CITY COUNCIL STAFF REPORT

Consent Item No. **Date** **File No.**

SUBJECT: CalPERS Pension Funding Workshop

DEPARTMENT: Administrative Services

RECOMMENDATION: Receive workshop information and provide policy direction on various options to address long-term funding needs.

FISCAL ANALYSIS: Ongoing information for budget planning purposes

BACKGROUND:

For the past several years, the Escondido City Council has adopted a balanced budget without the use of reserves. Financial stability is one of the four parts of the City Council Action Plan. Planning ahead is a key part of maintaining financial stability.

Generally speaking, full-time employees of the City are members of the California Public Employees Retirement System (CalPERS), which is a defined benefit pension plan. The financial woes of CalPERS have been widely discussed for some time. Both CalPERS and numerous financial experts agree that due to funding short falls in recent years, plan design changes had to be made. In 2013 California pension reform became law under Public Employees' Pension Reform Act, which reduced pension benefits of newly hired employees. However, savings from the reform will take many years to be realized.

The general fund budget which was adopted by the Escondido City Council on June 14, 2017, projected future deficits because of the issue commonly known as the "CalPERS unfunded liability." The future deficits are primarily related to the CalPERS' unfunded liabilities. Deficits in 2018-19 were estimated at $1.8 million and in 2019-20 were estimated at $6.5 million assuming the use of one-time General Fund sources from the Redevelopment loan repayment.

In order to deal with potential long-term budget impacts as a result of pension liabilities, the City embarked on a comprehensive plan to work with all of the City's bargaining units to address this important issue. Prior to the Public Employee Pension Reform Act of 2013 (PEPRA), the City already had escalating cost-sharing formulas in place for its employees and had already reduced the pension benefit formulas for both Miscellaneous and Safety employees. With the passage of PEPRA, the City implemented all the required pension reform measures, including lowering of pension formulas for all new employees. Pension reform for existing employees included the elimination of Employer Paid Member Contribution (EPMC) and increasing employee-paid contributions. The implementation of the increased cost sharing by City employees is well in advance of the 1-1-2018 date where such cost increases may be imposed by an employer under state law.

The following depicts the change in retirement benefits since the City began implementing pension reform measures:

Miscellaneous Employees (Non-Safety)

<u>Tier I</u>
3% at age 60 – Single highest year salary calculation
Employee Contribution 8% of salary
<u>TIER II</u>
2% at age 60 – 12-23-2012 - Average highest three-year salary calculation
Employee Contribution 7% of salary
<u>TIER III</u>
2% at age 62 – 01-01-2013 - Average highest three-year salary calculation
Employee Contribution 6.25% of salary

Safety Employees (Police and Fire)

<u>Tier I</u>
3% at age 50 – Single highest year salary calculation
Employee Contribution 9% of salary
<u>TIER II</u>
2% at age 50 – 2012 - Average highest three-year salary calculation
Employee Contribution 9% of salary
<u>TIER III</u>
2.7% at age 57 – 01-01-2013 - Average highest three-year salary calculation
Employee Contribution 12.25% of salary

Combined, these actions represent a major collaboration between the City and its employees, bringing budgetary savings as employees now pay the full employee share of their CalPERS pension and additional long-term savings from the second and third-tier pension structure for new employees. These pension reform measures are significant achievements. However, the City and its employees still face major financial hurdles related to pensions.

<u>City's Unfunded Liabilities</u>

To assure pension sustainability, the CalPERS Board periodically reviews specific factors to determine if adjustments need to be made which can impact the long-term funding of the system. Over the past few years, adjustments have been made to demographic assumptions such as higher salaries and retirement rates, and also the expectation that retired employees are living longer. Since these assumptions ultimately impact employer pension costs, the Board also developed a strategic plan to spread out costs to local public agencies over 20 years, with increases phased in over five years beginning in Fiscal Year 2016-17.

The CalPERS Board has also recently made adjustments to the discount rate (assumed rate of return), which will also impact public agencies. The discount rate will be incrementally lowered from 7.5% to 7.0% within the next three years, beginning Fiscal Year 2018-19.

Investment earning affect how much future benefit payments can be funded by investment income rather than by contributions. If lower investment earning occur, future contributions must increase to make up the expected difference. The volatility of the investment earnings in recent years have been a significant contributor to the required employer contribution. CalPERS investment returns in the last six fiscal years have been:

2012	0.1%
2013	13.2%
2014	18.4%
2015	2.4%
2016	0.6%
2017	11.2%

CalPERS total net investment returns in recent years have been well under the assumed 7.5%. For the past 10 years, the average annual returns have been closer to 5%.

Lowering the discount rate increases the City's unfunded liabilities. CalPERS has implemented a 30-year amortization payment schedule for agencies to pay off their unfunded liabilities in 30 years. For fiscal year 2017-18, the City's payment towards unfunded liabilities is $13.7 million.

The below chart depicts by fiscal year, the City's total projected CalPERS payments, including the portion that is categorized as the unfunded liability portion.

CalPERS CONTRIBUTIONS (In Millions)		
Fiscal Year	Unfunded Liability Portion	Total PERS Projected Cost
2017-18	$13.7	$22.5
2018-19	$16.2	$25.6
2019-20	$19.1	$28.8
2020-21	$21.4	$32.1
2021-22	$24.2	$35.2
2022-23	$26.7	$37.8

CalPERS has also changed the methodology in the way agencies are now billed. In the past, CalPERS billed agencies on a percentage of payroll for both the normal cost and unfunded liability portion. Beginning in fiscal year 2017-18, CalPERS now bills agencies the normal cost on a percentage of payroll; however, the unfunded liability portion is factored as a flat-dollar amount and billed monthly. The purpose in the change is to ensure that CalPERS is properly funded. For example, if an agency were to reduce staffing, the normal cost would be reduced but there would be no change to the unfunded liability obligation.

The result of the increased payments to the budget projections in the upcoming fiscal years is shown in the below table.

Escondido General Fund Multi-Year Financial Plan					
	Adopted FY 2017-18	**Projected FY 2018-19**	**Projected FY 2019-20**	Projected FY 2020-21	**Projected FY 2021-22**
Operating Revenue	$ 97.30	$ 99.20	$ 101.20	$ 103.20	$ 105.30
Transfers In	2.1	2.1	2.1	2.1	2.1
Total Sources	**$ 99.40**	**$ 101.30**	**$ 103.30**	**$ 105.30**	**$ 107.40**
Required PERS Contribution	$ 17.40	$ 19.60	$ 22.20	$ 24.80	$ 27.20
Operating Budget - All Other	81.3	85.5	88.7	91.8	95.0
Transfer Out	0.7	0.7	0.7	0.7	0.7
Total Uses	**$ 99.40**	**$ 105.80**	**$ 111.60**	**$ 117.30**	**$ 122.90**
Total Sources Over/(Under) Uses	**$ -**	**$ (4.50)**	**$ (8.30)**	**$ (12.00)**	**$ (15.50)**
$ in millions					

Pension funding will be the biggest financial challenge the City and its employees will face over the next decade. Key steps that will need to be taken are outlined below.

Step 1: Establish the City's Priorities

Staff has identified two priorities facing the City as a result of the growing unfunded pension liability. The first priority is obviously to address the necessary pension contributions, toward both the normal and the unfunded portion, and to do so promptly and prevent severe cuts to City services. A second objective is to address the unfunded liability portion of the required payments earlier than the 30-year amortization period required by CalPERS. Addressing the unfunded liability portion will result in significant cost savings to the City in the long term, and again, avoid severe cuts to City services or other more dire consequences.

California cities and counties will see their required pension contributions double in 10 years. The City of Escondido and its employees are no exception. The Fiscal Year 2017-18 employer required pension contribution for the City's General Fund is $17.4 million and is projected to increase by $15.4 million to reach $32.8 million by Fiscal Year 2027-28. These increasing contributions are required by CalPERS because the City's combined unfunded pension liability for both City plans (safety and miscellaneous) grew by $181 million to reach $244 million in just 10 years. The reasons for this increase were described in the City's Unfunded Liabilities section of this Staff Report. Realistically speaking, General Fund revenue growth will not keep up with these increases.

The following chart illustrates the two primary factors. The first factor is the City's General Fund operating budget and the second factor is the required employer pension contributions. Currently, in Fiscal Year 2017-18, the required employer pension contribution for the General Fund is $17.4 million and the adopted operating budget is $98.7 million so 18% of the General Fund operating budget goes to paying the pension cost. The City's policy is to adopt a structurally balanced budget each year so by Fiscal Year 2027-28, if the City follows this policy, the percentage of General Fund operating budget committed to paying the required pension cost will climb to 27% of the operating budget. Unless meaningful action is taken, as these pension costs rise, they will require a larger share of the operating budget resulting in reduced services in the City.

Escondido Pension Costs as % of General Fund Operating Budget			
Fiscal Year	2007-08	2017-18	2027-28*
General Fund Operating Budget	$85.6	$98.7	$120.0
Required Pension Contribution	$11.0	$17.4	$32.8
Pension Cost as % of General Fund Operating Budget	13%	18%	27%
$ in millions * Assumes General Fund adopts a balanced operating budget			

As noted above, the City's first priority is to make sure the required pension contributions (both normal and unfunded liability) are made each year to CalPERS. However, a "do-nothing" scenario using our current amortization schedules will pay off the City's unfunded liability in 30 years but only by incurring huge (indeed, unrealistic) budget deficits each year. On the other hand, if the City and its employees do not make the required payments, the result will be dire, for the City, and its current and future retirees. Thus, the goal in the short term is to find ways to reduce or stabilize the required pension contribution and explore options that will provide budget flexibility to the City.

However, the City may also choose to pay more on each of the longer amortization bases that make up the unfunded liability portion. The City's unfunded liability is made up of separate payment schedules following different amortization policies depending on the cause of the base and what year the liability was created. CalPERS refers to these payment schedules as amortization bases. Each base is separately amortized and paid for over a specific period of time. This can be likened to a home mortgage that has 24 years of remaining payments and a second on that mortgage that has 10 years left. On April 17, 2013, the CalPERS board adopted a new asset smoothing policy that was included in the June 30, 2013 valuation. This policy employs a 30-year fixed amortization with a 5-year ramp up to pay off the unfunded liability. The 5-year ramp effectively defers the full cost of the unfunded liability over time with the upside of giving the City time to plan for the increase and the downside being additional interest costs. By paying the full amount sooner and shortening the amortization period, the City can realize significant additional interest savings in the long run.

Step 2: Identify Funding Sources

To meet the City's above priorities, additional funding sources or costing saving measures must be identified that can be used to stabilize or reduce the employer required contribution in the short term and provide interest cost savings in the long run. Various options the City may consider are listed below:

1. Payments from sources of one-time money
2. Borrow from excess reserves of the General Fund or other City funds
3. Cuts in services which the City provides
4. Ongoing budgetary changes that result in savings (changes in the workforce, outsourcing, etc.)
5. Employees paying a higher share of the pension cost
6. Sales tax increase or other ongoing revenue increases

However, each of these alternatives has pros and cons, and some alternatives are also insufficient, by themselves, to adequately address the problem.

Step 3: Section 115 Trust Option

Historically, Internal Revenue Code (IRC) Section 115 Irrevocable trusts have been used to pre-fund Other Post-Employment Benefits (OPEB). In 2015, Public Agency Retirement Services (PARS) received a favorable private letter ruling from the Internal Revenue Service that allows public agencies to pre-fund pension obligations in a Section 115 Irrevocable Trust. This ruling allows the City to safely and securely set aside funds, separate and apart from the state retirement system, in a tax-exempt irrevocable trust to reduce pension liabilities and stabilize pension costs. Establishing a Trust for both rate stabilization and pre-funding will provide the City with an alternative to sending funds directly to CalPERS.

Step 4: Recommendation and Next Steps

At this workshop, staff recommends that the City Council ask any questions they may have and assist in making sure that the Council, the employees, and the public have a thorough understanding of the difficult problem we face. Staff is requesting that Council provide policy direction on the various funding sources identified above. Staff is also requesting policy direction on whether or not to pursue a Section 115 Pension Trust as a mechanism for addressing this issue. And finally, Council policy direction on the various funding sources and options is also requested. In addition to a Section 115 Pension Trust, other options to consider for the use of these funds are outlined below along with the advantages and disadvantages of each.

1. Establish a Section 115 Pension Trust

   Advantages
   - Assets can be accessed any time to offset contribution rate increases (rate stabilization) or as a rainy day fund during adverse budgetary or economic conditions
   - Investments held in an irrevocable trust are significantly less restricted than General Fund investments which will likely produce a higher investment return
   - More local control and oversight of investment fund management and monitoring performance of investments
   - Investment security with the Trust compared to CalPERS investment return fluctuations
   - Trust assets can be used to reduce pension liability reported on City's financial statements
   - Potential improvement in the City's credit rating

   Disadvantages
   - Assets can only be used to pay the City's pension obligations

2. Make one-time payments directly to CalPERS unfunded liability and pay off the shorter amortization bases

   Advantages
   - Lowers required unfunded pension liability contribution in the short-term

   Disadvantages
   - Less budget flexibility because once payment is made to CalPERS it cannot be used in the future to offset contribution rate increases or economic slowdowns

3. Make one-time payments directly to CalPERS unfunded liability and pay off the longer amortization bases

   Advantages
   - More interest savings in the long-term

   Disadvantages
   - Less budget flexibility because once payment is made to CalPERS it cannot be used in the future to offset contribution rate increases or economic slowdowns

4. Set-up a City Internal Service Fund

   Advantages
   - Funds can be accessed any time to offset contribution rate increases (rate stabilization) or as a rainy day fund during adverse budgetary or economic conditions

- Asset can be used by Council for other purposes

  Disadvantages
- Restricted investments
- Assets do not reduce pension liability reported on City's financial statements

Staff will listen to your policy direction and return with a Pension Funding Policy that identify ways to use these above funding sources to eliminate future projected deficits caused by these rising pension costs. The goals of this policy will be to stabilize or reduce required pension contributions, provide budget flexibility, allow for City control over assets, and provide long-term structural stability for the City.

Many cities believe that any meaningful action must come from the State. However, cities that do not take meaningful actions themselves risk deficits and bankruptcy for their city. The City of Escondido must not be one of these cities.

For more detailed information, Escondido CALPERS Valuations are located on the City's website at:
https://www.escondido.org/pers-actuarial-valuation-reports.aspx,
Other resources may be found at:
https://www.calpers.ca.gov/

APPROVED AND ACKNOWLEDGED ELECTRONICALLY BY:

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ATTACHMENTS:

Bartel Associates, LLC, presentation for the City Council workshop, September 27, 2017