STAFF REPORT
City Council Business Item

DATE: June 20, 2023

TO: Honorable Mayor and Council Members

FROM: Aaron Felmlee, Finance Director

THROUGH: Merritt Perry, City Manager

SUBJECT: **Authorize a $1,400,000 Supplemental Budget Request for an Additional Discretionary Payment to the California Public Employee's Retirement System (CalPERS) Pension Trust**

STAFF RECOMMENDATION:

Authorize City Manager to execute a Supplemental Budget Request and make an additional Discretionary Payment in the amount of $1,400,000 to be paid to the CalPERS Pension Trust to recognize interest payment savings.

EXECUTIVE SUMMARY:

Unfunded long-term liabilities for City employee pension plans continue to be one of the biggest issues facing local municipalities. In fiscal year 2018-19 staff identified and reviewed a number of potential strategies to address the unfunded pension liabilities including pros and cons of each strategy with the Council. It was determined that making additional discretionary payments when the City was able to was the best strategy and in fiscal years 2018-19, 2020-21, and 2021-22 the Council gave direction to staff to make additional discretionary payments to CalPERS in order to help "smooth" the future mandated unfunded liability payments. This report includes a recap of the pension plan and a discussion of the status and history of the unfunded liabilities.

New accounting standards dramatically impacted local government financial statements by requiring the net pension liability be reported as a liability on the City's Statement of Net Position; thereby, reducing the City's financial net position (assets in excess of liabilities). Prior to the change in accounting standards the long term liability amounts referred to as unfunded accrued actuarial liability were not included on the City's balance sheet. Annual payments for pension costs were paid on a "pay-as-you-go" basis, therefore no additional accrued actuarial expenses were added to City pension costs and there was no additional liability reported on the balance sheet. The addition of these unfunded long-term liabilities to the entity-wide financial statements brought these liabilities to the forefront amongst public officials and can have an effect on the City's ability to secure future credit (loans, bonds etc.).

CITY PLANS:

City of Fortuna permanent full-time employees participate in the CalPERS retirement system. Sworn employees are covered under the Safety Plan, while all other employees are covered in the Miscellaneous Plan, both of which are a part of the statewide pool. A pooled plan was required by

California law for those agencies who had fewer than 100 active members. These assets and liabilities are pooled with all other safety and miscellaneous plans in the State with fewer than 100 active members to provide a large, risk sharing pool. This risk sharing dramatically reduces large fluctuations in an employer's pension contribution rate caused by unexpected demographic events.

Depending on an employee's position and hire date, a City employee is included in one of the six possible plans in the table below:

Plan	Miscellaneous	Safety
Classic Members (Employees Hired Prior to March 1, 2012)	2.7% @ 55	3.0% @ 50
Tier 2 Plan (Effective March 1, 2012)	2.0% @ 55	3.0% @ 55
PEPRA Plan (Effective Jan 1, 2013)	2.0% @ 62	2.7% @ 57

CALPERS FUNDING REVIEW:

The CalPERS retirement system is funded by three main categories: (1) CalPERS Investment Earnings, (2) employer contributions to CalPERS, (3) employee contributions to CalPERS.

CalPERS reports that over the past twenty years every dollar spent on public employee pensions has been sourced from the following as of June 30, 2021

- 56 cents – CalPERS Investment Earnings
- 32 cents – Employer Contributions to CalPERS
- 12 cents – Employee Contributions to CalPERS

As of Fiscal Year 2021-22, CalPERS announced the following average returns on its investment portfolio:

- 6.7% percent over the past five years
- 7.7% over the past ten years
- 6.9% over the past twenty years

Per CalPERS, the average retiree annual allowance is $38,300 per year. The benefit paid to a retiree varies depending upon the number of years they have worked for a CalPERS participating government agency, the employee's salary, and the government agency's retirement formula.

PENSION FUND STABILITY INITIATIVES:

Over the past decade CalPERS has taken steps to stabilize and improve the system's fiscal strength and lower future risk to the pension trust's sustainability.

In November 2012, California voters passed the Public Employees' Pension Reform Act (PEPRA) providing that new employees hired after January 1, 2013 are required to contribute more to their pensions and must also work longer before they can retire and begin to receive the benefits promised by their employers.

Effective during the 2014-15 fiscal year the expected rate of return on CalPERS pension fund's investments referred to as the "discount rate" was reduced from 7.75% to 7.5%. In December 2016, CalPERS voted again to lower its discount rate in steps beginning in FY 2018-19 from 7.5% to 7.0%. Lowering the discount rate impacts local governments because with lower expected returns over time this will require contribution rates to increase to provide sufficient assets to pay pension benefits.

FORTUNA UNFUNDED LIABILITY STATUS:

As of June 30, 2021 the City of Fortuna's proportionate share of the net pension liability for each plan is shown in the below table:

	1% Decrease (5.95%)	Current Discount Rate (6.95%)	1% Increase (7.95%)
Miscellaneous Plan (~98% Classic)	$ 9,926,942	$ 6,820,183	$ 4,248,277
Safety Plan (~99% Classic Members)	$ 7,824,355	$ 5,203,551	$ 3,074,701
Total	$ 17,751,297	$ 12,023,734	$ 7,322,978

In FY 2017-18, the City of Fortuna was mandated by CalPERS to pay $427,958 towards the City's proportionate share of the unfunded liability. For FY 2022-23 the mandated payment was $788,765. An overall increase of more than $350,000 in five years.

FUTURE PROJECTED UNFUNDED LIABILITY PAYMENTS:

Fiscal Year	Payment	Fiscal Year	Payment
22-23	**$ 769,815**	34-35	**$ 1,273,000**
23-24	**$ 775,319**	35-36	**$ 1,222,000**
24-25	**$ 880,000**	36-37	**$ 842,000**
25-26	**$ 960,000**	37-38	**$ 665,000**
26-27	**$ 1,037,000**	38-39	**$ 591,000**
27-28	**$ 1,098,000**	39-40	**$ 531,000**
28-29	**$ 1,241,000**	40-41	**$ 491,000**
29-30	**$ 1,266,000**	41-42	**$ 412,000**
30-31	**$ 1,292,000**	42-43	**$ 335,000**
31-32	**$ 1,320,000**	43-44	**$ 710,000**
32-33	**$ 1,312,000**	44-45	**$ 56,000**
33-34	**$ 1,301,000**	45-46	**$ 4,000**

The chart above shows that the mandated liability payment is projected to increase by over $500,000 by fiscal year 2031-32. The City would be hard pressed to make such a payment without making cuts to the budget elsewhere. In order to address the unfunded liability issue now rather than let it get to those exorbitant numbers staff is recommending making Additional Discretionary Payments in order to "smooth" the payments and reduce the peak years.

ANALYSIS OF UNFUNDED LIABILITY STRATEGY:

Staff is proposing to continue with the strategy to make Additional Discretionary Payments (ADP). This approach offers the following benefits:

- The City's additional payments are discretionary as to time and amount of payment, providing flexibility if future circumstances allow for higher, lower or perhaps no payments for that particular fiscal year.

- The City would be initially credited with the CalPERS' assumed ROR. For FY 2022-23 the rate is set at 6.8%. Under CalPERS practices, additional contributions would be applied evenly over a period of time (can be chosen by the City).
- Functions like a homeowner making additional mortgage principal payments, this strategy provides flexibility and if the City commits to a funding strategy with regular pay-downs, the unfunded liability could be retired ahead of the scheduled amortization period by a number of years.

This approach offers the following risks:

- The primary drawbacks to making additional contributions directly to CalPERS are that the City would have less flexibility, as the City would not control the timing of when funds would be applied.
- CalPERS has stated that once monies are paid into the pension trust, they are never returned back to the City. Future assets in excess of liabilities, should they occur, will not be refunded back to the City.
- City receives interest on additional discretionary payments in tandem with what CalPERS earns, which can be volatile. Below is a list of the last ten years earnings rate:

Year	Rate	Year	Rate
2021	21.3%	2016	0.60%
2020	4.70%	2015	2.40%
2019	6.70%	2014	18.40%
2018	8.60%	2013	13.20%
2017	11.20%	2012	0.10%

- Future City Councils may not view the discretionary payments as a priority and the fiscal discipline to make these payments may decline as service level demands on the operating budget increase in future budgets. (It is important to remember that Measure E is set to terminate in FY 2032-33 at which time the City would realistically be unable to make ADP's without another general tax Measure)

ANALYSIS OF MAKING $1,400,000 ADP:

The table below shows future mandated payments if staffs recommended Additional Discretionary Payment is made to CalPERS.

Fiscal Year	Total Mandated Payment wo/ADP	Total Payment w/ADP	Difference (Negative amount represents savings)
22-23	**$ 769,815**	$ 2,169,815	$ 1,400,000
23-24	**$ 775,319**	$ 651,417	$ (123,902)
24-25	**$ 880,000**	$ 752,000	$ (128,000)
25-26	**$ 960,000**	$ 828,000	$ (132,000)
26-27	**$ 1,037,000**	$ 902,000	$ (135,000)
27-28	**$ 1,098,000**	$ 958,000	$ (140,000)
28-29	**$ 1,241,000**	$ 1,097,000	$ (144,000)
29-30	**$ 1,266,000**	$ 1,119,000	$ (147,000)
30-31	**$ 1,292,000**	$ 1,141,000	$ (151,000)
31-32	**$ 1,320,000**	$ 1,164,000	$ (156,000)
32-33	**$ 1,312,000**	$ 1,151,000	$ (161,000)
33-34	**$ 1,301,000**	$ 1,136,000	$ (165,000)
34-35	**$ 1,273,000**	$ 1,104,000	$ (169,000)
35-36	**$ 1,222,000**	$ 1,048,000	$ (174,000)
36-37	**$ 842,000**	$ 803,000	$ (39,000)
37-38	**$ 665,000**	$ 624,000	$ (41,000)
38-39	**$ 591,000**	$ 549,000	$ (42,000)
39-40	**$ 531,000**	$ 488,000	$ (43,000)
40-41	**$ 491,000**	$ 446,000	$ (45,000)
41-42	**$ 412,000**	$ 367,000	$ (45,000)
42-43	**$ 335,000**	$ 288,000	$ (47,000)
43-44	**$ 710,000**	$ 605,000	$ (105,000)
44-45	**$ 56,000**	$ 8,000	$ (48,000)
45-46	**$ 4,000**	$ -	$ (4,000)
Total	$ 20,384,134	$ 19,399,232	$ (984,902)

This strategy results in projected interest and payments savings of $984,902 over the next 23 years. It also lowers the peak fiscal year of 2031-32 from $1,320,000 to $1,164,000 a difference of $156,000.

Given the magnitude of the projected increases, the long-term fiscal sustainability of the City depends upon taking prudent, meaningful, and swift actions to address the City’s pension obligations. Staff is recommending that estimated FY 21-22 General Fund surplus monies as well as Water, Wastewater and Transit fund reserves be used to make an additional payment directly to CalPERS.

FINANCIAL IMPACT:

The City budgeted for the mandatory unfunded liability payment of $790,000 for FY 22-23. Staff is recommending making an additional payment of $1,400,000, which would require a supplemental budget adjustment to be done to the FY 22-23 budget. The allocation between funds would be as shown in the table below:

ADP Allocation Table				
Plan Type	**Fund Number**	**Fund Name**	**Allocation %**	**Amount**
Safety Tier I	100	General	84.21%	353,682
Safety Tier I	101	Measure E	15.79%	66,318
Misc Tier I	100	General	29.94%	293,412
Misc Tier I	101	Measure E	6.39%	62,622
Misc Tier I	120/160/280	Building/River Lodge/Street	16.52%	161,896
Misc Tier I	200/210	Storm Drain/Solid Waste	0.89%	8,722
Misc Tier I	500/550	Water/Wastewater	43.74%	428,652
Misc Tier I	590	Transit	2.52%	24,696
Total				**1,400,000**

Including funds 120 (Building), 160 (River Lodge), and 280 (Streets) into the General Fund portion, as these funds are supplemented by the General Fund, would require $937,930 to be taken from General Fund reserves. As presented during the special budget workshops the estimated FY 21-22 General Fund financials resulted in a surplus of ~$937,000. Additionally, as presented to the Measure E committee Measure E revenues exceeded FY 21-22 budgeted numbers by approximately $300,000. As for the other funds 200/210 (Storm Drain & Solid Waste), 500 (Water), 550 (Wastewater), and 590 (Transit) the required funds would need to be drawn from reserves for FY 22-23.

The $1,400,000 payment would translate to interest payment savings of approximately $985,000 through fiscal year 2045-46.

RECOMMENDED COUNCIL ACTION:

1. Receive staff presentation and review Council questions with staff;
2. Open public comment;
3. Close public comment;
4. Motion to Authorize City Manager to execute a Supplemental Budget Request and make an additional Discretionary Payment in the amount of $1,400,000 to be paid to the CalPERS Pension Trust to recognize interest payment savings. Voice vote.