AGENCY:	City Council
MEETING DATE:	July 8, 2024
DEPARTMENT:	City Manager
PRESENTED BY:	I. Whippy/Consultants
EMAIL ADDRESS:	iwhippy@fortbragg.com

AGENDA ITEM SUMMARY

TITLE:
Receive Report and Presentation of the City's Unfunded Accrued Liability with CalPERS and Pension Cost Management Strategies

ISSUE:

The City of Fort Bragg (the "City") has a reported $6.2M Unfunded Accrued Liability ("UAL") with the California Public Employees Retirement System ("CalPERS") as of 6/30/2022. With the upcoming valuation reports to be released later this summer, the City's UAL is projected to increase further to approximately $6.6M after CalPERS achieved 6.1% investment returns in FY 2023. The UAL represents the shortfall/gap between what is projected to be needed to pay retiree benefits relative to assets held by CalPERS.

After CalPERS underperformance (-7.5% returns) in FY 2022, a new layer of UAL was created, which offset the previous UAL that was paid down and restructured by the City's 2021 Lease Revenue Bond ("LRB") issuance. The City is now again making payments against the UAL with CalPERS charging 6.8% annually on the outstanding UAL. While the City's combined payments on its UAL and 2021 LRB are currently lower than those made prior to the UAL restructuring, these current payments are projected to increase rapidly through the end of the decade from approximately $0.8M in FY 2025 to over $1.5M by FY 2029. Rising pension costs are one of the largest financial challenges facing public agencies statewide and are projected to impact the City's budget significantly over the next 5-10 years.

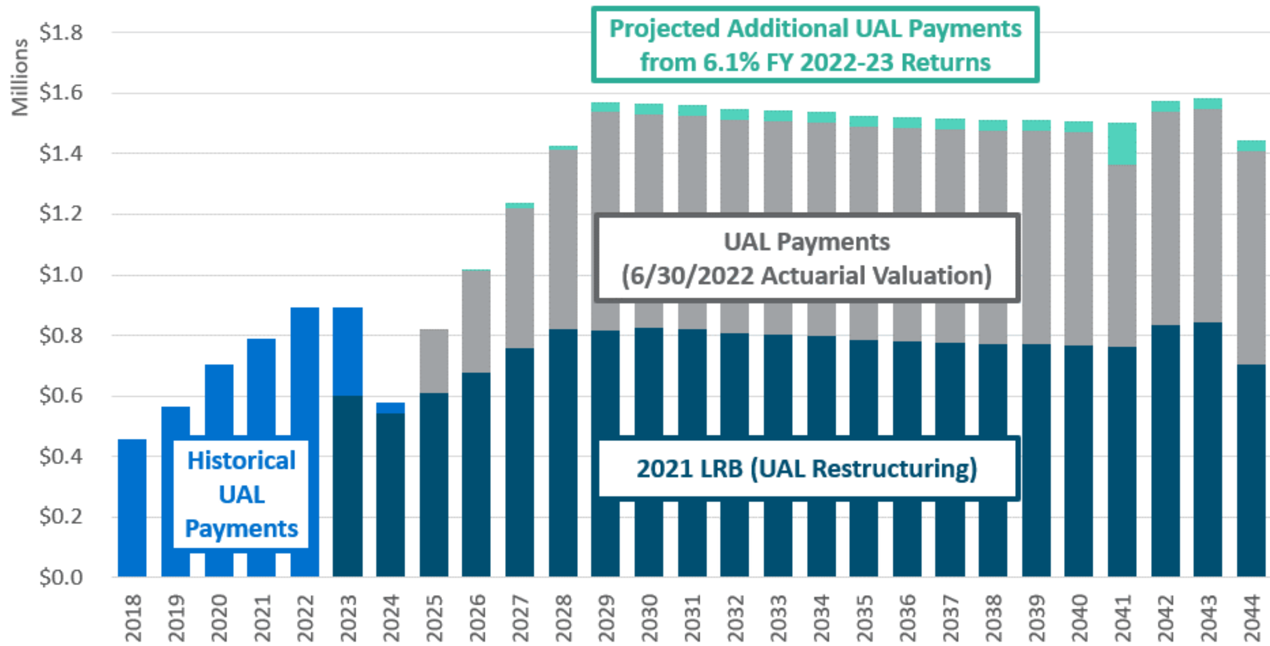
The City has been proactively addressing this pension challenge over the past several years, including through its 2021 UAL restructuring LRB issuance, the establishment of a pension Section 115 Trust ("Trust") and formation of a Pension Funding Policy to guide pension cost management. Over the years, the City has funded the Trust to an approximate $2.0M level.

The following information and accompanying presentation materials are intended to provide background information on the City's CalPERS pension liability, historical actions taken to manage pension costs, various cost management strategies and policy considerations relating to the City's CalPERS unfunded pension liability.

DISCUSSION/ANALYSIS:

The City, like most cities in California, has a UAL associated with its CalPERS pension plans for Miscellaneous & Safety employees. A UAL occurs when current pension plan assets are not projected to be sufficient to pay projected pension costs in future years. As of June 30, 2022, the City's UAL was $6.2M. CalPERS investment earnings for fiscal year 2023 were 6.1%, which is estimated to further increase the UAL to $6.6M in the upcoming CalPERS June 30, 2023 valuation.

CalPERS effectively charges the City a 6.8% interest rate on this UAL debt and requires a repayment schedule that escalates over the next decade as shown in the chart below (colored bars represent payments to amortize the UAL and LRB). Payments on the UAL and LRB are relatively low in FY 2024 at under $0.6M, but are projected to rise to over $1.5M by the end of the decade.



Historical Efforts: The City has historically taken proactive steps to address rising pension costs. In June 2021, the City held a pension cost management workshop to assess available options for managing its CalPERS UAL. After a thorough evaluation of both the risks and potential benefits of a UAL restructuring, the City issued $11.4M of LRBs in the fall of 2021 to refinance and restructure its UAL to smooth the projected peaking shape of UAL payments.

During the UAL restructuring process, the City also established a formal Pension Funding Policy and a Section 115 Pension Trust to memorialize strategies for managing the City's target pension funding ratios and future pension expenses. As a consequence of these efforts, the City has funded its Trust to a $2.0M level, which will be a strong asset for weathering and managing any future CalPERS cost volatility. The City has also historically taken advantage of the prepayment discount offered by CalPERS by making a lump sum UAL payment at the beginning of each fiscal year. Currently, the prepayment discount is approximately 3.4%.

Cost-Management Strategies: With the return of the UAL balance and projected pension costs increases due to poor recent CalPERS investment performance, it has become imperative for the City to continue evaluating ways to manage growing expenses and implement cost management strategies to help stabilize future pension cost volatility. City

Staff, working with NHA Advisors (the City's financial advisor), evaluated multiple options for maximizing the benefit of the funds in the Pension Section 115 Trust.

Section 115 Trust Smoothing

Due to the strong balances accrued in the Section 115 Trust to date, one option the City can consider is "smoothing" future UAL payments at lower payments levels by making tailored withdrawals from the Trust during years with high payments. The partial withdrawals can help to offset a portion of the required annual payment during the high payment years and allow the City to better manage the projected increase in UAL payments at its discretion. The City can also continue to grow balances in the Trust over time and make lump sum pay downs towards its UAL at a future date.

Funds in the Trust are restricted to addressing pension costs (i.e. unfunded liability and/or normal cost payments), but exist as an asset on the City's balance sheet and support flexible strategies for managing rising future CalPERS pension costs. The Trust also provides access to potentially higher investment earning opportunities than those restricted under the California Government Code (e.g. LAIF).

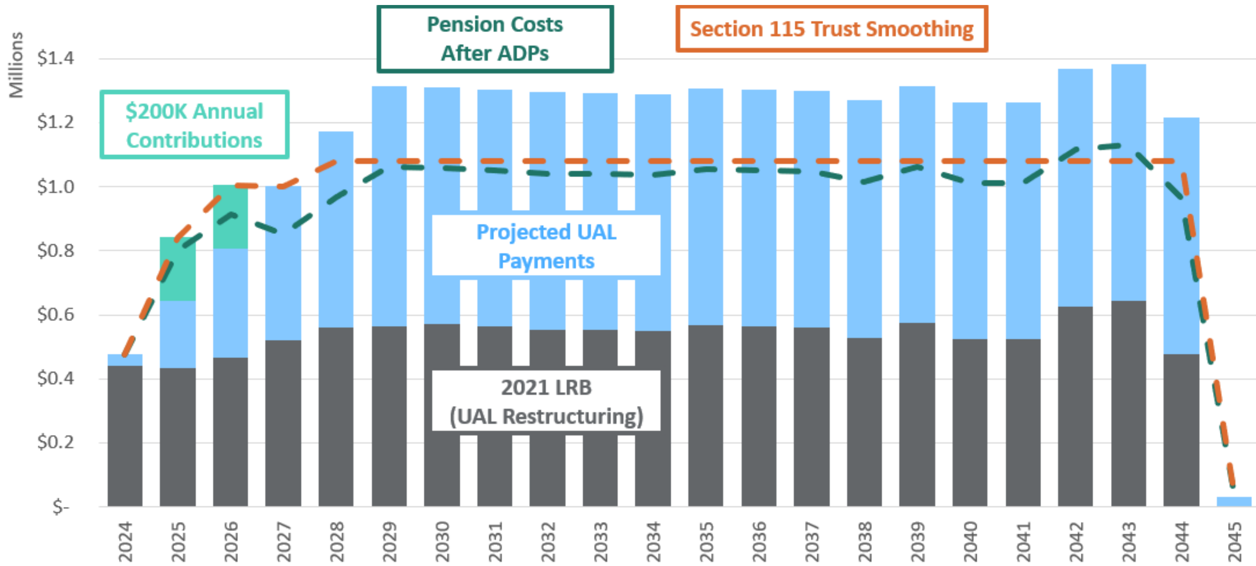
Additional Discretionary Payments ("ADP")

Another approach for utilizing available reserves for pension costs management is making direct additional pay downs of the UAL with CalPERS. This is commonly referred to as an Additional Discretionary Payment, and represents payments to pay down UAL debt above and beyond the required annual contribution.

A benefit of an ADP is that it directly pays down what is currently 6.8% debt with CalPERS, which is the most expensive debt on the City's balance sheet. Paying down additional UAL will directly increase the City's funded ratios and reduce future annual UAL payments. One nuance with ADPs is that the City would need to consider which particular amortization base it would pay down with CalPERS, with each base of the UAL having a unique repayment shape and structure. Additionally, funds sent to CalPERS cannot be clawed back in the future.

Preliminary Comparison of Section 115 Smoothing vs. ADP Approaches

The graphic below illustrates a preliminary comparison of what both approaches can do to manage the City's future projected pension payments, assuming approximately $2.0M is initially applied for both approaches. Additionally, further contributions of $200K for FY 2025 and FY 2026, respectively, are modeled to factor in continued progress in managing pension costs. It should be noted that these approaches are not mutually exclusive and can be considered in tandem with each other. The analysis also assumes long-term investment earnings on the Section 115 Trust of 4.00% to be conservative.



Strategy:	ADP	Section 115 Trust Smoothing
Assumed Interest Rate Benefit	6.80%	4.00%
Estimated Gross Savings	$4.53 Million	$3.58 Million
Contributions	$2.35 Million	$2.35 Million
Estimated Net Savings	**$2.18 Million**	**$1.23 Million**
Budgetary Flexibility	$0 (ADPs deposited cannot be retrieved from CalPERS)	Assets in Trust are available to City for pension costs
Target Smoothing Level	Net payments fluctuate	$1.08 Million

As depicted in the summary above, long-term savings are projected to be higher through the ADP approach as a function of higher assumed interest rate benefit. However, the flexible applications of a Section 115 Trust show greater ability to smooth and manage payment levels at a designated target. Both approaches illustrate positive long-term savings potential with tradeoffs relating to how funds are managed by the City.

Policy Considerations

In 2021, the City adopted a Pension Funding Policy that establishes guidelines for target pension funding ratios, Section 115 Trust funding levels and transparent reporting of the City's pension plans. Following these guidelines has enabled strong balances in the City's Section 115 Trust, but the return of the unfunded liability makes it imperative to continue evaluating processes and procedures for managing future pension costs.

The City's current funded ratios as of the 6/30/22 CalPERS valuation reports are approximately 86-87%, which is under the target funding level of between 90-100%. However, the balances in the Trust represent additional pension-restricted assets that are not currently factored into the CalPERS funding ratios. As the Trust grows over time, it is recommended that the City consider a holistic view of its funding ratios, including the Trust, to better manage potential pension overfunding scenarios.

RECOMMENDED ACTION:
Staff recommends that the City Council receive and file the pension cost management strategies presentation and report.

ALTERNATIVE ACTION(S):
1. Provide alternative direction to staff.

FISCAL IMPACT:
There is no financial impact to the FY 2024 budget.

GREENHOUSE GAS EMISSIONS IMPACT:
There is no impact to greenhouse gas emissions from receiving the presentation and report.

CONSISTENCY:
N/A

ATTACHMENTS:
1. Pension Cost Management Strategies Presentation

NOTIFICATION:
N/A