City of Chula Vista

Pension Cost Management Strategies & Policy Considerations

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Delivered.

May 28, 2024

Executive Summary

- City issued $350M of Pension Obligation Bonds (“POB”) in February 2021 to refinance & restructure its CalPERS Unfunded Actuarial Liability (“UAL”)
  - Objectives included cash flow savings and smoothing pension payments to enhance fiscal sustainability
- New $85M UAL (6/30/2022 CalPERS Report)
  - After POB, City benefited from initial CalPERS investment generating ~$116M surplus (overfunded)
  - New UAL payments start FY 2024-25
- CalPERS FY 2022-23 Investment Returns: 6.1%
  - Loss will increase UAL to ~$100M (6/30/2023 CalPERS Report)
- Considerations for managing future Pension & General Fund Debt Liabilities:
  - Update Pension & OPEB Reserve Fund Policy to provide flexibility of POB Bond Call Reserve
  - Section 115 Trust Smoothing and Additional Discretionary Payments (“ADPs”) can help stabilize pension cost volatility

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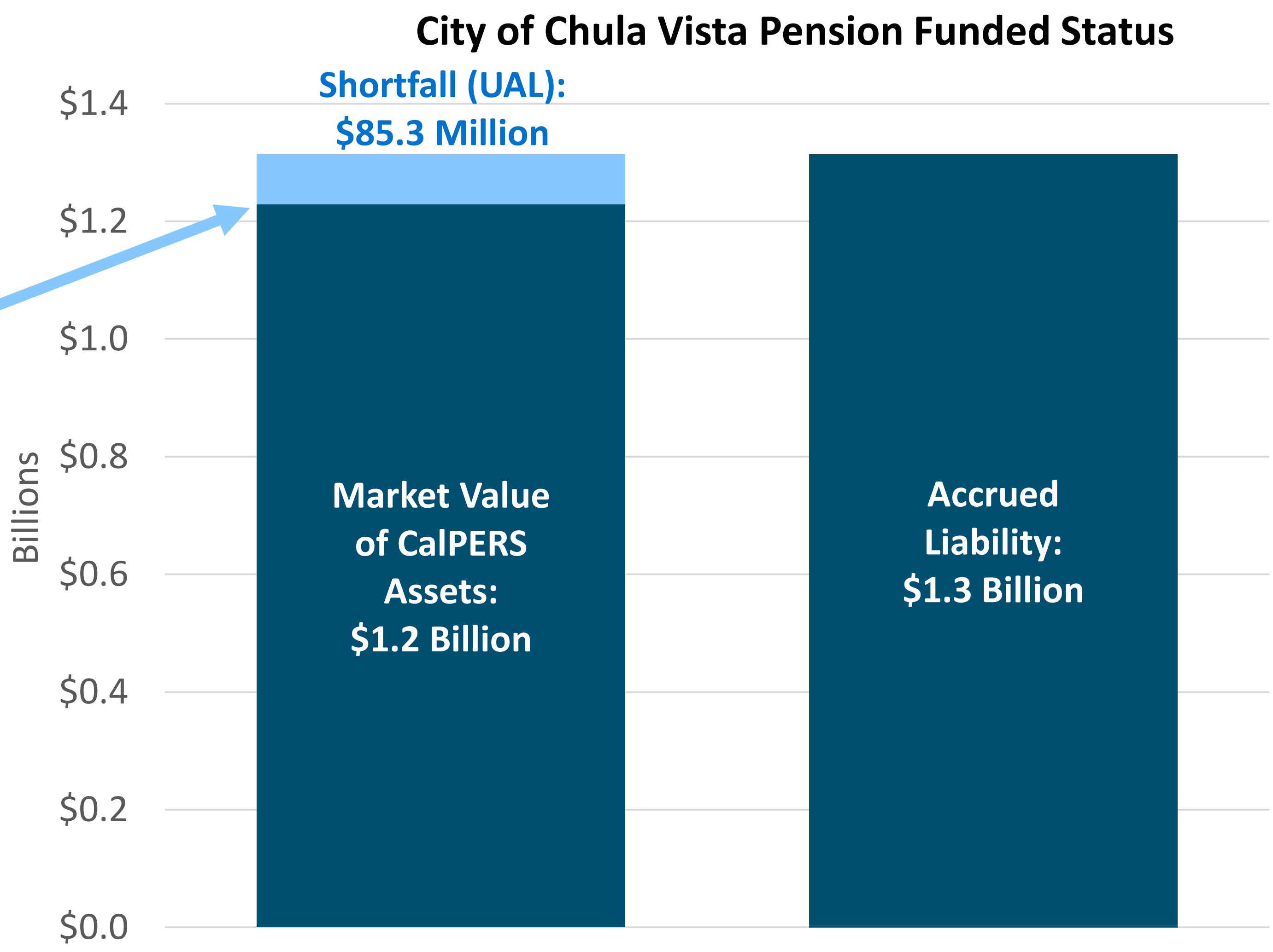
I. Background on CALPERS Costs

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%



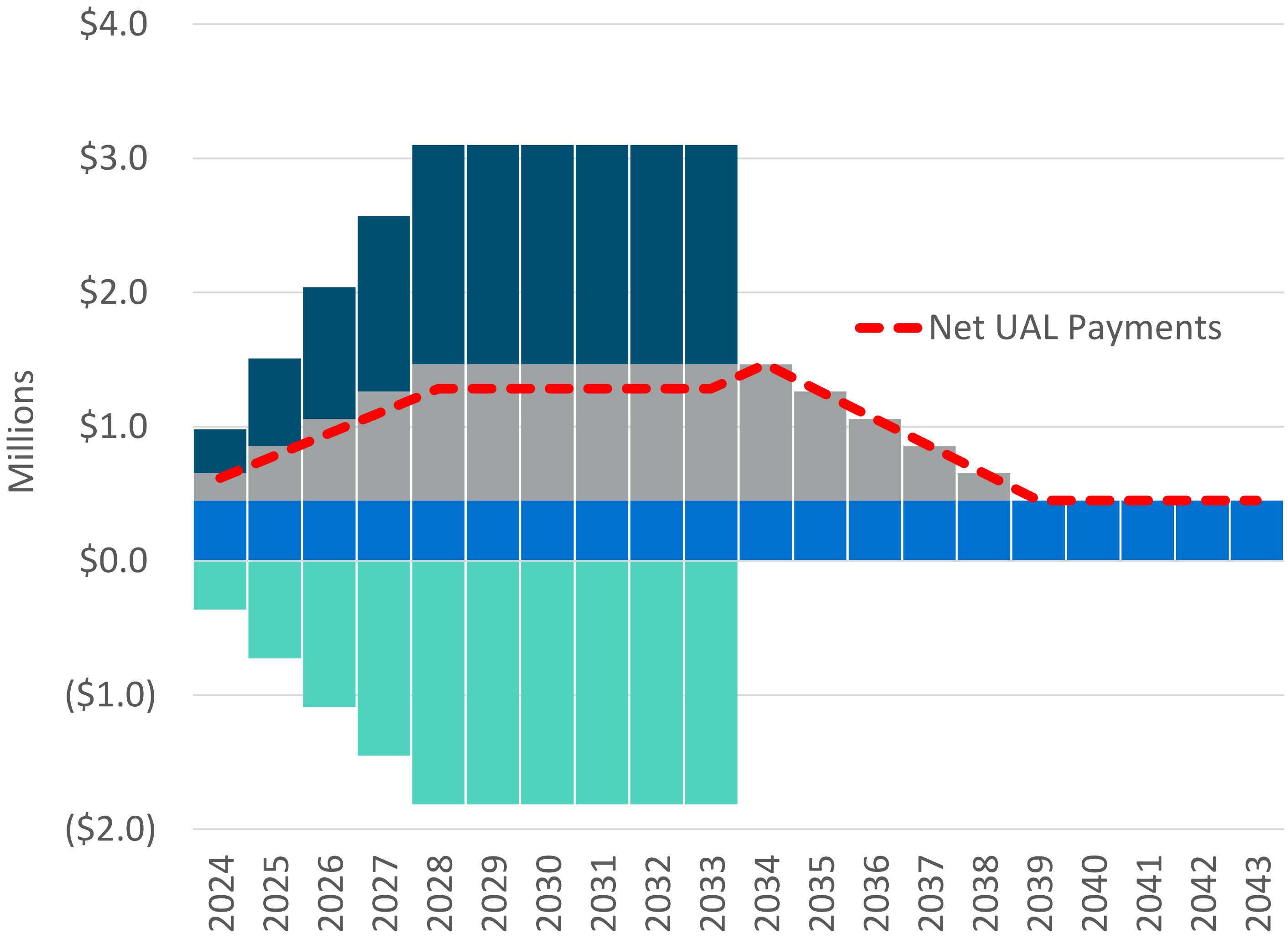
Source: CalPERS Actuarial Reports. Reflects UAL balance as of 6/30/2022.

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.



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Why CalPERS Contribution Costs Have Trended Higher

Historical PERS Returns
(as of 6/30/2023)
5-Year: 6.1%
10-Year: 7.1%
20-Year: 7.0%
30-Year: 7.5%

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% → <u>6.80%</u>
  - 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

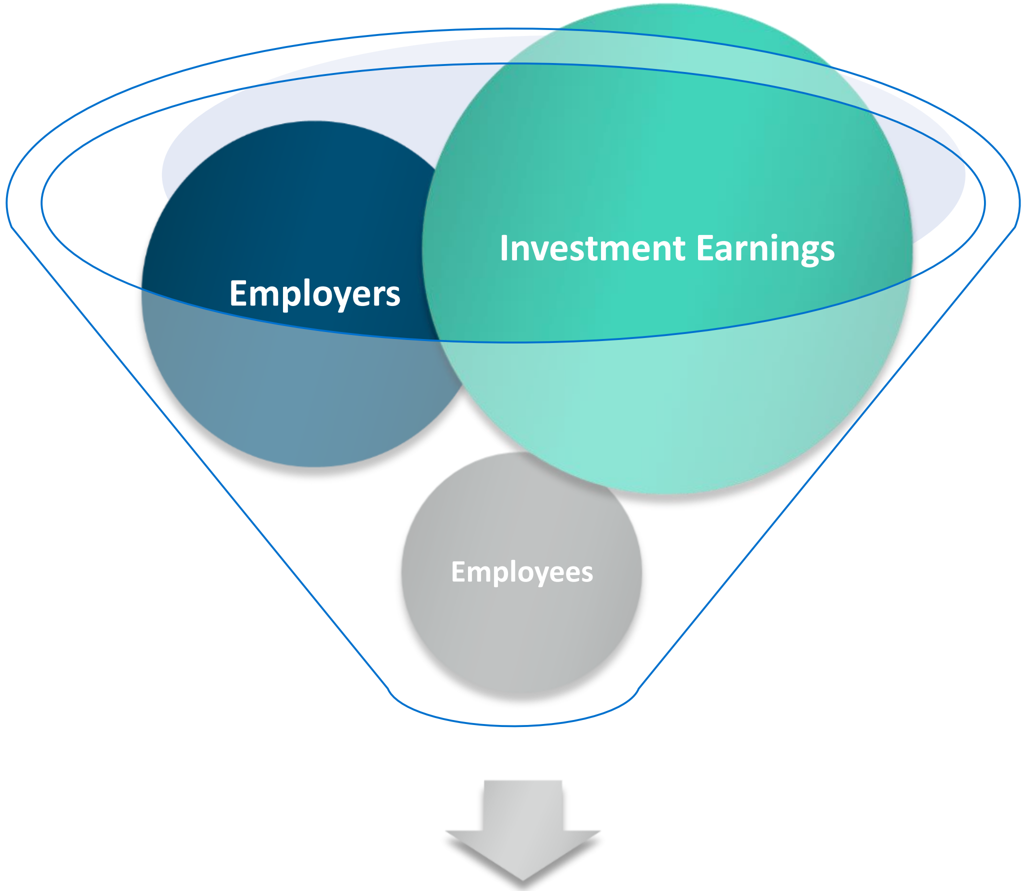
Employee Contributions: ≈11-13%

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%

- Investment earnings used to make up a higher percentage (> 65-70%) of total contributions (pre-2008)
- As investments underperform assumptions, employers must make up the difference



Retirement Benefits & Plan Expenses

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Background - Retirement Plans

- 2 Main CalPERS plans
  - **Miscellaneous:** 2,552 covered members
  - **Public Safety:** 960 covered members
- PEPRA helpful to manage long term pension costs for new employees
- However, over 99% of current UAL is estimated to come from Classic plans and not reduced by PEPRA

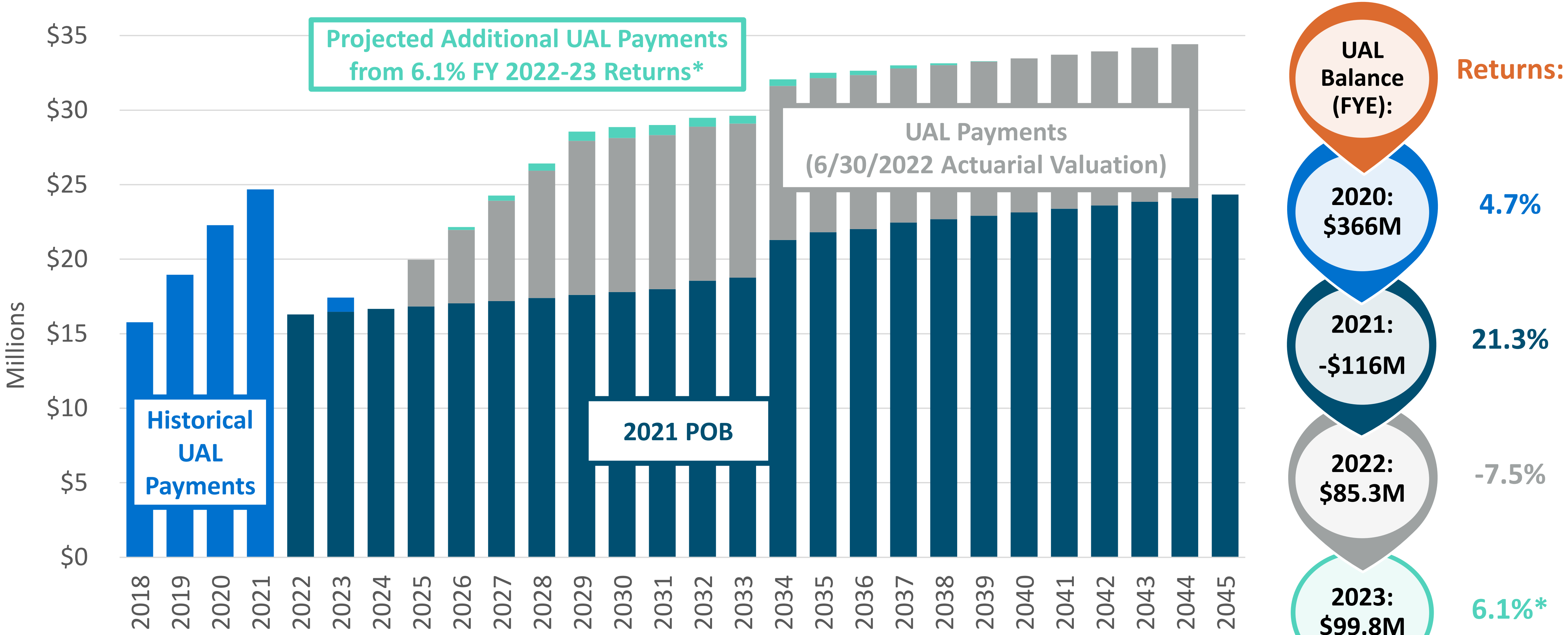
MISCELLANEOUS PLANS			
Benefit Group	**# of Actives**	**% of Actives**	**Benefit Formula**
Miscellaneous First Level	272	37.9%	3% @ 60
Miscellaneous Second Level	52	7.3%	2% @ 60
PEPRA Miscellaneous	393	54.8%	2% @ 62
Total Active Members	**717**	**100.0%**	-
Total Covered Members	**2,552**	-	-

PUBLIC SAFETY			
Benefit Group	**# of Actives**	**% of Actives**	**Benefit Formula**
Public Safety First Level	166	42.3%	3% @ 50
Public Safety Second Level	30	7.7%	3% @ 55
Public Safety PEPRA	196	50.0%	2.7% @ 57
Total Active Members	**392**	**100%**	-
Total Covered Members	**960**	-	-

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

II. Historical and Projected CalPERS Costs

Historical & Projected UAL + 2021 Pension Obligation Bond Payments



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.*

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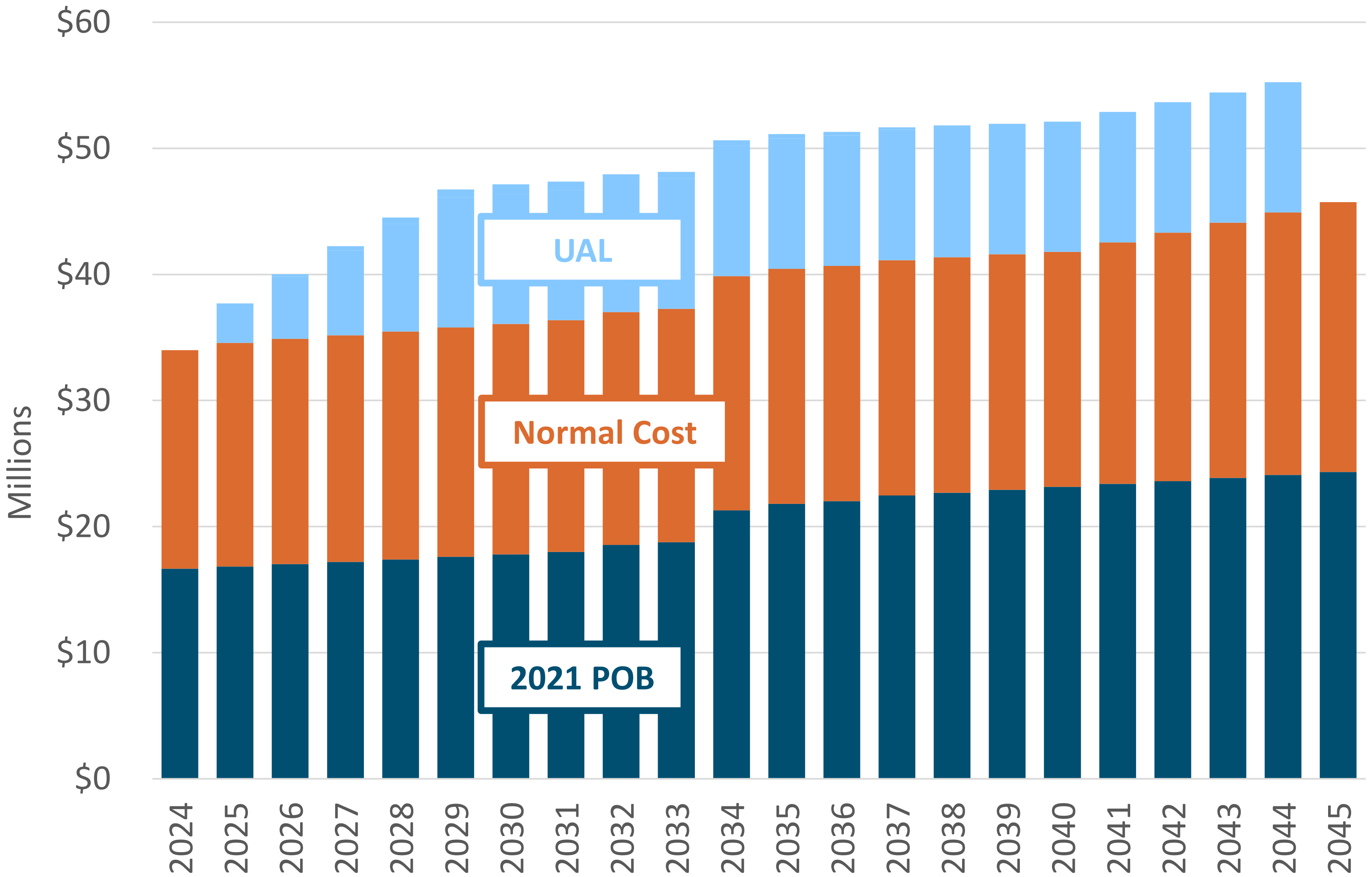
Total Projected Pension Payments (UAL + Normal Cost + POB)

- Annual Normal Cost Contributions ~$19M through 2045
- Total pension payments projected to increase to $51M (2035)
  - Max @ $55M (2044)
- Pension costs as % of General Fund budget projected to increase through 2030
  - FY 2023-24 pension payment accounts for 13.2% of total General Fund budget
  - UAL payments start in FY 2024-25



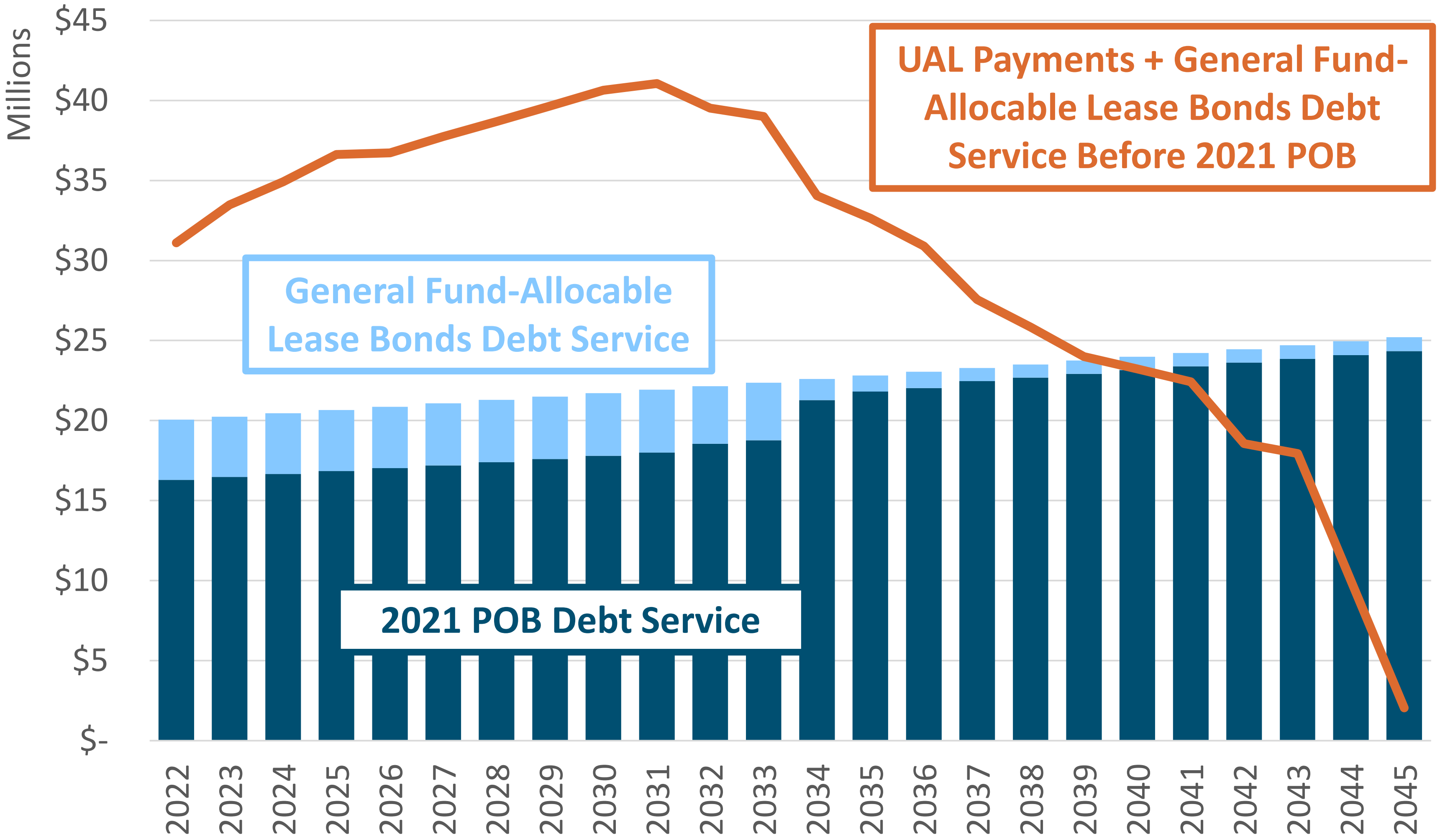
Source: *CalPERS Actuarial Valuation Reports and CalPERS Pension Outlook Tool. Pension Outlook Tool assumes FY 2022-23 returns of 6.1% and 6.80% returns from FY 2023-24 onward.*

III. Recap of City's 2021 Pension Obligation Bonds

2021 Pension Obligation Bonds

Summary of Strategy

- **Strategy:**
  - Restructure UAL over 24 years
- **Bond Stats:**
  - **All-In Cost:** 2.54%
  - $158M PV Savings*
- **Goals:**
  - Maximize cash flow savings
  - Absorb future UAL "shocks"
  - Create pension funding policy



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Savings calculated at the time of the POB issuance in February 2021, assuming CalPERS would meet its annual target investment return each year after the POB issuance.

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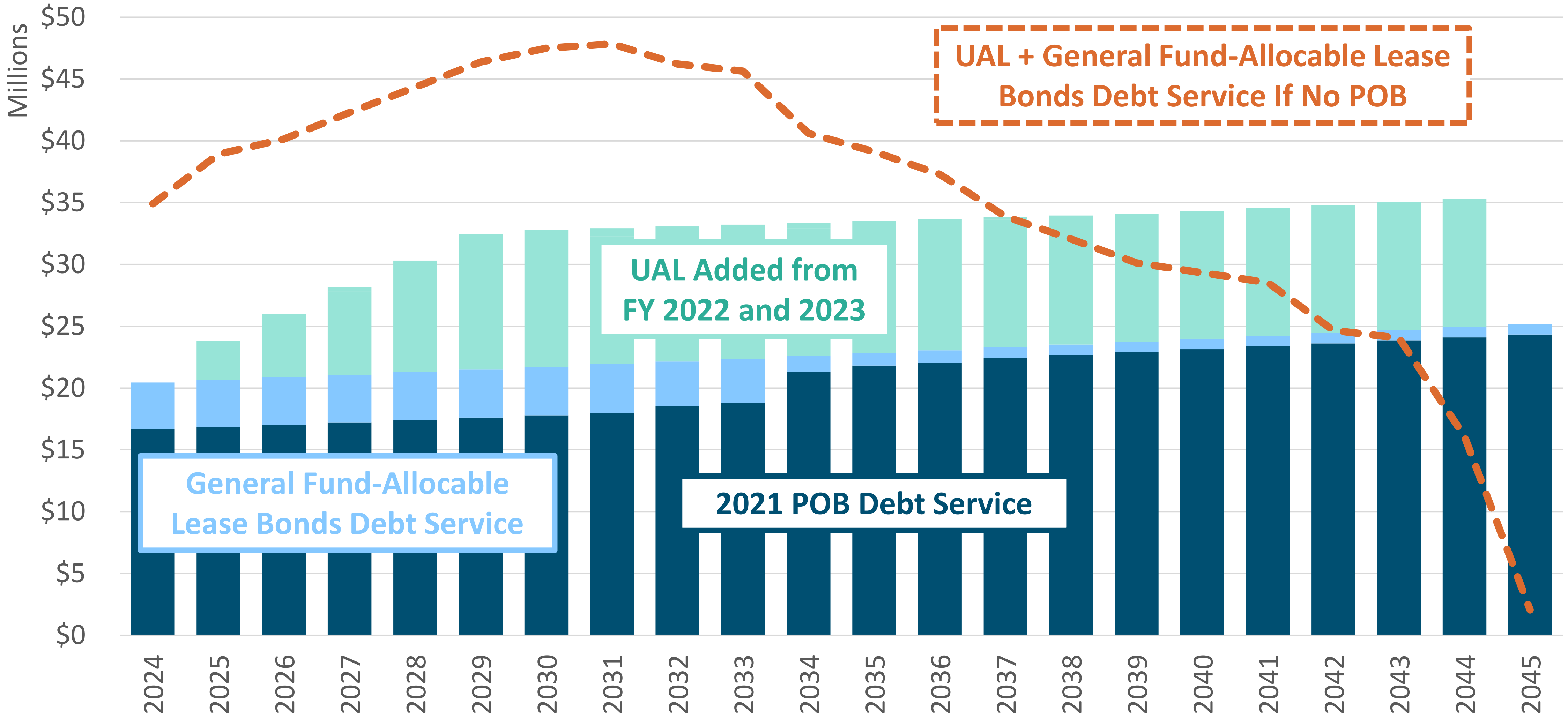
What Happened After the 2021 POB?

-7.5% Investment Returns in 2022 and 6.1% in 2023



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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. 6.1% is the money-weighted rate of return reported by CalPERS in its FY 2022-23 Annual Comprehensive Financial Report.*

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IV. Potential Pension Cost Management Strategies

Cost-Containment Strategies – Not Mutually Exclusive

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

(2) Negotiate Cost Sharing With Employees

- Require employees to pay their share; new employees already governed by lower cost/benefit PEPRA 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 $25.7M (as of 6/30/2023) 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%)
  - *The proceeds from the City's 2021 POB were essentially used to make a very large ADP*
- 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
  - <u>Longer-Term Benefit</u>: Trust funds can grow over time and pay off a large % of UAL in the future
  - <u>Shorter-Term Benefit</u>: 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)

Background & Concept

- The City has built up a Section 115 Trust balance of $25.7 million (as of 6/30/2023) that is on track to meet the City's policy target of 15% of General Fund expenses

<u>Section 115 Smoothing</u>:

- 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 POB savings for the next several years, allowing 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 (PARS for the City's Trust)	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 <u>both</u> 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
    - Given City's current funding ratios (92-93%), potential "super" funding of plans should be kept in mind

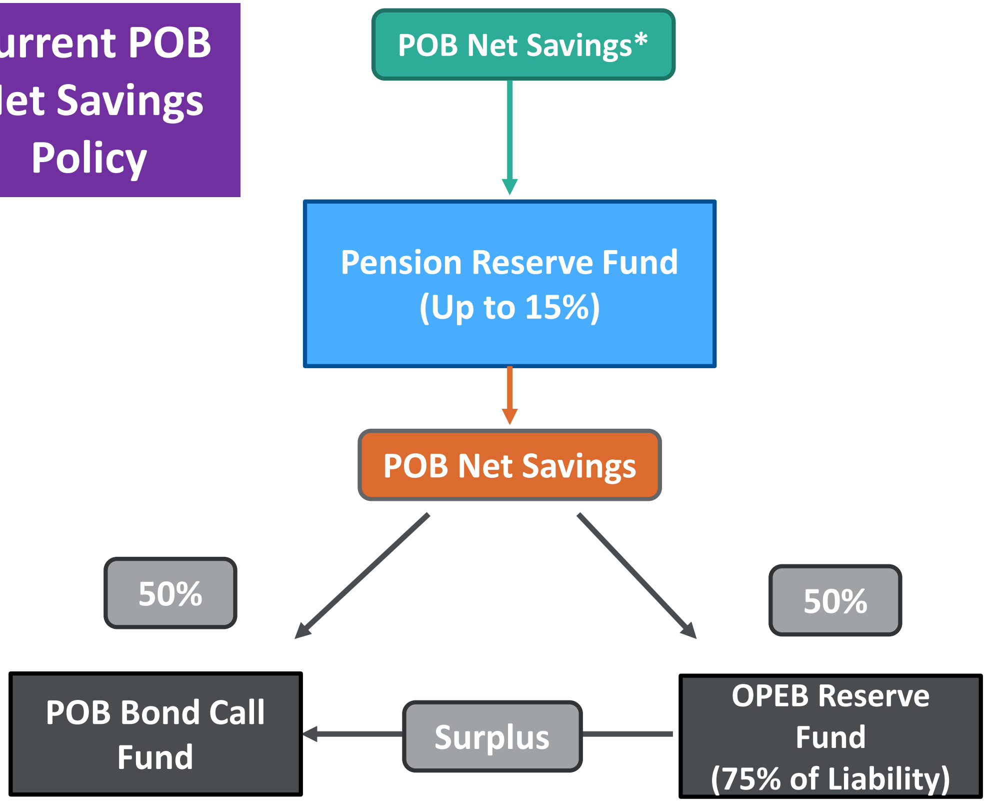
V. Policy Considerations

Overview of City's Reserve Policy

- Comprehensive Reserve Policy revised and adopted in November 2020
- Provides funding mechanism and flow of funds priority for 6 distinct reserves / funds
- Pension Reserve Fund, OPEB Fund, and POB Bond Call Reserve were developed to address future pension and OPEB costs and potentially pay off the 2021 POBs prior to maturity

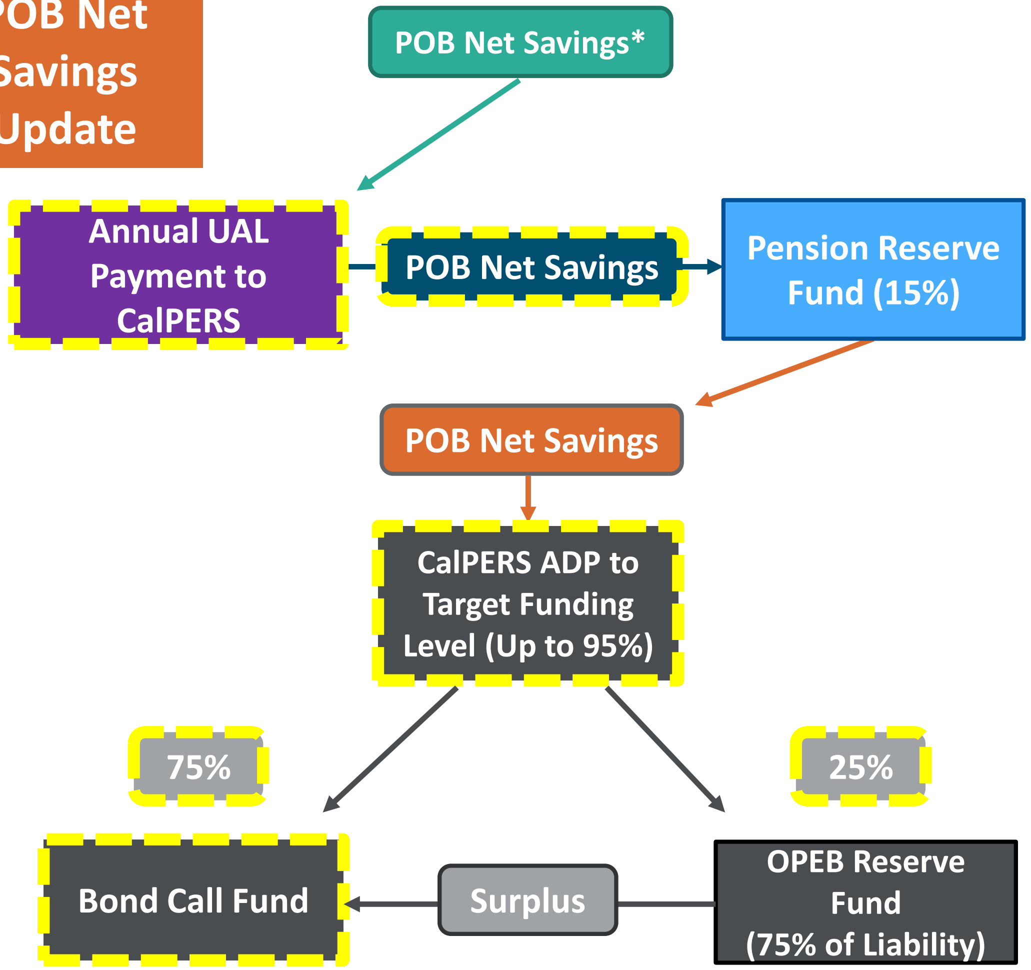
Potential Policy Changes for Consideration

Current POB Net Savings Policy



*75% of the net annual savings from the issuance of the POBs

POB Net Savings Update



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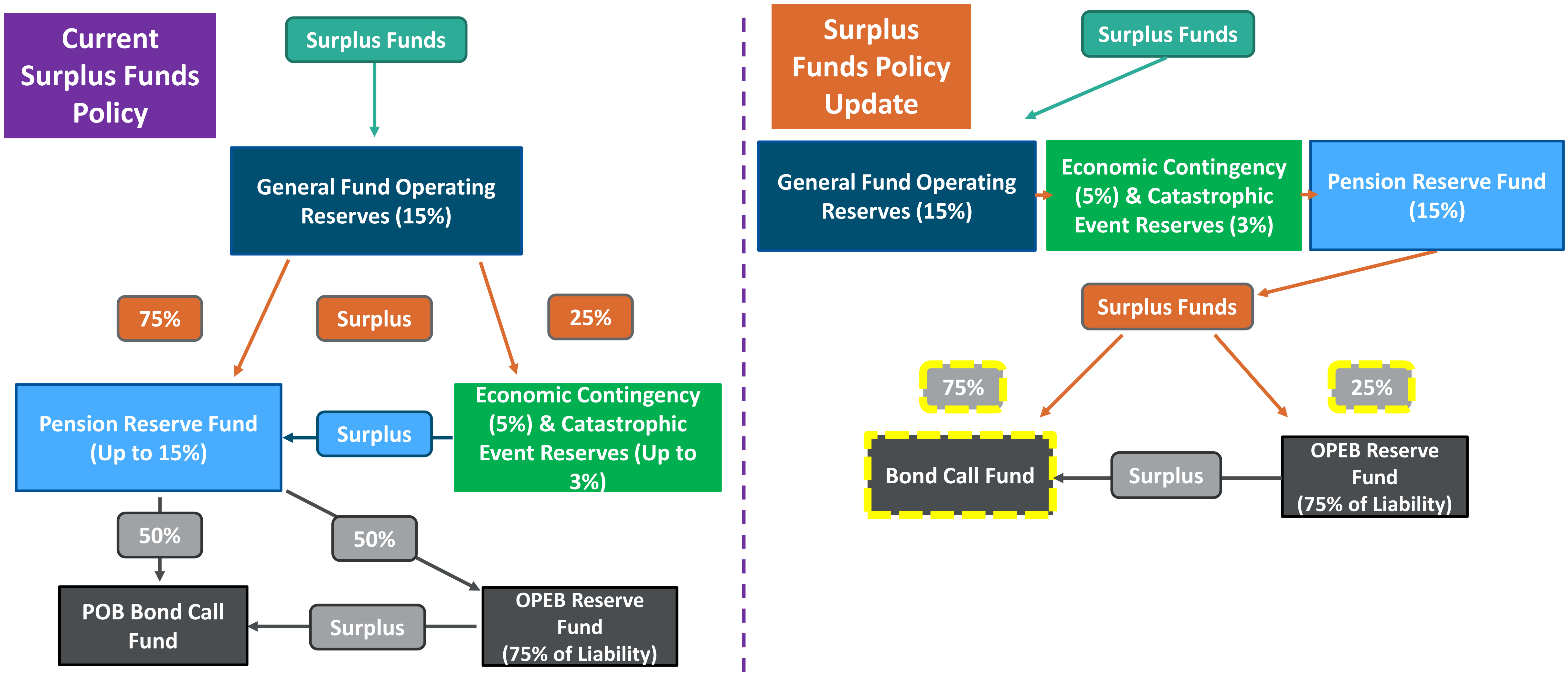

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Considerations for Reserve Policy & Pension Cost Management

Re-evaluating Scope of POB Bond Call Reserve

- Expand the scope of the POB bond call reserve to encompass other more expensive City/General-Fund debt, including potential Lease Revenue Bond/COP issues & UAL
- Allows City to 1) increase financial benefit from intended interest cost savings and 2) pay down outstanding debt sooner than allowable for the 2021 POB (2031 par call)

Sizing of Pension Reserve Fund/115 Trust

- Surplus from the PRF flows to the OPEB and POB bond call reserves, and the City can consider adjusting the PRF target if it would like to allocate more/less toward restricted pension funds
- Higher PRF balance allows for more impactful cost-smoothing strategies, but more restricted funds

Annual ADPs / Section 115 Trust Smoothing

- City can maintain PRF target balance while proactively addressing future pension costs by allocating remaining surpluses first towards ADPs or smoothing annual pension payments
- Once target plan funded ratios are achieved, additional surpluses can flow to other buckets

Additional Policy Considerations

- Expanding Bond Call Reserve Policy to allow savings opportunities
  - Allows for one-time monies to be used for one-time expenditures
  - Can be used to call bonds before final maturity, providing ongoing budgetary savings in future years
- City can prioritize surpluses after funding the Section 115 Trust toward annual CalPERS ADPs to increase plans' funded ratios (95% - 100%) before building up the Bond Call and OPEB Reserve
  - Achieves greater total savings than paying down an equivalent amount of 2021 POBs
  - Enables City to proactively address scheduled pension cost increases at more manageable levels

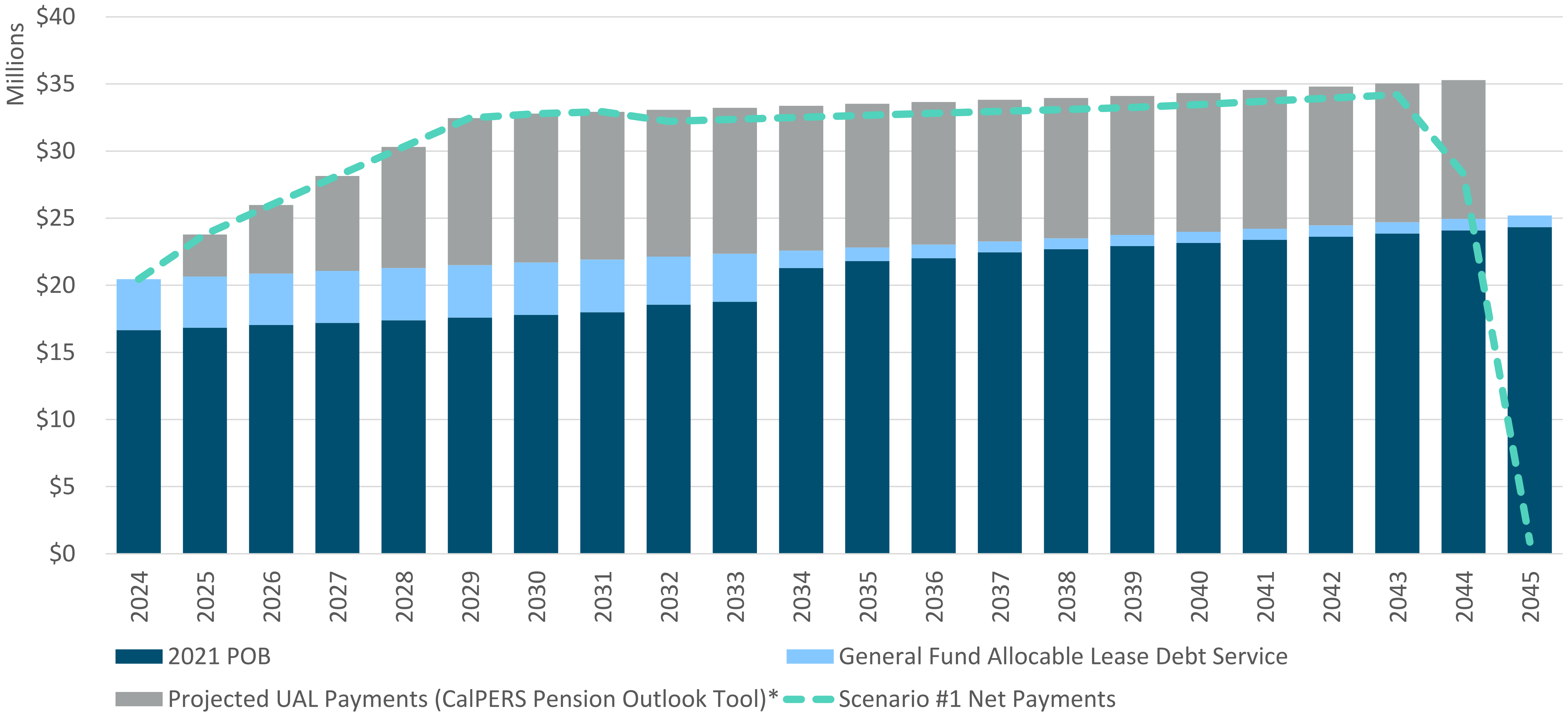
Analysis Scenario #1:
Pension & OPEB Reserve Policy Status Quo

Scenario #1 Summary

- In Scenario #1, NHA assumes surplus funds flow through the City's Reserve Policy as established
- NHA calculates that the City would have $29.8 million in its Bond Call Reserve to partially pay down the POB at first optional redemption on June 1, 2031
  - Assumes pay down of longest maturities on the POB to maximize savings

Net Savings for Scenario #1	
Gross Savings from POB Paydown:	$41,574,933
Funds Used for POB Paydown:	($29,781,632)
Net Savings:	**$11,793,301**

Scenario #1 Net Payments



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**Pension Outlook Tool assumes FY 2022-23 returns of 6.1% and 6.80% returns from FY 2023-24 onward. 6.1% is the money-weighted rate of return reported by CalPERS in its FY 2022-23 Annual Comprehensive Financial Report.*

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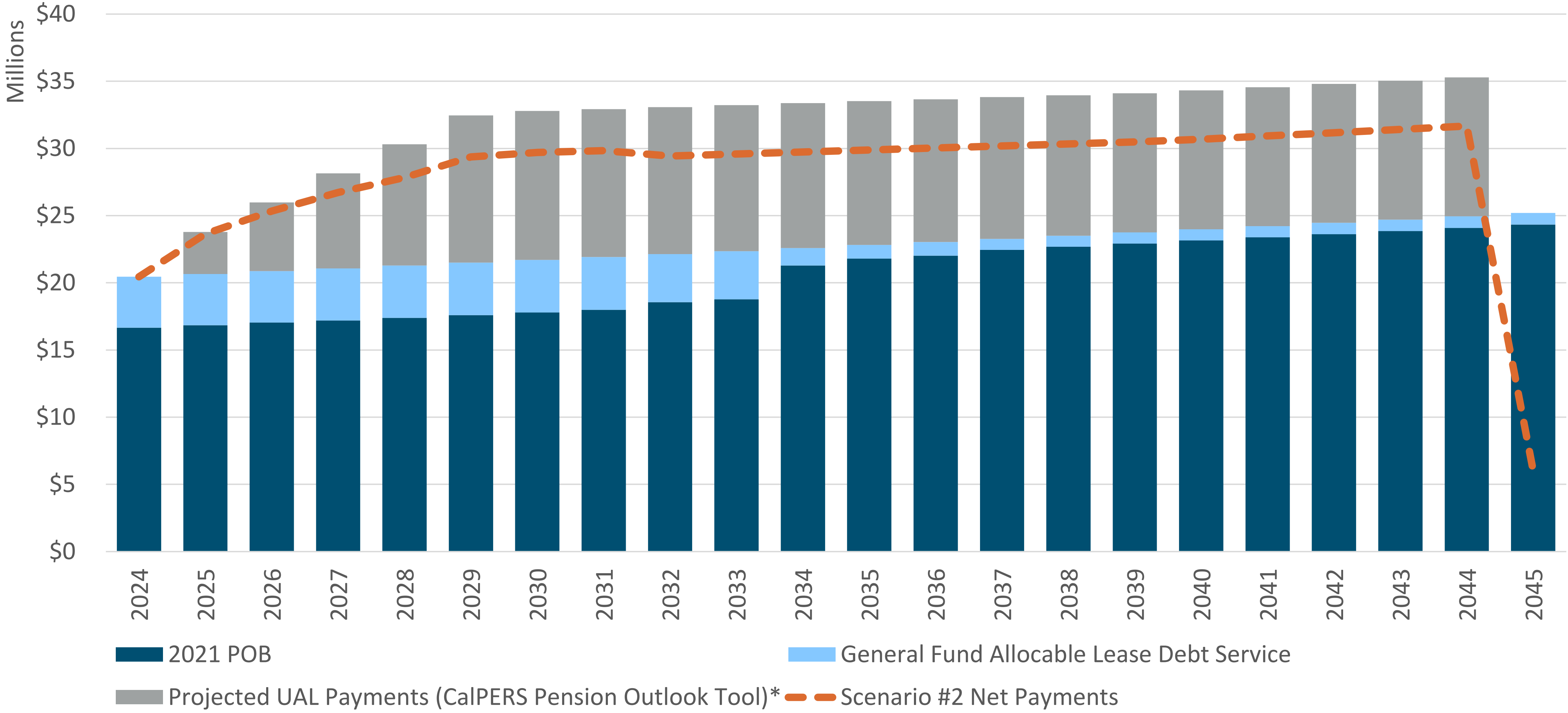
Analysis Scenario #2:
Proposed Reserve & OPEB Policy

Scenario #2 Summary

- In Scenario #2, NHA assumes ADPs are made with some of the surplus that would previously flow to the Bond Call and OPEB Reserve
  - Targets an approximate 95% funded ratio before surplus resumes flowing to the Bond Call and OPEB Reserve
- City would make ADPs (from surpluses) in fiscal years 2024 – 2027, totaling $28.8 million
- From 2028 – 2031, remaining surpluses would build up the City's Bond Call Reserve to $18.7 million, which would be used to partially pay down the POB at first optional redemption on June 1, 2031

Net Savings for Scenario #2	
Gross Savings from ADPs + POB Paydown:	$80,404,818
Funds Used for ADPs + POB Paydown:	($47,464,284)
Net Savings:	**$32,940,534**

Scenario #2 Net Payments



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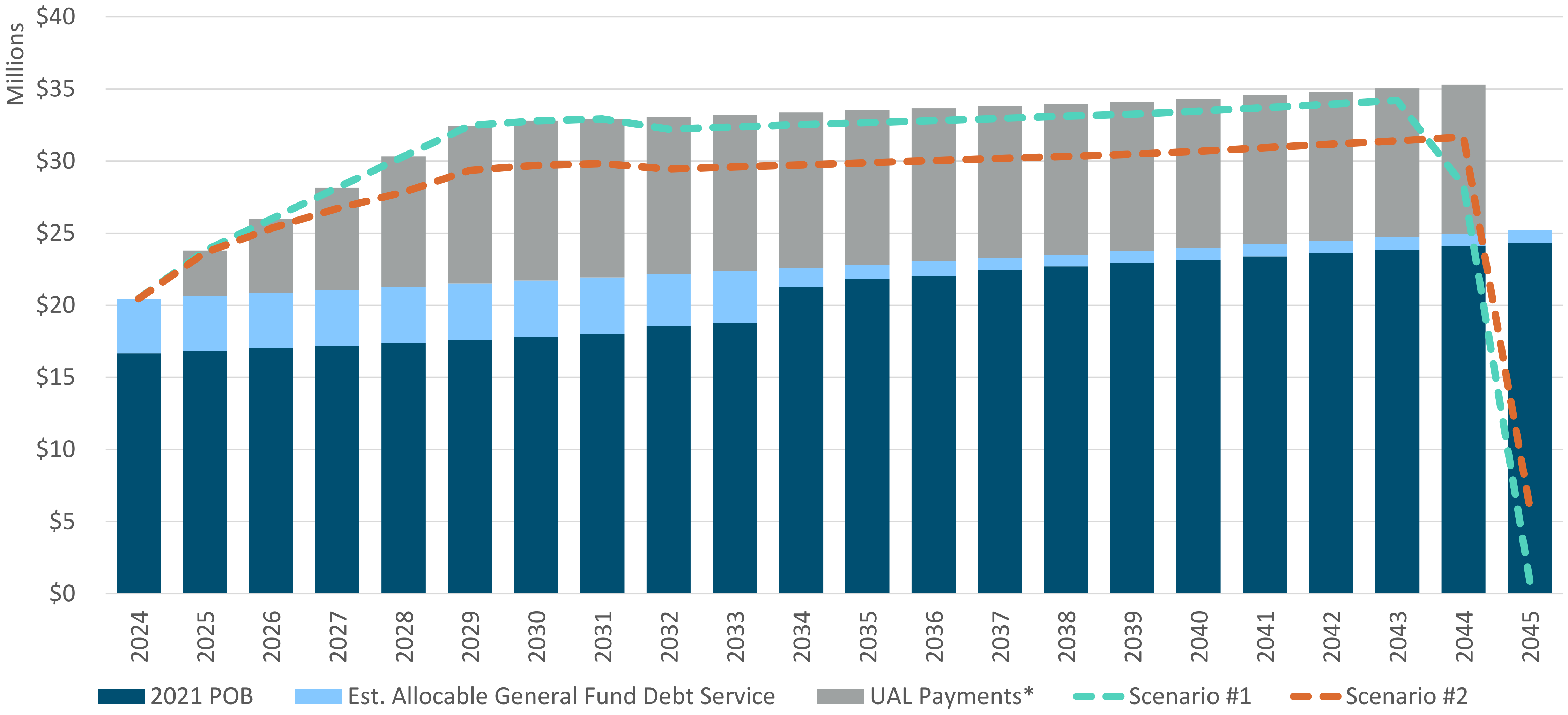
Comparison of Scenario #1 and #2

Scenarios Analysis: Summary

- The difference in potential savings is attributable to how much higher costing debt (e.g., UAL vs. POB) is being paid down
  - Note: While ADPs pay down 6.8% debt with CalPERS, the ADPs are invested by CalPERS and are subject to future CalPERS returns
- More funds are used in Scenario #2 because ADPs will theoretically lower future UAL payments and free up more surplus to be used for additional ADPs
- Paying down more UAL generates higher projected savings, however the City could see reduced upside potential from any long-term overfunding scenarios if CalPERS achieves sustained outperformances

Net Savings Comparison			
Scenario #:	**#1 Status Quo**	**#2 Proposed**	**Difference**
Gross Savings:	$41,574,933	$80,404,818	$38,829,885
Funds Used:	($29,781,632)	($47,464,284)	($17,682,652)
Net Savings:	**$11,793,301**	**$32,940,534**	**$21,147,233**

Scenario Comparison



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VI. Conclusion

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 POB 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 $100M
- To assist with proactive pension and General Fund debt management, the City can consider the following:
  - Expand the scope of its POB Bond Call Reserve to encompass more expensive debt
  - Leverage POB net savings to make direct ADPs to CalPERS to pay down UAL
  - Consider target funded ratios

Consolidate Various Council Policies into a Single Citywide Reserve Policy

May 28, 2024

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Summary of Proposed Policy Changes

1. Consolidation of Reserve Policies
2. Change in Calculation of Reserve Level
3. Updated Funding Allocation & Uses

Consolidation of Reserve Policies

Citywide Reserve Policy

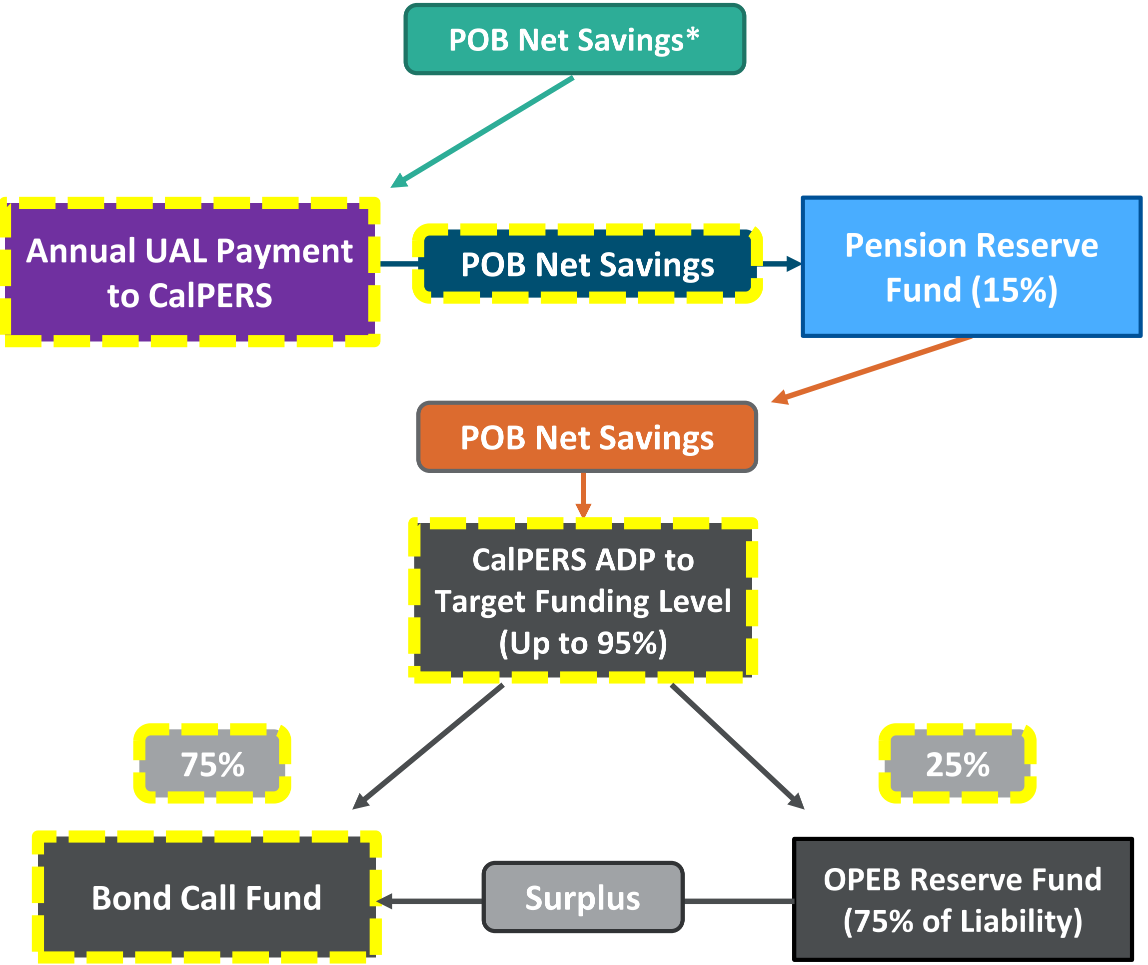
- General Fund
- Pension & OPEB
- Measure A Fund
- Sewer Service Fund
- Ambulance Transport Fund

Change in Calculation of Reserve Level

Prior Year's Budget instead of Future Year's Budget.

Clarification of Operating Expenditures

Updated Funding Allocation & Uses



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Policy Comparison

POB and UAL Payment and Savings* (in millions)			
	Current	Proposed	Difference
Additional Discretionary Payment	$ -	$ 28.8	$ 28.8
Bond Call Payment	29.8	18.7	(11.1)
Total Payments	$ 29.8	$ 47.5	$ 17.7
ADP Savings	$ -	$ 54.2	$ 54.2
Bond Call Savings	41.5	26.2	(15.3)
Total Savings	$ 41.5	$ 80.4	$ 38.9
Net Savings	$ (11.7)	$ (32.9)	$ (21.2)

*Based on the 6.30.2022 CalPERS report and NHA projections

General Fund Long-Term Financial Plan

	Adopted	Projected								
	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Major Discretionary Revenues	$ 219.0	$ 229.3	$ 231.5	$ 217.6	$ 224.7	$ 232.1	$ 239.7	$ 247.6	$ 255.7	$ 264.1
Other Revenues	55.2	55.9	56.7	57.5	57.8	58.0	58.8	59.6	60.5	61.4
New Development Revenues	-	2.7	3.5	3.8	4.0	4.1	4.2	4.4	4.5	4.7
Total General Fund Revenues	$ 274.1	$ 287.9	$ 291.7	$ 278.9	$ 286.5	$ 294.1	$ 302.7	$ 311.6	$ 320.7	$ 330.2
Personnel Services Expenditures	$ 147.3	$ 156.6	$ 164.8	$ 171.1	$ 177.5	$ 183.1	$ 188.0	$ 193.3	$ 198.9	$ 204.3
Other Expenditures	126.8	126.4	121.1	99.6	100.5	102.4	105.0	104.0	106.5	106.7
New Development Expenditures	-	5.3	6.4	7.0	7.4	7.7	8.0	8.2	8.4	8.5
Total General Fund Expenditures	$ 274.1	$ 288.2	$ 292.4	$ 277.7	$ 285.4	$ 293.3	$ 300.9	$ 305.5	$ 313.8	$ 319.5
General Fund Surplus / (Deficit)	-	(0.3)	(0.7)	1.2	1.1	0.8	1.8	6.0	7.0	10.7

Estimated Balances	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Pension Reserve Fund	$ 32.3	$ 33.6	$ 35.0	$ 36.1	$ 37.3	$ 38.5	$ 39.8	$ 41.0	$ 42.4	$ 43.8
Balance of Bond Call Fund	-	-	-	4.9	9.2	13.8	18.7	-	-	-
Balance of OPEB Reserve	-	-	-	1.6	3.1	4.6	6.2	6.2	6.2	6.2

Recommended Action

Approve the "Resolution of the City Council of the City of Chula Vista amending and repealing various City Council Policies related to reserves into a consolidated Citywide Reserve Policy"

Consolidate Various Council Policies into a Single Citywide Reserve Policy

May 28, 2024

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