

# STAFF REPORT – CITY COUNCIL MEETING

November 06, 2024

**TO:** Honorable Mayor and City Council Members

**FROM:** Tabatha Miller, Finance Director

**PREPARER:** Tabatha Miller, Finance Director

**DATE:** October 30, 2024

**TITLE:** **Receive an Update on the City of Arcata's Pension Funding and Outstanding Unfunded Accrued Liability (UAL).**

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## **RECOMMENDATION:**

It is recommended that the Council receive a staff report on the status of the City's pension funding and UAL and provide direction to staff as appropriate.

## **INTRODUCTION:**

Like many municipalities in California and across the United States, Arcata's pension liability is its single largest debt and a significant ongoing expenditure. The Unfunded Accrued Liability (UAL) is the present value of future employer contributions for service. It is the shortfall between the City's pension assets and what is needed to fully payout the benefits already promised to retirees. The most current CalPERS Actuaries (dated June 30, 2023) place the City's UAL at \$32.8 million, which do not include the \$7.5 million invested by the City in FY 2023-24.

## **BACKGROUND:**

The City participates in the California Public Employees' Retirement System (CalPERS). On March 15, and April 19, 2023, the City Council received presentations by GovInvest, a private company that provides tools and resources for understanding, managing and reducing pension costs and liabilities. In response to direction from the Council, staff developed a strategy to begin to reduce the City's UAL balances. That plan incorporated additional discretionary payments (ADPs), contributions to a section 115 prefunding pension obligation trust, a 15-year fresh start on the amortization of UAL bases and a plan to make smaller additional ADPs over the next 5 years with the goal of reducing the 15-year amortization to 10 years, resulting in higher interest savings.

As part of developing the Fiscal Year (FY) 2023-2024 Budget, the City Council authorized the \$5 million additional payment and funding the Section 115 Trust with \$2.5 million. To ensure that the City and future City Councils make pension funding a priority, the City Council adopted the Pension Funding Policy on August 16, 2023.

## **DISCUSSION:**

Funding a defined pension plan is a long-term obligation that requires a long-term horizon and continual monitoring. Pension liability is not stable or locked in like a 30-year fixed rate mortgage and paying off the current UAL does not mean there will be no UAL in the future. The CalPERS actuaries recalculate the total UAL every year and add a base or layer to the multi-year amortization schedule. Each year's base layer reflects CalPERS' investment performance, actual pension plan experience, and changes in pension formula assumptions. These layers can be positive or negative but the net effect in more recent years has been negative and this trend is anticipated to continue. Payments towards the new UAL amortization bases are generally amortized over a 20-year period, with impacts typically being phased in over the first five years.

As an example, on July 19, 2023, CalPERS announced a 5.8% investment return for FY 2023. While this was not a loss, it fell short of the 6.8% target or discount rate that is required to maintain the current funded level. That 1% shortfall in investment earnings was included in the CalPERS actuaries' calculations for FY 2023 which was published in August of 2024. This new amortization base started accruing interest at 6.8% as of July 1, 2023, but the City won't begin paying this portion of the UAL until FY 2025-26 and then only at the 5-year phased in 20% of the normal annual amortization schedule. This means higher overall interest costs to the City, as this amortization base grows larger for the first several years from accrued interest.

The cost of that investment return shortfall and changes in the pension plan position from factors like demographic shifts, economic conditions or changes in actuarial assumptions or the difference between expected and actual experience outside of investment performance decreased the funded status from 69.2% as of June 30, 2022, to 68.7% as of June 30, 2023. The UAL as of the June 30, 2022, actuarial was \$30.8 million and the most recent measurement dated June 30, 2023, is \$32.8 million.

These figures do not include the City's recent \$7.5 million payments as they occurred after June 30, 2023. They also do not include the investment return announced by CalPERS for FY 2023-24 of 9.3%, which exceeds the expected investment return rate of 6.8%. The impact of the City's \$5 million ADP and the 9.3% investment return will be included in the actuarial reports issued in August of 2025 and included in the UAL payment for FY 2026-27. The impact from the better-than-expected investment return is an estimated 5-7% reduction in UAL. With the \$5 million ADP, this would reduce the total UAL to an estimated \$25.8 million.

The \$5 million ADP will also save \$2.2 million in interest on the annual UAL payment over the existing 20-year amortization, without a Fresh Start to reduce the amortization period to 10 or 15 years. The balance in the City's Section 115 Trust is \$2,672,284 as of 9-30-2024 and those funds can be used at any time to make regular annual pension payments or to pay towards the City's UAL.

Staff would like the Council to consider and provide feedback and two decisions the UAL:

1. Consider whether to apply 25% of the FY 2022-23 General Fund Surplus (\$480,000) to pension funding either as a direct ADP to CalPERS or as contribution to the City's section 115 pension trust fund.
2. Consider applying a 10 or 15 year Fresh Start to the UAL amortization for the Classic Miscellaneous Plan. This would re-amortize the existing UAL balances into equal payments over either 10 years or 15 years. A 10-year Fresh Start would save the City \$5.2 million in interest and a 15-year Fresh Start would save the City \$2.1 million.

**POLICY IMPLICATIONS:**

Reviewing the City's Pension Funding Policy annually is consistent with the City's existing Pension Funding Policy.

**BUDGET/FISCAL IMPACT:**

Receiving an update on the Pension Liability does not by itself impact the budget or the fiscal state of the City. However, adherence to the City's Pension Funding Policy, committing to a Fresh Start Amortization or making an ADP will save the City interest charges and reduce the amount of the UAL over time.