CITY OF NEWPORT BEACH
FINANCE COMMITTEE
STAFF REPORT

Agenda Item No. 5A
October 13, 2016

TO: HONORABLE CHAIR AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
Dan Matusiewicz, Finance Director
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SUBJECT: **PRELIMINARY FISCAL YEAR 2017-2018 PENSION FUNDING RECOMMENDATION**

SUMMARY:

Each year, staff analyzes the most recent CalPERS actuarial valuations and evaluates opportunities to more efficiently amortize the City's unfunded pension liability compared to the default minimum contribution schedules proposed by PERS. Staff has also engaged an actuary to review and comment on staff's recommendations. Based on a review of the most current actuarial valuations, but prior to consulting with the actuary, staff's preliminary recommendations are to:

1) The City should estimate and start paying on the 2016 investment experience loss in 2017-2018, one year ahead of schedule.
2) The 2015 and 2016 experience losses should be amortized over 20 years versus the default 30-year schedule.
3) Make discretionary payments in an amount and manner to accomplish recommendations 1 and 2 and not perform a "Fresh Start".
4) The City should continue to let the 2014 experience gain ($71 million credit) continue to amortize over the remaining 29-year schedule to provide rate relief when and if needed in the future.
5) After considering all budget objectives, consider budgeting for the unfunded pension liability on a level-payment amortization basis rather than a level-percent-of-pay amortization basis.

If recommendations 1-4 are approved, these actions would cost an additional $5 million over the default payment schedule for the first year, but save $69 million over 30 years. This would result in a net present value savings of approximately $25 million and the 2015 and 2016 losses would be paid off more than 10 years sooner than the default option (See Attachment A – Alt 1 columns).

If recommendation 5 is approved in addition to recommendations 1-4, the cost would be $7.3 million more than the default minimum during the first year resulting in $143 million savings over 30 years or $68 million on a net present value basis (See Attachment A - Alt 2 columns).

Neither plan commits the City to the proposed payment schedules. The City can revert to the default payment schedule at any time.

RECOMMENDED ACTION:

1) Receive and file staff recommendations.
2) Direct consulting actuary to comment on staff recommendations at a subsequent meeting.
3) Provide consulting actuary direction as to Committee expectations for the November 10, 2016, Finance Committee meeting.

DISCUSSION:
The most recent actuarial report presents the results of the June 30, 2015, California Public Employees' Retirement System (CalPERS) valuation of both the Miscellaneous and the Public Safety Plans for the City of Newport Beach. This report sets the Fiscal Year 2017-2018 required contribution rates.

Net of investment returns, annual contributions and benefit payments, the City's unfunded pension liability increased $23.1 million from $252.6 million to $275.7 million, resulting in an overall funded ratio of 67.5 percent. The components of the unfunded liability are displayed in the following table.

	Miscellaneous	Public Safety	Total
Accrued Liability	$356,419,112	$491,953,837	$848,372,949
Less Market Value of Assets (MVA)	$255,215,749	$317,483,254	$572,699,003
Unfunded Liability	$101,203,363	$174,470,583	$275,673,946
Funded Ratio (MVA/Accrued Liability)	71.6%	64.5%	67.5%

It is the City's policy (See Reserve Policy F-2) to: 1) amortize the unfunded actuarial liability in accordance with the actuary's funding recommendations; and 2) make effort at maintaining its UAL within a range that is considered acceptable to actuarial standards. Policy F-2 further prescribes that the City Council shall consider increasing the annual CalPERS contribution should the UAL status fall below acceptable actuarial standards.

Not included in this valuation is the 2016 experience loss. CalPERS expected investment return continues to be 7.5 percent, but the fund only earned 0.6 percent during 2016 resulting in an experience loss of 6.9 percent. This loss can be reasonably estimated at $39.5 million by multiplying the June 30, 2015, MVA of $572.7 million times 6.9 percent. Ignoring what might happen on the liability side of the equation, our unfunded liability at June 30, 2016, will likely reach $315 million.

If we do not address the 2016 investment loss during our 2016-17 budget or 2017-2018 budget, the $39.5 million dollar experience loss will grow 15.6 percent (1.075^2) to 45.6 million. It would be beneficial to initiate a payment plan before the 2016 results would impact our contribution rates in Fiscal Year 2018-2019.

Together the 2015 and 2016 experience losses total $68.5 million as indicated by the table below. By default, these losses would be amortized (paid-off) over 30 years.

2015 & 2016 Investment Experience Losses

Valuation Year	Contribution FY Year	Experience Loss	Two Year Interest Accumulation
2015	2017-18	28,921,514	33,422,425
2016	2018-19	39,516,231	45,665,944
		68,437,745	79,088,369

How liabilities are amortized can make significant difference in the net economic savings/cost of particular payment plans. Our previous efforts to accelerate payment schedules in 2015, 2014 and years prior have already made a noticeable difference relative to many of our neighboring cities who may have chosen to stick with the default plan. The table on the next page compares this City's amortization efficiency (interest as a percent of principal) relative to surrounding larger cities based on the June 30, 2015, actuarial valuations.

UAL Amortization Efficiency Comparison by City

City	UAL Balance	Total Payments	AER* (Payments ÷ Principal)	Interest as % of Principal	Amortization Efficiency Relative to Newport	Interest included in Total Payments
Newport Beach	$ 272,977,868	$ 467,100,918	171%	71%	0%	42%
Irvine	$ 115,178,121	$ 211,629,106	184%	84%	-13%	46%
Anaheim	$ 609,881,577	$ 1,303,628,563	214%	114%	-43%	53%
Long Beach	$ 963,327,181	$ 2,126,017,847	221%	121%	-50%	55%
Santa Ana	$ 527,005,976	$ 1,167,087,776	221%	121%	-50%	55%
Costa Mesa	$ 255,359,653	$ 566,799,114	222%	122%	-51%	55%
Huntington Beach	$ 359,407,114	$ 810,431,873	225%	125%	-54%	56%

*Amortization Efficiency Ratio (AER)

From the table above, we can conclude that the City of Newport Beach's default amortization schedule is already 13 percent more efficient than Irvine's payment schedule and 54 percent more efficient than Huntington Beach's payment schedule.

Unfortunately, staff expects further experience losses to continue to roll-in. Consensus analysis by the investment community believes that CalPERS will continue to have difficulty achieving a 7.5 percent investment return. CalPERS is also under great pressure to reduce its assumed discount rate sooner rather than later. Staff has modeled the impact of both lower investment returns and a permanent reduction of the discount rate. While the timing and extent of further losses are uncertain, staff believes the City has significant exposure to its pension obligations. If experience losses are persistent, there could be a point where it could be difficult for the City just to keep up with the interest on its pension obligations. For this reason, it is particularly important for the City to continue to make headway in paying down its unfunded pension liability.

RECOMMENDATIONS

Alternative 1

Consistent with the California Actuarial Advisory Panel (CAAP), the Government Finance Officers Association (GFOA) has recommended as a best practice that the amortization of an unfunded pension liability not exceed 25 years but ideally fall in the 15-20 year range. This is also consistent with staff's view because level-percent-of-pay amortization schedules greater than 20 years negatively amortize and become exponentially more expensive. Staff recommends the following:

1) The City should start paying on the 2016 experience loss in 2017-2018, one-year ahead of schedule.
2) The 2015 and 2016 experience losses should be amortized over 20 years versus the default 30-year schedule.
3) The City should not execute another fresh start but rather make additional discretionary payments equal to the difference between the proposed and default schedules.
4) The City should continue to let the 2014 experience gain ($71 million credit) continue to amortize over the remaining 29-year schedule to provide rate relief when and if needed.

The bulk of our remaining unfunded liability ($244 million) will continue to amortize over its current 17-year schedule. This alternative would require $5 million more in contributions over the first year, save $69 million over thirty years with an approximate net present value of $25 million. This alternative will also improve the amortization efficiency ratio from the default schedule (with the impending 2016 experience loss) of 1.89 percent to 1.67 percent. Since a Fresh Start is not proposed, the City will not be committed to the proposed payment schedule. The City can stop making discretionary payments at any time. No special action is required. See Schedule A – Alt 1 columns.

Alternative 2

One of many CalPERS actuarial assumptions is that payroll will grow 3 percent per year. In an effort to maintain contribution rates level, the payments in their amortization schedule are then designed to also grow by 3 percent per year and this is why they are referred to as a level-percent-of-pay amortization schedule.

While this logic works well for maintaining the contribution as a percent of payroll level, in absolute dollars, the payments grow by 3 percent per year. This may be palatable when we are not expecting continuous experience losses. However, if our base unfunded liability payment is growing by 3 percent per year and we are hit with additional experience losses, it makes it more challenging to keep up with the growth of both the base payment as well as an experience loss in the budget each year.

The benefit of a level payment plan, is that once it is accommodated by a balanced budget, we generally do not have to worry about it again except to the extent there are new losses. Since we are expecting new losses, it may serve the City well to work towards accommodating the additional up-front cash flow requirement of a level payment schedule. In addition to leveling out the budget challenge each year, the level payment plan is significantly more efficient in that it is 30-40 percent more cost effective.

Therefore, staff also recommends that the City work towards amortizing its unfunded pension liability over a level payment amortization schedule. Combined with the recommendations in Alternative 1, the level payment alternative would initially cost $7.3 more than the default option, but save $143 million over 30 years with an approximate net present value of $68 million. It also further improves our amortization efficiency ratio . Again, the City would not become obligated to maintain this payment schedule and could revert to the minimum contribution required by the default schedule. See Schedule A - Alt 2 columns.

Contribution/Rate Smoothing

From a cash flow perspective, staff recommends using “Additional Discretionary Payments (ADP)” as opposed to the fresh start payment method. This will allow the City to contribute any desired amount above the minimum payment. The City’s actuary, credit rating agencies and staff believe that electing to pay the unfunded liability on a discretionary basis is the preferred method because the City preserves its budget flexibility in the event of an economic downturn.

As an added benefit to embracing a payment schedule in excess of the required minimum contribution, the City, at its option, can graduate the actual payment down as necessary to meet its budgetary requirements. By maintaining the 2014 credit balance ($70 million and growing) with PERS, the City may use this credit at any time to reduce its required payment to CalPERS.

Funding

Staff proposes that the incremental cost of the first year could come from the Fiscal Year 2016-2017 operating surplus, per City Council Policy F-5 (General Fund Surplus Utilization) and future contributions could come from future anticipated revenue growth and future operating surpluses until the incremental cost can be fully absorbed into the operating budget.

Prepared by:

/s/ Steve Montano
Steve Montano
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Submitted by:

/s/ Dan Matusiewicz
Dan Matusiewicz
Finance Director

Attachment:

A. Preliminary Funding Recommendations Schedule

ATTACHMENT A

Preliminary Funding Recommendations Schedule

Preliminary Funding Recommendations

	Val	Sch. Pmt	Default - Amortizing 2015 & 2016 Losses Over 30 Years					Alternative 1 - Amortize 2015 & 2016 Losses Over 20 Yrs						Alternative 2 - Level Pmt. Plan	
	FYE	FYE	2014 Base	2014 Credit	2015 Loss	2016 Loss	Total	2014 Base	2014 Credit	2015 Loss	2016 Loss	Total	Pmt Over Default		Pmt Over Default
1	2015	2018	26,500,897	(1,950,558)	406,782		24,957,121	26,500,897	(1,950,558)	2,183,731	3,177,327	29,911,398	(4,954,276)	32,204,184	(7,247,063)
2	2016	2019	27,295,924	(3,013,612)	837,971	636,258	25,756,541	27,295,924	(3,013,612)	2,249,243	3,272,647	29,804,202	(4,047,661)	32,204,184	(6,447,643)
3	2017	2020	28,114,802	(4,138,693)	1,294,665	1,310,691	26,581,464	28,114,802	(4,138,693)	2,316,721	3,370,827	29,663,655	(3,082,191)	32,204,184	(5,622,720)
4	2018	2021	28,958,246	(5,328,568)	1,778,007	2,025,017	27,432,702	28,958,246	(5,328,568)	2,386,222	3,471,951	29,487,851	(2,055,149)	32,204,184	(4,771,482)
5	2019	2022	29,826,993	(5,488,425)	2,289,184	2,781,024	29,408,776	29,826,993	(5,488,425)	2,457,809	3,576,110	30,372,487	(963,711)	32,204,184	(2,795,408)
6	2020	2023	30,721,803	(5,653,078)	2,357,860	3,580,568	31,007,153	30,721,803	(5,653,078)	2,531,543	3,683,393	31,283,661	(276,508)	32,204,184	(1,197,031)
7	2021	2024	31,643,457	(5,822,670)	2,428,596	3,687,985	31,937,368	31,643,457	(5,822,670)	2,607,489	3,793,895	32,222,171	(284,803)	32,204,184	(266,816)
8	2022	2025	32,592,761	(5,997,350)	2,501,453	3,798,625	32,895,489	32,592,761	(5,997,350)	2,685,714	3,907,712	33,188,836	(293,348)	32,204,184	691,305
9	2023	2026	33,570,543	(6,177,271)	2,576,497	3,912,584	33,882,354	33,570,543	(6,177,271)	2,766,285	4,024,943	34,184,501	(302,148)	32,204,184	1,678,169
10	2024	2027	34,577,660	(6,362,589)	2,653,792	4,029,961	34,898,824	34,577,660	(6,362,589)	2,849,274	4,145,691	35,210,037	(311,212)	32,204,184	2,694,640
11	2025	2028	35,614,989	(6,553,466)	2,733,406	4,150,860	35,945,789	35,614,989	(6,553,466)	2,934,752	4,270,062	36,266,338	(320,549)	32,204,184	3,741,605
12	2026	2029	36,683,439	(6,750,070)	2,815,408	4,275,386	37,024,163	36,683,439	(6,750,070)	3,022,795	4,398,164	37,354,328	(330,165)	32,204,184	4,819,978
13	2027	2030	37,783,942	(6,952,572)	2,899,870	4,403,647	38,134,887	37,783,942	(6,952,572)	3,113,479	4,530,109	38,474,958	(340,070)	32,204,184	5,930,703
14	2028	2031	38,917,461	(7,161,150)	2,986,866	4,535,757	39,278,934	38,917,461	(7,161,150)	3,206,883	4,666,012	39,629,206	(350,272)	32,204,184	7,074,750
15	2029	2032	40,084,984	(7,375,984)	3,076,472	4,671,830	40,457,302	40,084,984	(7,375,984)	3,303,090	4,805,993	40,818,082	(360,780)	32,204,184	8,253,118
16	2030	2033	41,287,534	(7,597,264)	3,168,766	4,811,984	41,671,021	41,287,534	(7,597,264)	3,402,182	4,950,172	42,042,625	(371,604)	32,204,184	9,466,837
17	2031	2034	42,526,160	(7,825,181)	3,263,829	4,956,344	42,921,152	42,526,160	(7,825,181)	3,504,248	5,098,678	43,303,904	(382,752)	32,204,184	10,716,968
18	2032	2035		(8,059,937)	3,361,744	5,105,034	406,842		(8,059,937)	3,609,375	5,251,638	801,076	(394,235)	(8,059,937)	8,466,778
19	2033	2036		(8,301,735)	3,462,597	5,258,185	419,047		(8,301,735)	3,717,656	5,409,187	825,108	(406,062)	(8,301,735)	8,720,782
20	2034	2037		(8,550,787)	3,566,474	5,415,931	431,618		(8,550,787)	3,829,186	5,571,463	849,862	(418,243)	(8,550,787)	8,982,405
21	2035	2038		(8,807,311)	3,673,469	5,578,409	444,567		(8,807,311)	-	-	(8,807,311)	9,251,877	(8,807,311)	9,251,877
22	2036	2039		(9,071,530)	3,783,673	5,745,761	457,904		(9,071,530)			(9,071,530)	9,529,434	(9,071,530)	9,529,434
23	2037	2040		(9,343,676)	3,897,183	5,918,134	471,641		(9,343,676)			(9,343,676)	9,815,317	(9,343,676)	9,815,317
24	2038	2041		(9,623,986)	4,014,098	6,095,678	485,790		(9,623,986)			(9,623,986)	10,109,776	(9,623,986)	10,109,776
25	2039	2042		(9,912,706)	4,134,521	6,278,548	500,364		(9,912,706)			(9,912,706)	10,413,070	(9,912,706)	10,413,070
26	2040	2043		(8,168,070)	4,258,557	6,466,905	2,557,392		(8,168,070)			(8,168,070)	10,725,462	(8,168,070)	10,725,462
27	2041	2044		(6,309,834)	3,509,051	6,660,912	3,860,129		(6,309,834)			(6,309,834)	10,169,963	(6,309,834)	10,169,963
28	2042	2045		(4,332,752)	2,710,742	5,488,591	3,866,581		(4,332,752)			(4,332,752)	8,199,333	(4,332,752)	8,199,333
29	2043	2046		(2,231,368)	1,861,376	4,239,937	3,869,945		(2,231,368)			(2,231,368)	6,101,313	(2,231,368)	6,101,313
30	2044	2047			958,609	2,911,423	3,870,032					-	3,870,032	-	3,870,032
31						1,499,383	1,499,383					-	1,499,383		1,499,383

	Default	Alternative 1	Alternative 2
Total Payments	597,332,274	527,893,055	454,757,441
30 Year Savings over default		69,439,219	142,574,833
PV savings over default		25,208,615	67,893,237
Amortization Efficiency Ratio (AER)	189.6%	167.6%	144.3%
Percent Interest Paid	47.3%	40.3%	30.7%