfunded liability portion, the normal cost remains the same.

Total Cost

For the next five years, the total average cost of funding the unfunded liability on a 30 year amortization basis, and the normal cost, is \$11.6 million a year (\$7.9 million for the unfunded liability and \$3.7 million for the normal cost). All other variables remaining the same, if the unfunded liability and normal cost are not fully funded each year, then future year payments will grow as the unfunded liability grows.

It is worth noting that the yearly cost could change from year to year based on the actuarial studies the District is required to undertake. The cost is influenced by changes in the cost of health care, the use of health care, the type of benefits provided and the number of eligible employees, retirees and their dependents. All of these factors are constantly changing and some are in the District's control while others are not.

Copies of the District's Actuarial Valuation of Post-employment Health Care and Life Insurance Benefits are available from the District Secretary's Office.

III. Decision to Fund the District's Liability

The GASB regulation requires that the District account for its liabilities in its financial statements but it does not require that it fund those liabilities. The choice to fund the liabilities is the Board's decision. The following issues play in the decision to fund the liabilities:

- *Lack of Future Revenue Growth:* The District's business is relatively mature, thus the District's fee-based revenues are unlikely to grow at a fast enough pace in future years to keep up with rapid increase in retiree healthcare costs that will come due in those future years. That could put pressure on the District to attempt to raise prices beyond what the market will allow. That situation could lead to the District not being able to live up to the promises it has made.
- *Debt Holder Concerns:* Rating agencies have stated that they will expect agencies to develop a plan to fund their liabilities. The credit rating of those that don't may be lowered. A lower credit rating increases the cost of borrowing funds.

- *Accuracy of Expense:* Funding retiree health care costs when they accrue increases the accuracy of the expense borne by those that use the District's services. That enables the user to judge their demand for the service and the value of the service properly.
- *Increased Investment Earnings:* Funding a reserve for liabilities would allow the District to earn interest income in the early years that would be available to pay for liabilities in the later years when those liabilities are at their highest levels. Those earnings could relieve the pressure on the District to increase prices in future years.
- *Increased Expenses Now:* Funding the unfunded liability now rather than waiting until the actual expense comes due (when a retiree draws on the benefits) means either reducing other expenses now (potentially reducing services) or increasing revenues (prices) sooner.

In consideration of these issues and others, staff recommends that the District consider funding the actuarial cost of retiree health benefits during its yearly strategic planning and budget processes and set up a trust to hold any potential increase in funding for retiree health benefits.

IV. Operation of the Trust and Future Actuarial Reports

If the District elects to fund its retiree health benefits through a trust, GASB requires that the trust be recognized for accounting purposes, that the trust be completely separate from the general fund of the District and that the assets can only be used for post-employment benefits. In the first years of the trust the District would make a payment to the trust that 1) reflected a portion of the cost of the benefits already promised to employees or past employees – the catch-up portion – and, 2) reflected the cost of the retiree health benefits earned by current employees that year. Once the trust has caught up with the cost of past promises (which will take 30 years under the current assumptions), the yearly payment to the trust would just reflect the cost of yearly retiree benefits earned by current employees. All payment of retiree health benefits would be made out of the trust.

The major benefit to the District of creating a trust fund is that the State of California allows the trust to invest the funds on the behalf of qualified beneficiaries in investments that historically have produced greater returns than investments of the District's general assets. Normally, such an investment portfolio would consist of a conservative mix of equity and debt investments. The assumption of the actuary report is that the trust would return an average of 8% rather than the historical average 5-6% return of the District's portfolio. The 8% assumption can be altered by the District if future returns materialize. As an example; if a rate of return of 4.25% were used the unfunded liability would be \$194 million.

Once in the trust, funds can only be used for the stated purpose of the trust: to pay retiree health and other post-retirement benefit costs. The amount needed for contributions to the trust will be recalculated every other year by an actuary. Thus, when the variables change that make up the actuarial liability, like retiree health care costs, benefit levels, requirements to qualify for health care benefits, trust investment return, etc., the actuarial report will adjust the District's liability and yearly payment accordingly. The District will receive its next actuarial report for the 2007/2008 fiscal year. That report is likely to produce a different and larger total liability amount.

The alternatives to using a trust is either to continue the pay-as-you-go funding, which is projected to lead to ballooning retiree health expenses in future yearly budgets unless benefits are curtailed, or for the District to save the funds in its own revenues which would produce lower investment returns. (See Projection Chart on Page 2).

V. Feasibility of Funding the GASB Requirement

The average yearly actuarial financial liability over the next five years of \$11.6 million is slightly misleading. Yes, funding a trust on a 30 year amortization basis plus normal cost for the first 5 years requires \$11.6 million/year total of contributions. However, \$5.9 million of this has already been budgeted because it is the pay-as-you go amount that the District would pay for retiree benefits under its current practice. This reduces the annual additional contribution to \$5.7 million. This additional \$5.7 contribution is further reduced by \$1.7 million per year which is the annual amortized value of money already in the projection and reserved for the next 5 years for this purpose. (There is \$3.5 million in a reserve and \$5 million in the last projection.) This leaves a net additional annual contribution over existing expenses, reserves and projection of \$4.0 million per year for 5 years or a total of \$20 million over that time period. (See Table on Page 2).

Additional \$20 Million Needed to Fully Fund the Trust over Next Five Years

To put that additional \$20 million in context, the FY 06/07 Budget that was passed by the Board on June 9, 2006, projected that the existing \$89 million five year deficit would be reduced by approximately \$6.6 million a year or almost \$35 million over the next five years. An additional \$20 million in expenses would reduce that projected five year savings to \$15 million.

VI. Next Steps

The District will comply on time and in full with the GASB reporting and accounting regulations. If the Board chooses to continue its pay-as-you-go method of funding retiree health care, no further action is required by the Board. If the Board selects the recommendation to set up a trust, staff will prepare the necessary documents and bring them to the Board in the next several months. If directed by the Board, staff will include the cost of fully funding the trust as an option in the next projection due out this summer. Options for funding the trust will be brought to the Board for consideration during its yearly strategic planning and budget discussions.

Fiscal Impact

There is no direct fiscal impact associated with this report.

Attachment A: Actuarial Accrued Liability Table

Attachment B: Medical Cost Inflation Rate Assumption Table

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Table 2-1
Golden Gate Bridge, Transportation and Highway District
 Actuarial Accrued Liability (i.e., Present Value of Future Postemployment Benefits)
Based on an 8.00% discount rate
as of July 1, 2005

	<u>Medical</u>	<u>Medicare Part D</u>	<u>Dental</u>	<u>Vision</u>	<u>Life Insurance</u>	<u>Total</u>
Bus Operators						
Actives	\$14,718,607	(\$570,905)	\$1,554,603	\$261,654	\$149,742	\$16,113,701
Retirees	<u>\$29,068,823</u>	<u>(\$1,557,121)</u>	<u>\$3,462,146</u>	<u>\$672,034</u>	<u>\$260,008</u>	<u>\$31,905,890</u>
Total AAL*	\$43,787,430	(\$2,128,026)	\$5,016,749	\$933,688	\$409,750	\$48,019,591
Non-Bus Employees						
Actives	\$22,136,506	(\$1,143,933)	\$2,690,248	\$406,876	\$135,081	\$24,224,778
Retirees	<u>\$34,845,080</u>	<u>(\$2,050,963)</u>	<u>\$4,285,510</u>	<u>\$769,238</u>	<u>\$394,044</u>	<u>\$38,242,909</u>
Total AAL	\$56,981,586	(\$3,194,896)	\$6,975,758	\$1,176,114	\$529,125	\$62,467,687
Overall Total						
Actives	\$36,855,113	(\$1,714,838)	\$4,244,851	\$668,530	\$284,823	\$40,338,479
Retirees	<u>\$63,913,903</u>	<u>(\$3,608,084)</u>	<u>\$7,747,656</u>	<u>\$1,441,272</u>	<u>\$654,052</u>	<u>\$70,148,799</u>
Total AAL	\$100,769,016	(\$5,322,922)	\$11,992,507	\$2,109,802	\$938,875	\$110,487,278
Actuarial Value of Assets						<u>\$0</u>
Unfunded Actuarial Accrued Liability						\$110,487,278

* Actuarial Accrued Liability

Attachment B

Health Care Trend

The rate of increase in per capita health care costs is commonly referred to as the *health care trend rate*. Although the term “health care inflation” is sometimes used synonymously with the trend rate, health care inflation is only one of several components of the trend rate. The analysis recognizes the following influences on health care trend: pure medical inflation, utilization changes, technological changes, regulatory requirements, Medicare cost shifting, and aging.

Based on our ongoing experience with post-employment health plans, we selected the following annual trend rates for use in this valuation:

Table 4-1
**Annual Health Care Cost
Trend Rate Assumption**

Medical and Prescription Drug

**Estimated Cost Increase
in the Plan Year
Beginning**

July 1, 2006.....	10.0%
July 1, 2007.....	9.0%
July 1, 2008.....	8.0%
July 1, 2009.....	7.0%
July 1, 2010.....	6.0%
July 1, 2011 and thereafter	5.5%
Dental	5.0% all years
Vision	3.0% all years