

CITY OF FORT BRAGG

PENSION COST MANAGEMENT STRATEGIES & POLICY CONSIDERATIONS



NHA | ADVISORS
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Delivered.

JULY 8, 2024

Executive Summary

- ▶ City issued \$11.4M of Lease Revenue Bonds (UAL Restructuring) in November 2021 to refinance & restructure its CalPERS Unfunded Actuarial Liability (“UAL”)
 - ▶ Objectives included cash flow savings and smoothing pension payments to enhance fiscal sustainability
- ▶ CalPERS underperformance has brought back a \$6.2M UAL as of the latest 6/30/2022 CalPERS actuarial reports
- ▶ UAL projected to increase to \$6.6M following CalPERS FY 2022-23 Investment Returns of 6.1%
 - ▶ Increase in payments to be seen in FY 2025-26
- ▶ Considerations for managing future Pension & General Fund Debt Liabilities:
 - ▶ Section 115 Trust Smoothing and Additional Discretionary Payments (“ADPs”) can help stabilize pension cost volatility

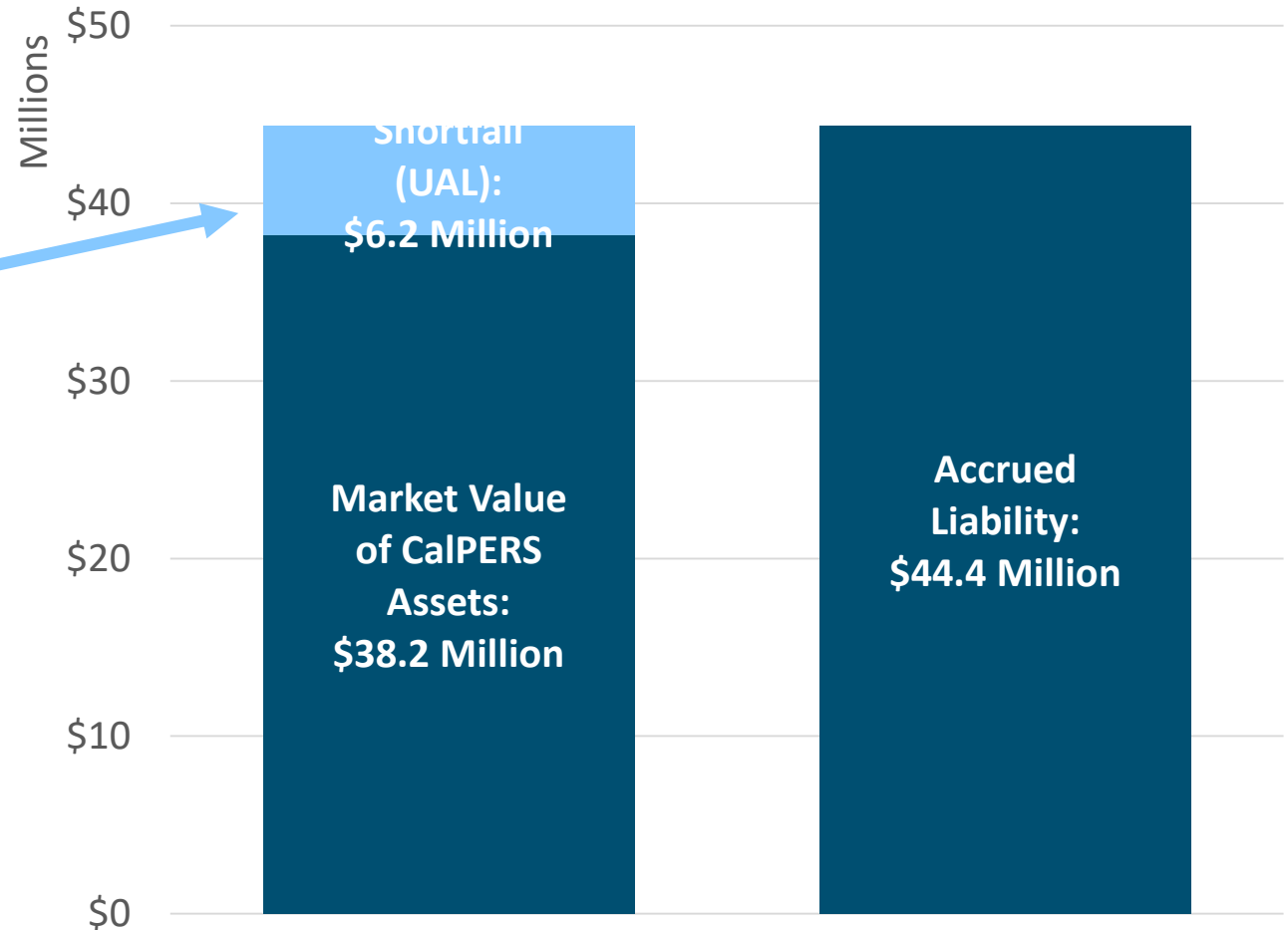


Background on How CalPERS Works

Two Payments Made to CalPERS Annually

- ▶ **(1) Normal Cost (“NC”)** = Annual cost for current employees
- ▶ **(2) Unfunded Accrued Liability (“UAL”)**: Annual payment to amortize the “debt” to CalPERS
 - ▶ UAL is amortized over 20 years
 - ▶ New UAL is created when CalPERS investment returns <6.80%

CalPERS Pension Funded Status



Source: CalPERS Actuarial Reports. Reflects UAL balance as of 6/30/2022.

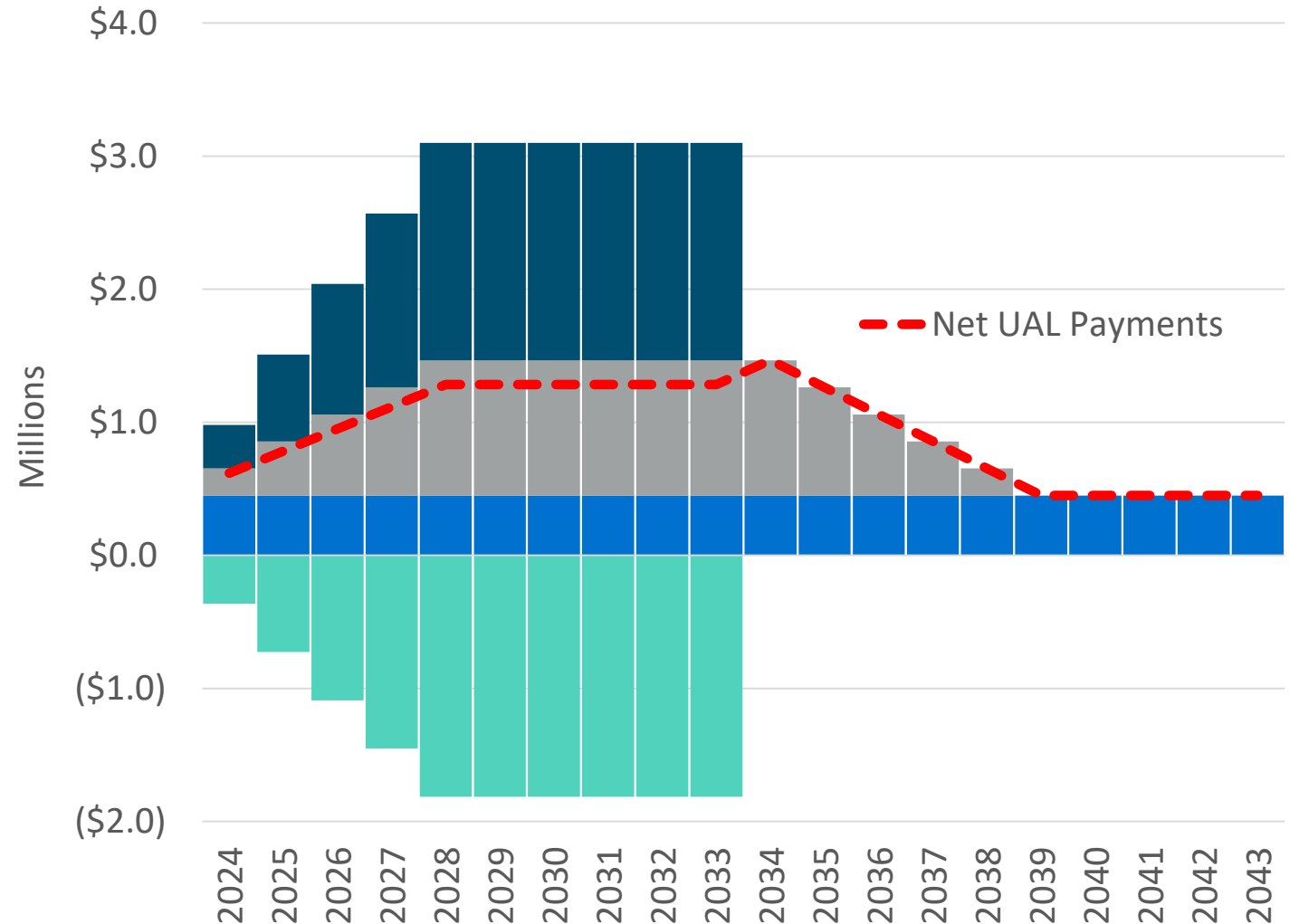


UAL Comprises Multiple Layers With Own Size, Shape and Term

New Layers Added Every Year Impacting Overall Shape of Repayment

Reason for Base	Ramp Shape	Term	Size of Base
Assumption Change	No Ramp	20	\$5,000,000
Method Change	Up/Down	15	\$7,000,000
Investment Loss	Ramp Up	10	\$9,000,000
Investment Gain	Ramp Up	10	(\$10,000,000)

Hypothetical amortization bases shown for presentation purposes.



**Historical PERS
Returns
(as of
6/30/2023)**

5-Year: 6.1%
10-Year: 7.1%
20-Year: 7.0%
30-Year: 7.5%

Why CalPERS Contribution Costs Have Trended Higher

Then (late 1990s)...

- ▶ Robust investment returns (10%+)
 - ▶ Retirement plans were “Super-Funded” through the 1990s
 - ▶ Investment Earnings cover retirement costs
- ▶ Lower Contribution Requirements Allowed Benefit Enhancements
- ▶ Past funding policies led to contribution holidays and “free” benefit improvements

Now ...

- ▶ Investment Returns Not Meeting Assumptions
- ▶ Assumptions have changed
 - ▶ Discount Rate: 8.25% → 7.00% → 6.80%
 - ▶ Inflation rate (prices going up)
 - ▶ Mortality rates (people living longer)
 - ▶ Actuarial Valuation → Market Valuation
 - ▶ Shorter, more conservative amortizations
- ▶ UAL payments have grown rapidly from past changes, remain exposed to the effects from future poor investment returns and assumption changes



How Retirement Benefits Get Funded

Money Going In vs. Money Going Out

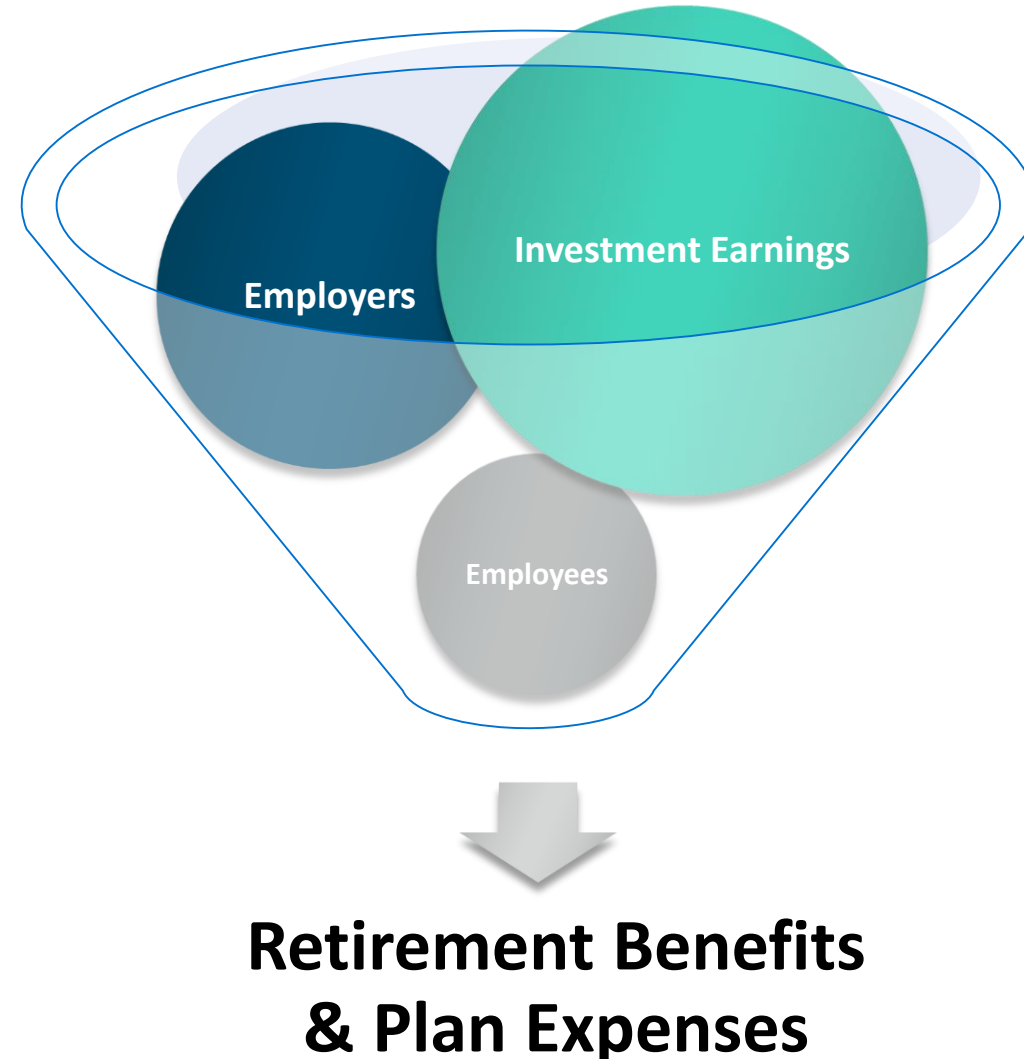
Employee Contributions: ≈11-13%

Employer Contributions: ≈29-32%

- Normal Cost: Payments to keep up with current employees
- UAL: Payments to amortize the Unfunded Accrued Liability

Investment Earnings: ≈55-60%

- As investments underperform assumptions, employers must make up the difference



Background - Retirement Plans

- ▶ 5 CalPERS plans
 - ▶ **Miscellaneous:** 120 covered members
 - ▶ **PEPRA Miscellaneous:** 56 covered members
 - ▶ **Safety Fire:** 1 covered member
 - ▶ **Safety Police:** 75 covered members
 - ▶ **PEPRA Safety Police:** 16 covered members
- ▶ PEPRA helpful to manage long term pension costs for new employees
- ▶ However, over 94% of current UAL is estimated to come from Classic plans and not reduced by PEPRA

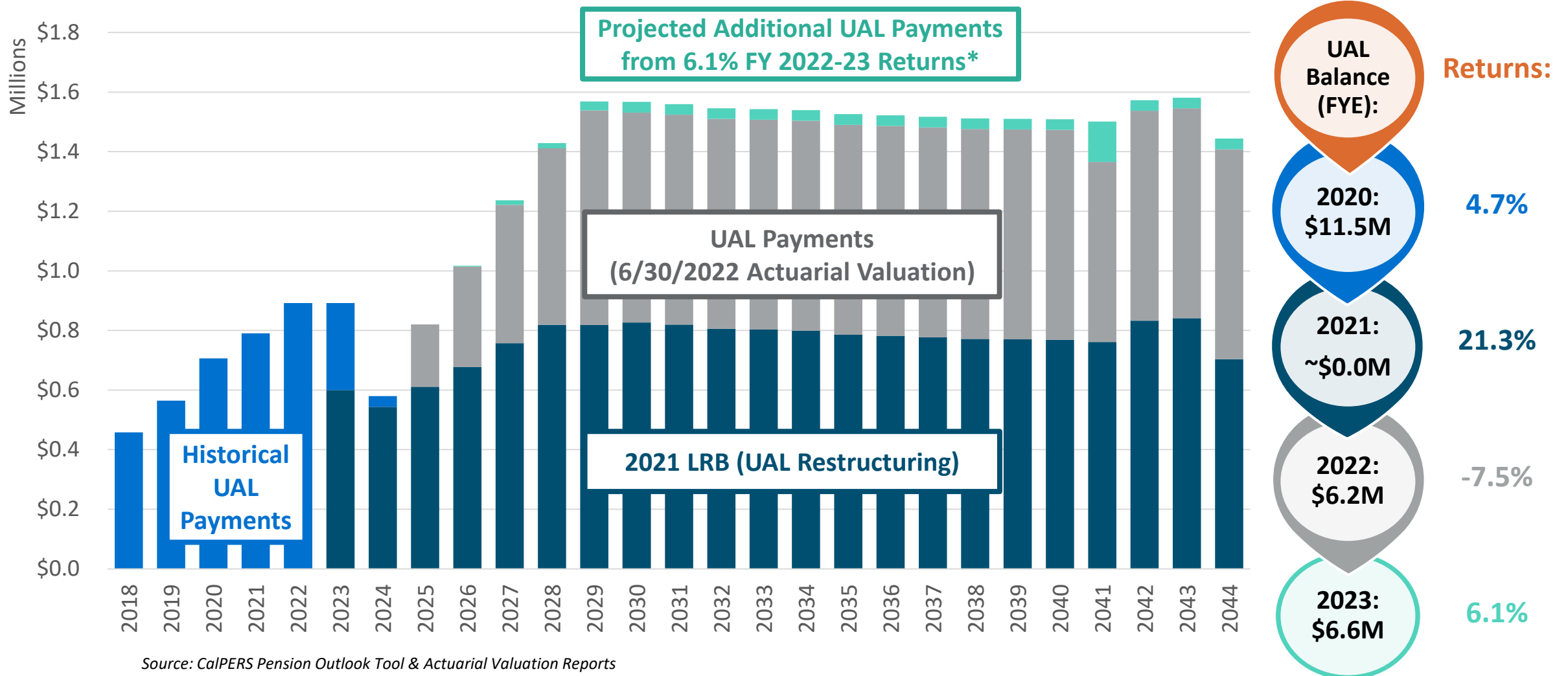
MISCELLANEOUS PLANS			
Benefit Group	# of Actives	% of Actives	Benefit Formula
Miscellaneous	11	27.5%	2% @ 55
PEPRA Miscellaneous	29	72.5%	2% @ 62
Total Active Members	40	100.0%	-
Total Covered Members	176	-	-

PUBLIC SAFETY			
Benefit Group	# of Actives	% of Actives	Benefit Formula
Safety Fire	0	0.0%	-
Safety Police	3	20.0%	2% @ 50
PEPRA Safety Police	12	80.0%	2.7% @ 57
Total Active Members	15	100%	-
Total Covered Members	92	-	-

Source: CalPERS Actuarial Valuation Report as of June 30, 2022



Historical & Projected UAL + 2021 LRB (UAL Restructuring)

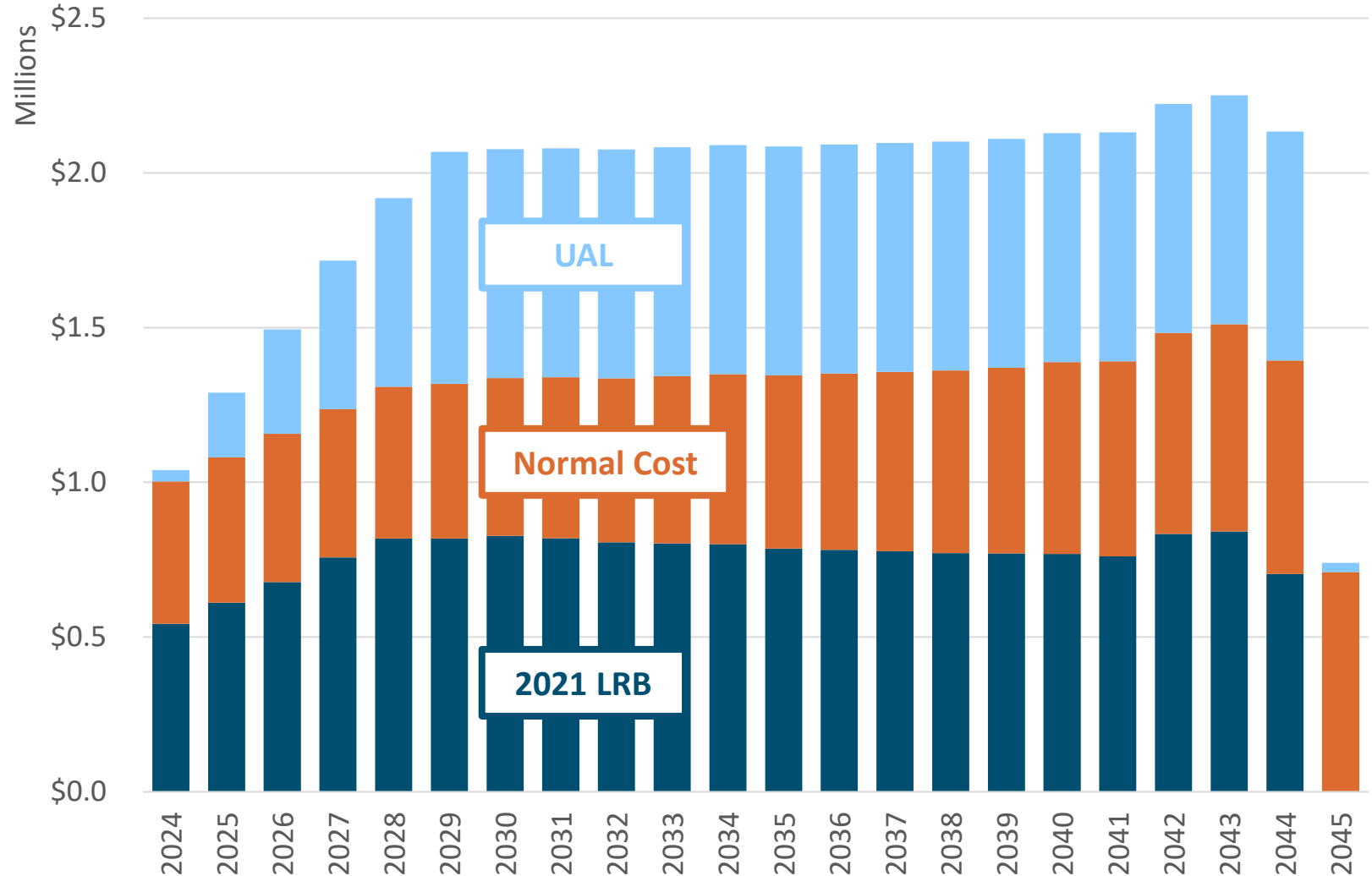


Source: CalPERS Pension Outlook Tool & Actuarial Valuation Reports
 *UAL balance and annual payments are projections from the CalPERS Pension Outlook Tool. Assumes FY 2022-23 investment returns of 6.1%, which is the money-weighted rate of return reported by CalPERS in its FY 2022-23 Annual Comprehensive Financial Report.



Total Projected Pension Payments (UAL + Normal Cost + LRB)

- ▶ Annual Normal Cost Contributions expected to increase from ~\$470K in 2025 to ~\$710K in 2045
- ▶ Total pension payments projected to increase to a max of ~\$2.3M in 2043
- ▶ FY 2024 pension payment accounts for 8.9% of total General Fund budget



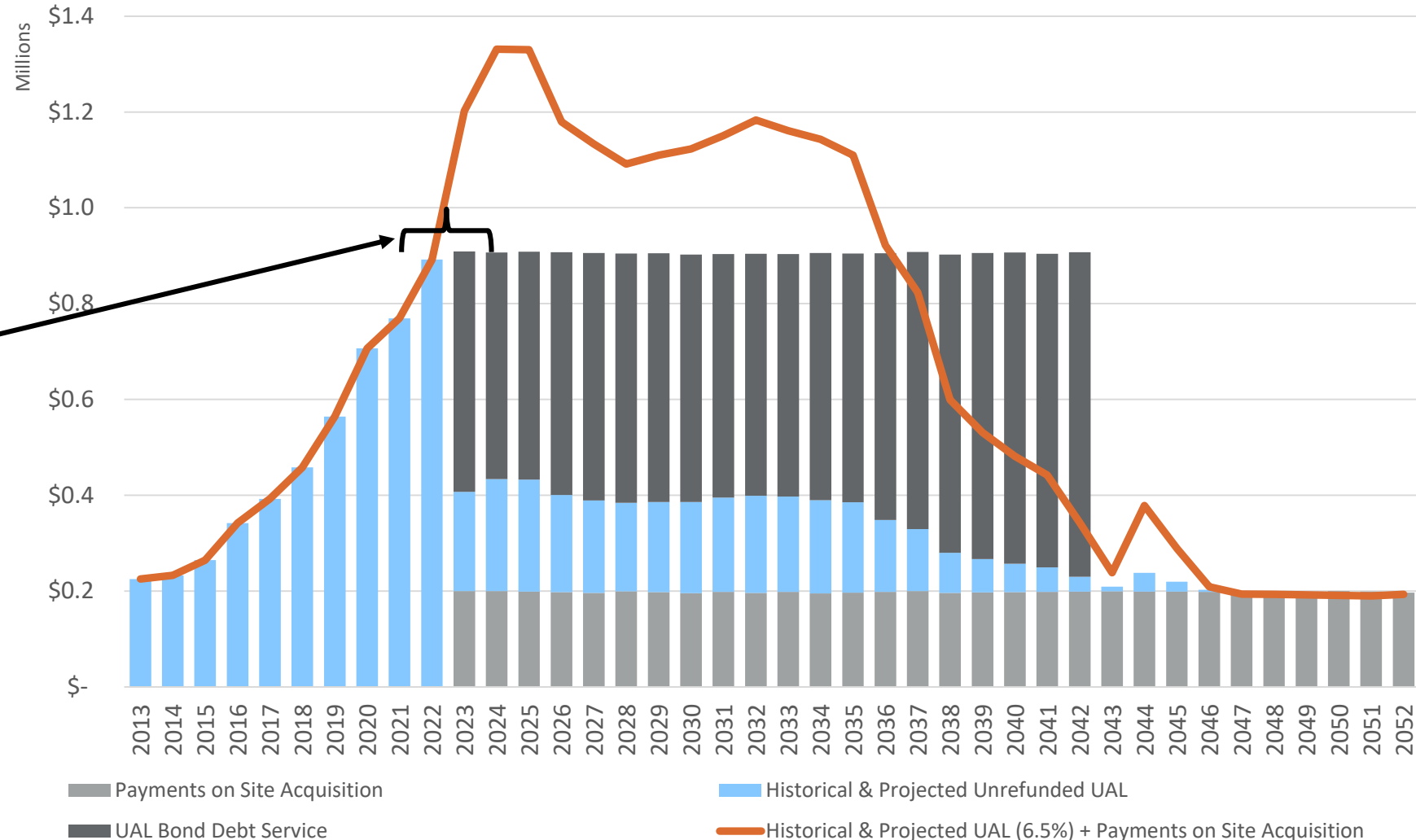
9 **Source:** CalPERS Actuarial Valuation Reports and CalPERS Pension Outlook Tool. Pension Outlook Tool assumes FY 2022-23 returns of 6.1% and 6.80% returns from FY 2023-24 onward.



STRATEGY AT ISSUANCE

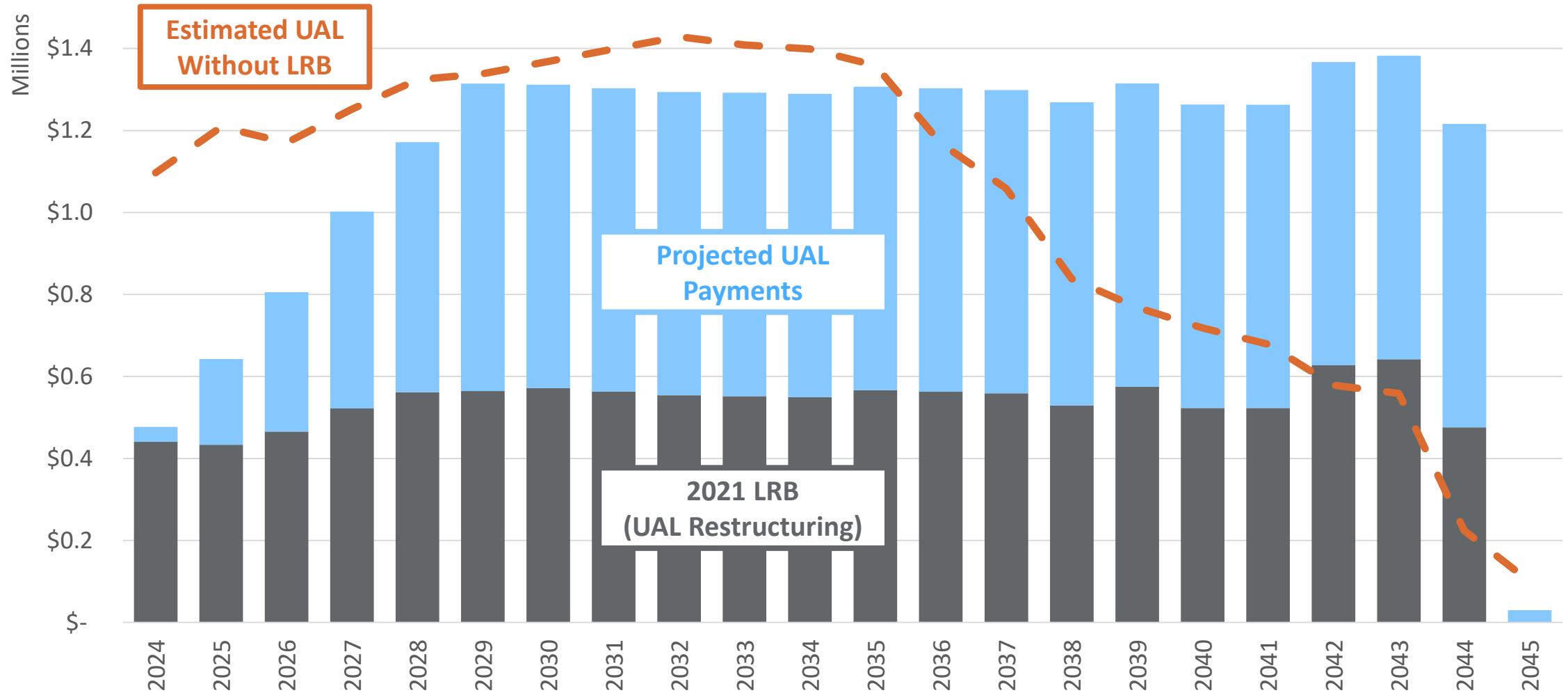
UAL Restructuring Strategy & CIP Funding to Minimize Budgetary Impact

- ▶ ≈70% of UAL refinanced (dark grey bars) to create overall lower/smoother debt payments for General Fund
 - ▶ Effectively 100% of UAL once CalPERS adjusted UAL for 21.3% returns and discount rate reduction
- ▶ No budgetary impact even with \$3.5M Mill Site Portion (light grey Bars) of debt payments
 - ▶ Financing team built in full flexibility to pay down this portion of debt early if not needed for Mill Site Project



Note: Estimated UAL payments sourced from CalPERS Outlook Tool

Current UAL and LRB Payments vs. Estimated UAL Without Restructuring



Cost-Containment Strategies – Not Mutually Exclusive

(1) Prepay UAL early in Fiscal Year (\approx 3.3% discount)



(2) Negotiate Cost Sharing With Employees

- Require employees to pay their share; new employees already governed by lower cost/benefit PEPRAs plans
- Negotiated cost sharing of the City's share

(3) Voluntary Fresh Start Amortization offered by CalPERS

- Pros: Smooths payment, shortens repayment period; reduces overall interest paid from shorter amortization period
- Cons: New structure “locked-in” + increased annual payments in near term; still amortized at discount rate

(4) Use Cash Reserves to Pay Extra (two options)



- Section 115 Trust – Separate trust solely dedicated to pension/OPEB → *City has a \$1.95M Section 115 Pension Trust*
- ADP – Reduce UAL through direct lump sum payment to CalPERS
 - Choose optimal amortization bases to pay off

(5) Restructure All or Portion of Remaining UAL



- Restructure portion of UAL at lower bond interest rate and “smooth out” payments for enhanced budget predictability, near and mid-term potential savings, and preservation of cash for other critical projects



Additional Discretionary Payment (“ADP”)

- ▶ **What is it?** City makes ADP directly to CalPERS and CalPERS eliminates payments associated with the portion of the UAL paid off, essentially giving the City credit at the discount/interest rate (currently 6.8%)
- ▶ **Advantages:**
 - ▶ Reduced UAL / higher CalPERS funding ratio
 - ▶ Reduced future payments
 - ▶ Broader, less restrictive CalPERS investment portfolio has potential for higher returns
- ▶ **Disadvantages:**
 - ▶ Requires reserves / surplus to fund
 - ▶ Re-investment and market timing risk with ADP funds
 - ▶ Less budgetary flexibility and investment control (vs. Section 115 Trust option)



Section 115 Trust

- ▶ **What is it?** Restricted Account for pension/OPEB
- ▶ **Advantages:**
 - ▶ Potential Higher Investment Returns in Managed Account
 - ▶ Longer-Term Benefit: Trust funds can grow over time and pay off a large % of UAL in the future
 - ▶ Shorter-Term Benefit: Apply funds to “*smooth*” payment spikes in UAL and/or Normal Cost
 - ▶ Flexibility – more investment options than CalPERS and the City can decide when and how to use
 - ▶ Potential shock absorber for volatility from CalPERS investment performance & assumption changes
- ▶ **Disadvantages:**
 - ▶ Doesn't directly reduce UAL until funds are transferred to CalPERS
 - ▶ Requires reserves/surplus contributions to build account balance
 - ▶ Investment risk (dependent on type of investment portfolio)



Section 115 Trust Smoothing Concepts

- ▶ City currently has a \$1.95 million balance in a Section 115 Trust

Section 115 Smoothing:

- ▶ City can grow its Section 115 Trust balance and selectively withdraw funds in future years to smooth and manage annual pension payments at lower levels
 - ▶ The City's annual UAL payment is projected to be covered by LRB savings for the next several years, so executing withdrawals after the LRB savings end can allow the Trust balance to grow uninterrupted for the next several years
- ▶ This smoothing strategy can be executed in conjunction with other cost management strategies, including ADPs and pension bond paydowns



Comparison of Section 115 Trust & CalPERS ADP

OPTION	Section 115 Trust	CalPERS ADP
Reduced UAL & UAL Payments with CalPERS	No	Yes
Reduced Pension Liability in Financial Statements	No (but Trust will show up as an asset on the City's financial statements)	Yes
Control of Investment Strategy	Yes	No
Funds Managed By	Trust Administrator	CalPERS
Flexibility in Uses	Yes	No
Enhanced Budgetary Flexibility	Yes	Limited
Savings	Varies; Depends on when City utilizes funds to pay liabilities	Immediate; Length of time varies based on which amortization bases are paid off



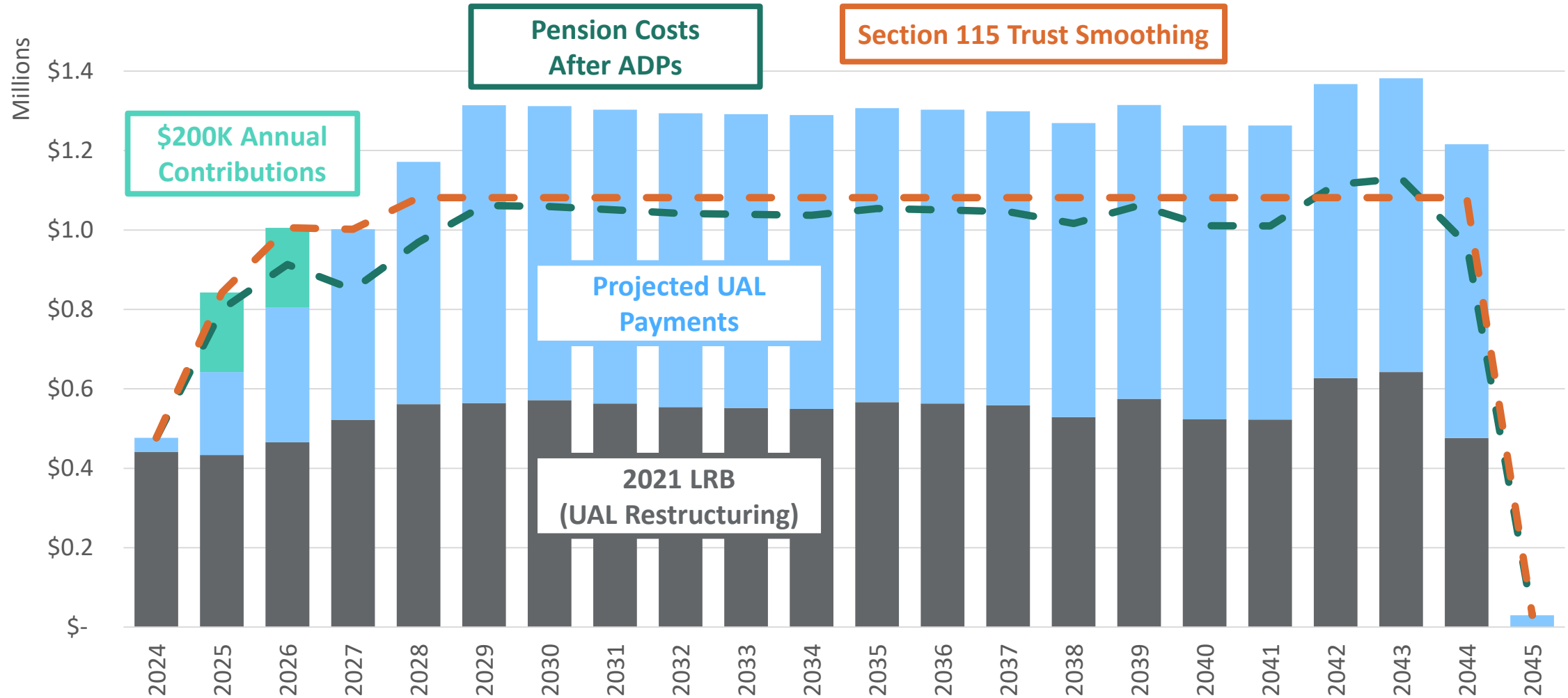
Additional Cost Savings Considerations

Section 115 Smoothing vs. ADPs

- ▶ While applying funds toward a Section 115 Trust or ADPs are both proactive approaches for UAL cost management, there are a few additional considerations:
 - ▶ **Section 115:**
 - ▶ Assets remain accessible as a balance sheet asset in the event unexpected needs arise
 - ▶ Supports flexible drawdown approaches for managing and smoothing annual pension costs
 - ▶ **While providing access to potentially higher-earning investment opportunities than LAIF, a more conservative investment strategy may not create the same nominal benefit as paying down 6.8% UAL with CalPERS**
 - ▶ **CalPERS ADPs:**
 - ▶ Directly pays down UAL with CalPERS, boosting funding ratios
 - ▶ Reduces future UAL payments with credit at a 6.8% interest (i.e., discount) rate
 - ▶ Proceeds sent to CalPERS, however, cannot be clawed back
 - ▶ Ability to smooth future UAL payments subject to shape of individual UAL amortization base layers



Section 115 vs. ADP Comparison for \$1.95 Million Contribution



Comparison of Section 115 Trust & ADP Preliminary Analysis

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



*Assumed long-term investment returns rate for Section 115 Trust; not necessarily fixed or guaranteed.

Policy Considerations

- ▶ Holistically consider funding ratios with the Section 115 Trust in mind
 - ▶ Better manage potential overfunding scenarios
- ▶ [Placeholder for consideration based on strategic preference]



Takeaways

- ▶ Rising pension costs are a challenge facing most public agencies, and the City has tackled the challenge through strategies such as:
 - ▶ Issuing a strategic LRB in a low interest rate environment
 - ▶ Establishing a pension funding policy
 - ▶ Building up Section 115 Trust reserves
- ▶ However, the UAL challenge has returned mainly due to recent poor CalPERS investment returns, potentially increasing the City's UAL to \$6.6M
- ▶ To assist with proactive pension and General Fund debt management, the City can consider the following:
 - ▶ Consider making direct ADPs to CalPERS to pay down UAL
 - ▶ Consider growing City's Section 115 Trust

