Funding Public Pensions

What is happening with contributions?

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DISCUSSION TOPICS

ACTUARIALLY DETERMINED CONTRIBUTIONS

PENSION OBLIGATION BONDS

ASSET SALES AND LEASES

ASSET-IN-KIND CONTRIBUTIONS

Government Actions That Can Impact Contributions

- Revenue Initiatives
  - Income Taxes
  - Sales Taxes
  - Real Estate Taxes
  - Direct User and Other Fees
- Cost Cutting
  - Wage and Hiring Freezes or Furloughs
  - Reduction in Services
  - Consolidation
- Contribution Initiatives
  - Adopting Actuarially Determined Contribution (ADC) Policy
  - Pension Obligation Bonds
  - Asset Sales, Leases, and In-kind Transfers

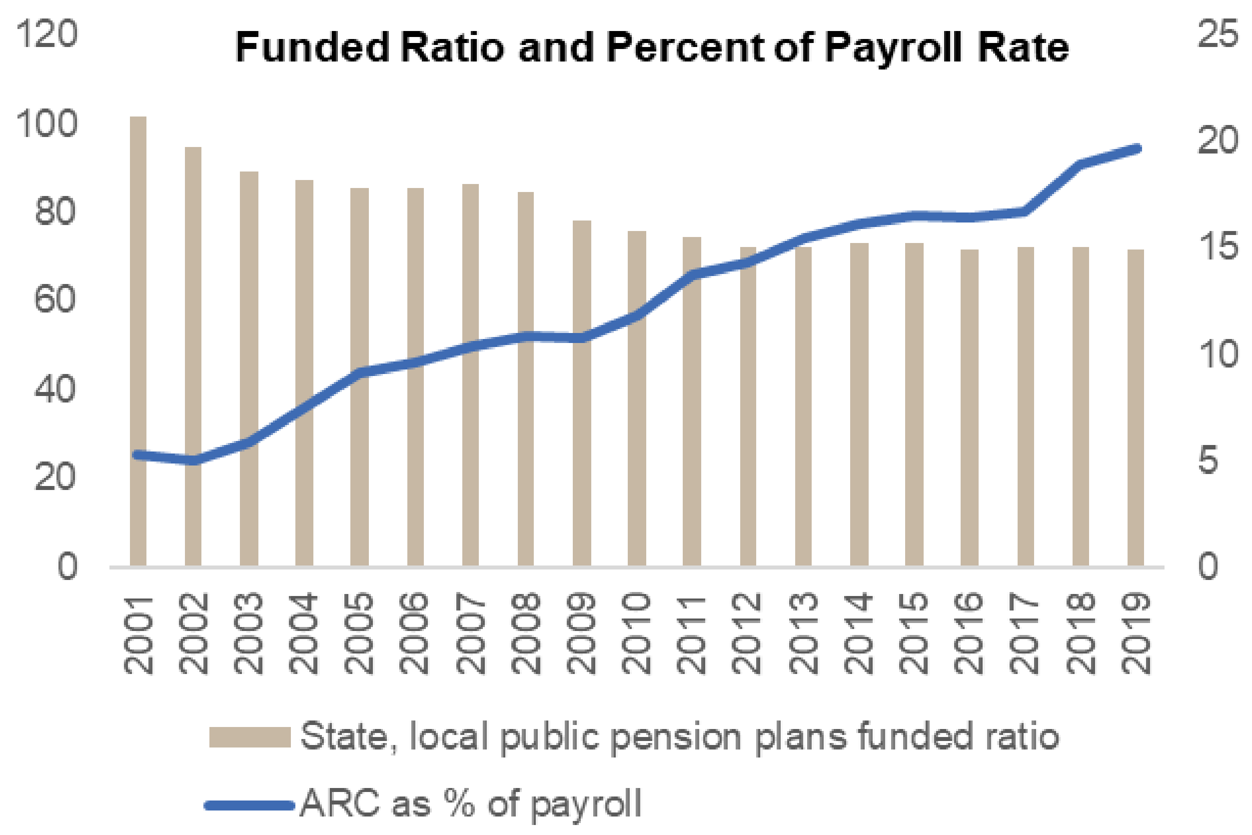
Plan Contributions

- Many plans in Texas use a fixed contribution formula
- Actuarially Determined Contributions (ADC) increasing in usage
- What is an actuarially determined contribution?
  - A method to allocate the costs of a plan in order to fully fund current and future benefits over a period of time. For example:

ADC = Normal Cost + the amortization payment of the unfunded actuarially accrued liability

- Why use ADC rather than fixed cost contribution?
  - ADC is a calculation that recognizes the normal (or annual) cost of a benefit and the unfunded liability as it exists at the time of the calculation.
  - Fixed cost is an arbitrary amount that creates budget stability but does not target plan funding health.
- Plans should be in favor of actuarially determined contributions, while employers may be conflicted given the contribution variability
- Designed to produce healthy plan finances, so adoption is positive

How the ADC Works



- Annual Required Contribution (ARC) or Actuarially Determined Contribution (ADC) started at 20% of payroll as plan funded ratios were approximately 100%
- As funded ratios declined, ADC increased to moderate losses
- Without increasing contributions from ADC, funded ratio declines would have been more severe
- As funded ratios increase, ADC will decline recognizing gains
- Regardless of the ADC in good times, contributions should never be less than normal (or service) cost

One-Time Contributions to Reduce Unfunded Liabilities

- Pension Obligation Bond
- Asset Sales and Leases
- Asset In-kind Transfers

Pension Obligation Bonds

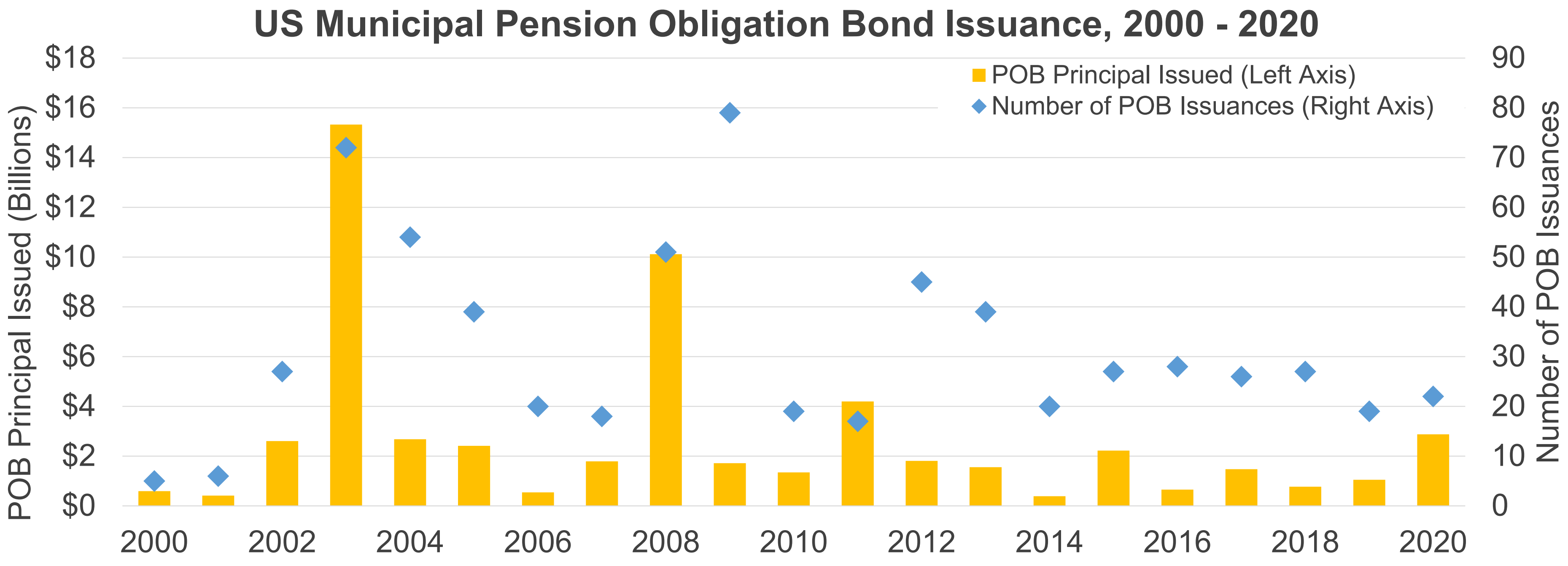
Key Features

Features	Description
Purpose	• Bonds are issued to finance the unfunded portion of an issuer's pension liabilities • Proceeds are deposited to the issuer's pension fund
Tax Status	• Federally taxable unlike tax-exempt municipal bonds
Security	• Absolute and unconditional obligation; paid from legally available funds
Assumed Benefit	• Lower budget cost of new lower employer contribution plus debt service versus current higher employer contribution • "Pension arbitrage" earning more on the proceeds than the cost of issuance

Flow of Funds

History of Issuance (since 2000)

- Over the last 20 years, state and local government entities have:
  - Issued a total of 660 series of pension obligation bonds (13 in Texas)
  - With total principal of more than $56.6 billion

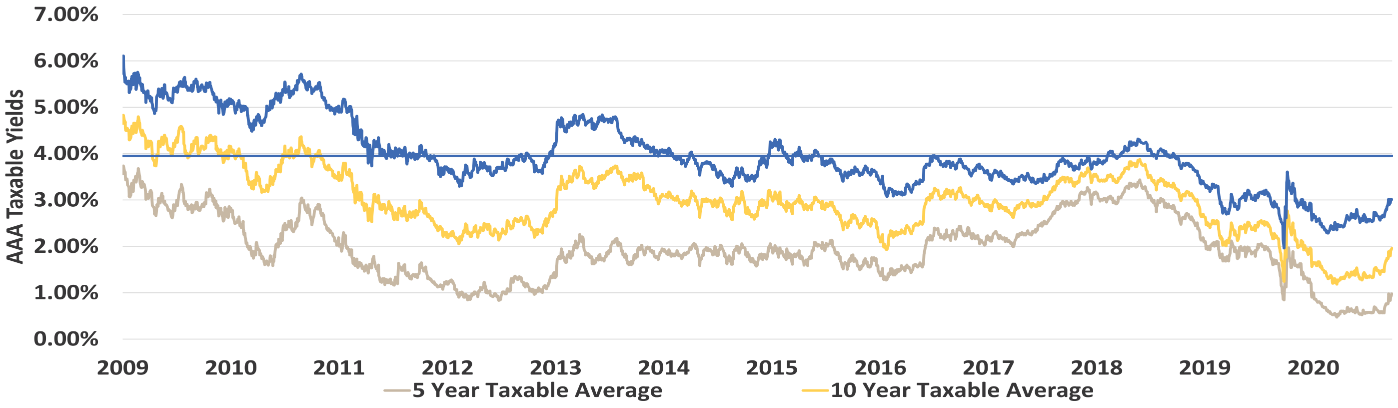


Source: Ipreo as of 1/14/2021

Why do POBs seem attractive today?

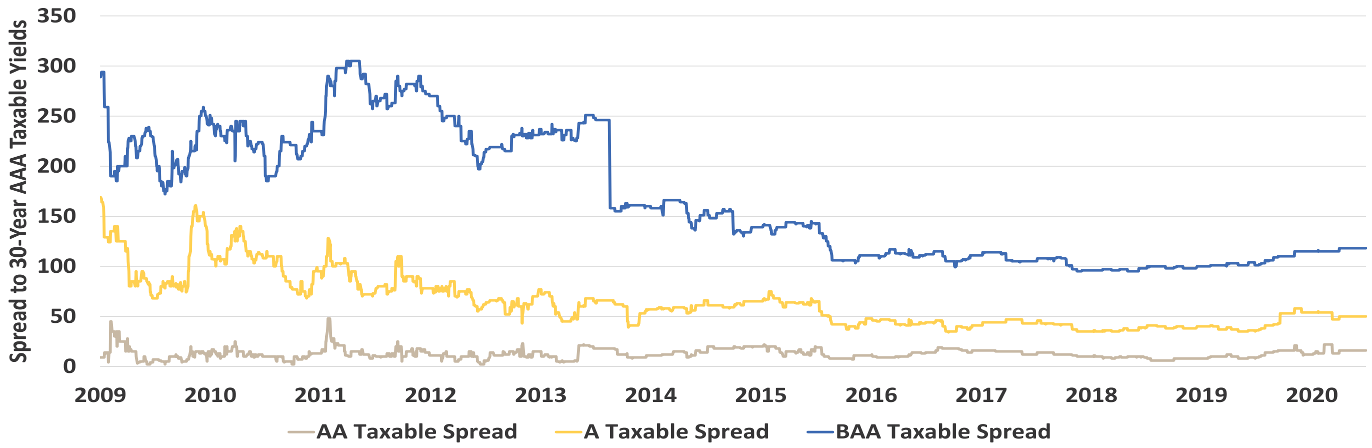
- Since 2018, taxable municipal debt issuance has become more common
- Cost effectiveness of POBs improved:
  - Interest rates have been dropping
  - Spreads for investment grade credits have narrowed relative to the high-grade benchmark
  - The spread between issuance cost and the expected return on investments has widened

Taxable Yields from 2009 to 2021



*Source: AAA Taxable Yields from Refinitiv (06/16/2009 - 03/08/2021)

Spread to 30-Year AAA Taxable Yields - 2009 to 2021



*Source: AAA Taxable Yields from Refinitiv (09/10/2009 - 03/08/2021)

Considerations for POBs

Municipal Issuers

- Does the POB produce budget savings sufficient to offset the risks?
- What pension or policy reforms will be needed to increase the future resilience of the plan?
  - Funding (contribution) policy development
  - Pension Stabilization Trust creation and funding
  - Other?
- Will the proceeds be invested in a manner that improves likely future outcomes from sufficient “pension arbitrage” or liability defeasance?
- If there is negative investment experience subsequent to the POB, can the budget sustain the increased costs?
- How will rating agencies view the issuance of the POB?

Pension Trustees

- Is the employer looking to obtain concessions in exchange for issuing the POB?
- Are employer policies and other strategies in place to avoid future reversion to the current situation?
- Will the infusion of cash be used as an opportunity to revise assumptions to improve plan sustainability?
- How will the significant cash flow be invested:
  - In equities, attempting to maximize pension arbitrage
  - In the plan’s asset allocation
  - In bonds, to defease known liabilities

Funding Pensions with Assets

- Some governments around the globe have used assets as contributions to pensions
- The concept of using assets to fund pensions versus cash contribution is based on:
  - Unlocking the market value of the asset in the pension rather than carrying the book value of the asset on government financial statements
  - Allowing the new owner of the asset to improve the asset or increase the productivity of the asset to create a higher value for the asset
- Considerations:
  - Is the asset to be contributed considered a core part of government?
  - Could the provision/cost of service be altered by divestiture of the asset?
  - What are the positive and negative impacts to the asset itself, to the owner, and to the beneficiaries?
  - Can the asset ownership be transferred, leased, or sold?
  - Valuation of the asset

Asset Monetization as a Funding Strategy

- Many governments own significant assets that provide a stable and long-term source of cash-flows. Governments may sell or lease these assets to match long-term cash-flows with the long-term liabilities associated with retirement systems

Pittsburgh, PA *rejected a bid of $453 million for a 50-year lease on parking revenues to fund its pension deficit. Instead, it sought to accomplish the same purpose by transferring the yearly parking revenue directly to the pension system. While the economics of this were similar, no changes were made to the pension system's benefits, and the funded ratio is falling.*

Allentown, PA *leased its water utility for 50 years to a public authority in return for $211.3 million, of which $160 million was used to reduce the unfunded pension liability. Future rate increases were limited and there was no initial cost to taxpayers. As a result, Standard & Poor's revised Allentown's ratings outlook from stable to positive.*

Scranton, PA *sold its wastewater system to Pennsylvania American Water for $195 million. The net proceeds of the transaction were utilized to pay off debt and a deposit to the pension system, which was roughly 25% funded in aggregate at 12/31/14*

Asset In-Kind (“AIK”) Transfer

- What is an AIK Transfer?
  - Contribution of public infrastructure assets into a pension plan
- Largely untested concept with only few data points
  - Australian Highway
  - New Jersey Lottery
- Identifying a fair asset market valuation may be difficult
- Understanding of the ownership rights and responsibilities, legal limitations, and asset exit options
  - Likely complicated and possibly intertwined with public policy issues
  - Pension will need clarity on its ability to make changes or sell the asset in furtherance of its fiduciary duty
  - Limiting of asset exit options likely to limit or otherwise reduce market value of asset
- New organizational burdens may be levied on the pension plan based on assuming the responsibility of managing the asset

Queensland Australia Motorway Asset Transfer

In-Kind Contributions are not uncommon in corporate finance or abroad — Queensland is a great example of its application for public plans

Queensland, Australia. On May 2011, the State sold Queensland Motorways (QML), 70 km tollroad network in Brisbane metro area, to Queensland DB Fund for **AUD$3.1 billion** per negotiations with QIC, the Fund's asset manager — In 2014, QIC sold QML for **AUD$7.1 billion** — *Gain of AUD$3.8 billion or 2.1 times*

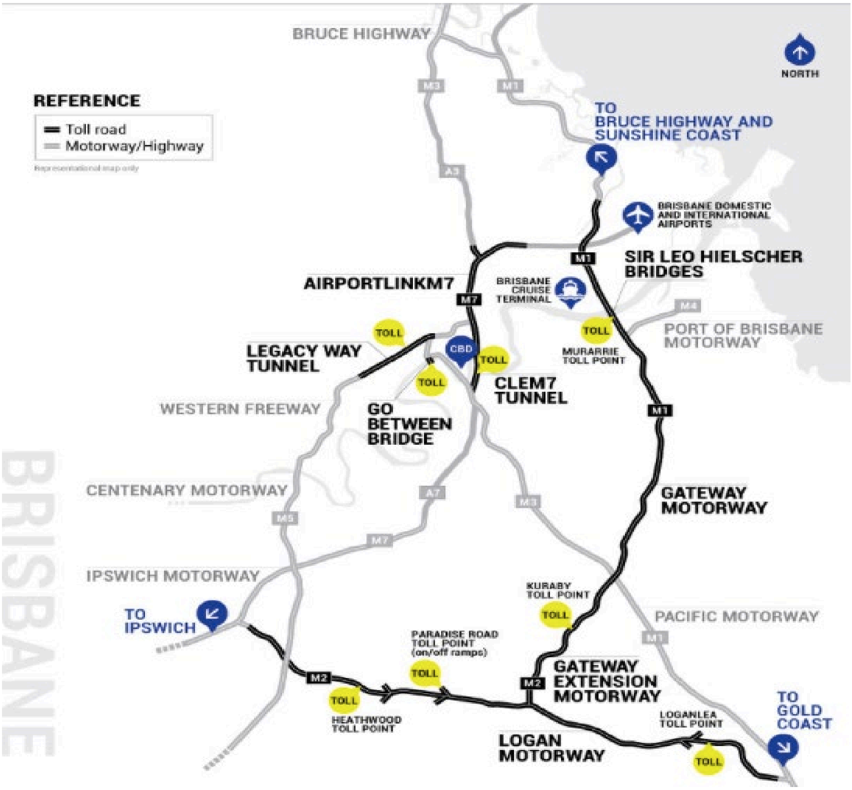
Commercialization. QIC transformed public agency into a business focused on better management, earnings, & growth— upgraded service, systems, & risk management — ***Immediately increased earnings 37%***

Expansion CapEx. Built genuine regional tollroad network via acquisitions and improvements

- Savings from improved Capital Execution, Synergies & Scale
- Greater Infrastructure Investment

Across the Board Benefits

- Better Service & Quality
- Lower Overall Cost Burden
- Political **"Win-Win"**



Source: API, September 2018

New Jersey Lottery Transaction

*Landmark Transaction — First municipality to transfer an asset of this magnitude **($13.5 Billion)** for the benefit of its public pension systems*

Overwhelming Bipartisan Support. Passed legislation and signed "memorandum of contribution" in July 2017 to irrevocably contribute NJ Lottery to pensions for a 30-year term

- **State's 4th Largest Revenue Source**. Net $1 billion annually
- ***Fair Market***. Actuary's DCF estimated value at ***$13.5 billion***
- **Pension Funding.** AIK dramatically improved funding ratios, replacing unsecure IOU
- ***Irrevocable Contribution.*** While no legislature can bind a future legislature, an irrevocable transaction based on Federal Tax Code's "Exclusive Benefit Rule", which is also State law

Application. Developed a new actuarial technique to set annual required contribution (ARC)

- ***Pension Funding.*** Lottery Enterprise is treated as a special asset, necessitating an annual adjustment (credit) to the ARC — Initially budget neutral, it shifts to level credit over time
- ***Upfront Funding.*** Similarly, can structure front-end budget relief and earmark pension cost savings to new infrastructure investment
- ***Over-Time Funding.*** Using level credit approach to the special asset adjustment, can fund infrastructure investments on pay-go or with bonds (matching debt service and credits)

Source: API, September 2018

Conclusions

- Contribution policy should be:
  - Flexible
  - Reactive to valuation changes
- One-time Contributions should be:
  - Utilized only in conjunction with other changes designed to create sustainability
  - Carefully planned since they usually involve new responsibilities or debts
- Use of Assets to fund pensions should be:
  - Weighed against public policy issues
  - Viewed warily by pension trustees to ensure complete understanding of fiduciary issues

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