Cotati City Council
Agenda Staff Report

Item type:	REGULAR AGENDA (ACTION)
To:	City Council
Subject:	**AUTHORIZATION OF A DISCRETIONARY PAYMENT TO CALPERS AND STATUS OF CITY PENSION PLANS**
Date:	December 10, 2024
Written by:	Angela Courter, Director of Administrative Services

Recommendation

It is recommended that the City Council receive a presentation, discuss options, and adopt a resolution authorizing an additional discretionary payment for amounts already included within the Fiscal Year 2024/25 budget.

Background

The City provides a defined-benefit pension to its retirees through the California Public Employees Retirement System (CalPERS) in lieu of a social security pension. Funding of CalPERS pensions relies on three sources: employee contributions, employer contributions, and investment returns. These three sources contribute to the City's Market Value of Assets (MVA). The MVA is then compared to the CalPERS actuarial determination of the Actuarial Accrued Liability (AAL) for all member agencies. The AAL is the actuarial projection of the total amount that CalPERS should currently have to cover promised benefits over time (accounting for anticipated investment earnings, expected future cost of living pay increases, future contributions of CalPERS members and member agencies, and various demographic assumptions such as life expectancy). If the AAL exceeds the MVA, the member agency's "account" is in a deficit position and an Unfunded Accrued Liability (UAL) exists.

With each new CalPERS actuarial update, CalPERS creates a new UAL "layer ", which either adds UAL or credits the UAL owed, depending on the investment returns for that year. For these long-term financial projections, CalPERS uses 6.8% as the assumed rate of return on investments, otherwise known as the "discount rate." If CalPERS over performs or underperforms this target, CalPERS will assign the loss or gain as additional UAL or a UAL credit in a layer for that year. If there is a loss, CalPERS will ramp up the full amortized payment for that loss over the first 5 years to soften the impact on the agency. During that time, the payments do not cover the full cost, so the agency is paying interest on the interest until the end of the 5-year ramp, adding significant additional cost over the term of the amortized Payments.

To address this issue, the City adopted a policy to evaluate pre-paying the interest up front to avoid compounding interest as well as leveling the amortization schedule, which generally increases costs to the City in the first 5 years but lowers the payments over the remaining 15 years. The policy also set a minimum of 80% funding level for UAL, with a future target of 90% Funded.

For the Fiscal Year Ending (FYE) June 30, 2021, CalPERS recorded investment earnings of 21.3% and therefore a credit actuarial base was added to the City's pension plans, lowering the UAL balance. Subsequently for the FYE June 30, 2022, CalPERS reported an investment loss of 7% (net loss of 13.8% compared to the discount rate), adding back in new unfunded liability, and increasing the UAL balance. For the FYE June 30, 2023, CalPERS had investment earnings at 5.8%, which is less than the target discount rate of 6.8%, which created a loss actuarial base and increased UAL balance.

For FYE June 30, 2024, CalPERS announced an investment earnings estimate of 9.3% which exceeds the 6.8% target and creates a future UAL reduction. CalPERS will provide updated actuarial reports which account for the full adjustment for 2024, in Fall of 2025.

<u>Historical Actions Taken to Address Increasing Costs</u>
The City has taken several steps to address the CalPERS pension costs. These have included:

- Lower Benefit Tiers for Employees - Two new lower benefit tiers have been established with CalPERS:
    - Tier 2 Employees hired in 2011-12 (depending on employee group) are required to pay the full employee contribution and have a lower retirement benefit.
    - Tier 3 was created in 2013 when the California Public Employees' Pension Reform Act (PEPRA) established a reduced tier of benefits for new CalPERS employees.
- Annual prepayments to CalPERS - Since FY2015/16 the City has prepaid the annual Unfunded Accrued Liability payment at the beginning of each fiscal year to save over 3% annually, rather than letting the interest accrue over the course of the fiscal year.
- Unfunded Pension Liability Policy – Creation of this policy guides City actions to address the outstanding UAL owed by the City, as discussed briefly above. This policy also included the establishment of a Section 115 Trust.
- UAL Refinancing - In January of 2022, the City Council approved a refinancing strategy to contribute approximately $6,000,000 (six million dollars) to pay down the UAL and invest in street rehabilitation. The contributions included borrowing approximately $4.0 million in the form of a tax-exempt pension loan at 3.2% interest rate; as well as an additional $2.0 million cash contribution to CalPERS from reserves and on-going revenues.
- Additional Discretionary Payments to eliminate negative amortization - in March and July of 2024 the City contributed a combined amount of approximately $670,000 to reduce negative amortization on the 2022 actuarial bases.

<u>Analysis/Discussion</u>

City staff reviewed the CalPERS actuarial reports as of June 30, 2023. According to these reports, the City's UAL has a combined underfunded balance of $7.7M, which equates to 83.1% funded. This is above the 80% minimum required for the Unfunded Pension Liability Policy, but under the target of 90% funded. This does not account for the City's additional discretionary payment of $670,000 or the subsequent CalPERS earnings for FYE June 30, 2024. With those adjustments staff estimate the unfunded ratio to be closer to 85.3%.

CalPERS remains focused on the long-term performance of the fund. The total fund annualized returns for the five-year period ending June 30 stood at 6.6%, the 10-year period at 6.2%, the 20-year period at 6.7%, and the 30-year period at 7.7%.

Staff are recommending two phases to address the unfunded liability.

- First for current implementation - staff recommend making an additional discretionary payment to CalPERS of $62,000 to eliminate the current year's negative amortization on the 2023 base. If this action is taken along with the additional payment for the same amount in fiscal year 2025/26, the estimated future interest savings is approximately $77,000.

- Second, staff recommend evaluating the conversion of the 2022 bases from ramp up to level repayment, the second $62,000 ADP for the negative amortization for the 2023 base, and other discretionary payments during our strategic planning and budget meetings next year. Committing to leveling the amortization of the 2022 bases <u>does</u> affect current cash availability in the short term, so this must be balanced against operational and capital needs as we develop the future budgets.

<u>Financial Considerations</u>

The Council's actions have allowed the City to meet the policy minimum requirements with an actuarial funded balance for 2023 of 83.1% and estimated actual funded balance for 2024 of 85.3%. Applying the strategy proposed would continue to maintain the City's funded status within the policy objectives.

This proposed ADP for the current fiscal year would not require a budget amendment but require council approval for payment authorization.

Future fiscal year actions for applying additional discretionary payments, as well as leveling the amortization of the UAL bases, will be explored by staff, and presented to City Council during the budget development meetings. Delaying this decision allows for direct analysis of the cost benefit against other competing budget demands.

<u>Environmental Issues</u>

This action is exempt from the California Environmental Quality Act (CEQA) because it is not a project which has a potential for resulting in either a direct physical change in the environment, or a reasonably foreseeable indirect physical change in the environment, pursuant to CEQA Guideline section 15378.