FINANCE COMMITTEE
FINAL MINUTES

Special Meeting
October 20, 2020

The Finance Committee of the City of Palo Alto met on this date via virtual teleconference at 6:02 P.M.

Present: Kniss, DuBois, Tanaka

Absent:

Oral Communications

None.

Agenda Items

1. Accept CalPERS Pension Annual Valuation Reports as of June 30, 2019.

Kiely Nose, Chief Financial Officer and Director of Administrative Services introduced Christine Paras and Jesse Deschamps who presented the item to the Finance Committee (Committee).

Christine Paras, Assistant Director of Administrative Services Department reported that the annual California Public Employees Retirement System (CalPERS) reports were prepared by CalPERS's Staff. The historical rate of return ranged from 11.6 percent to 4.7 percent. The Miscellaneous Plan funding increased from 65.8 percent to 66.1 percent and the Safety Plan decreased from 62.2 percent to 61.3 percent. One thing that was new as of June 30, 2019, was the new Amortization Policy and the policy contained three key points in changes and assumptions. The first change was that it was a shorter amortization period with the transition from 30 to 20 years. The second change was the elimination of a 5 year ramp up and down for Unfunded Accrued Liability (UAL) and the third key change was that CalPERS eliminated the 5 year ramp down on investment gains and losses occurring on or after the effective date of the policy change. Lastly, this was the final year of the phase-in of the lower Discount Rate. Items not accounted for in the June 30, 2019, Actuarial Reports included current labor contracts/negotiation parameters, the preliminary 4.7 percent return on investment, and the Pension 115 Trust which has a projected balance, as of the year 2021, $32.3 million.

Jesse Deschamps, Budget Manager for Administrative Services Department presented the past and projected employer rates for the Miscellaneous Plan, Safety Plan and the UAL. She disclosed that for the Miscellaneous Plan, the total cost was 41.8 percent for Fiscal Year (FY) 2022 and was estimated to increase to a peak of 43.7 percent in FY 2025 before decreasing to 36.2 percent in FY 2027. The Normal Cost (NC) decreases in the last 2 years of the forecast were due to the assumption that employees in lower-cost Public Employees' Pension Reform Act (PEPRA) Plans were going to replace employees in higher cost PEPRA Plans. Also, two large UAL bases were going to be fully amortized and drop off. For the Safety Plan, the total cost was 69.6 percent in FY 2022 with an estimated peak of 74.2 percent in FY 2025 before tapering to 73.2 percent in FY 2027. Similar to the Miscellaneous Plan, the Safety Plan saw a decrease due to lower employees replacing higher employees as well as a UAL base falling off after it reached its amortization period. The total UAL for both plans increased from the June 30, 2018 evaluation to the current June 30, 2019 evaluation by $21 million or 4.7 percent. Palo Alto (City) had approximately 64.4 percent of the funding it needed to meet pension obligations.

Council Member Kniss asked what the total number was for the UAL for FY 2019.

Ms. Deschamps answered roughly $477 million.

Council Member Kniss was shocked by that number.

Chair Tanaka agreed that the number was very large.

Vice Mayor DuBois noted that the UAL grew substantially in the past 4 years.

Jeremy Bulow suggested that the Committee read the article about CalPERS in the New York Times. The UAL situation was worse than what Staff was presenting and predicted it to be over $1 billion. He disclosed that Staff should present data that was more realistic and that future negotiations needed to include realistic numbers.

Vice Mayor DuBois inquired what the City's rated per capita was compared to other Cities in the State.

Ms. Nose responded that in terms of percentage the City was less funded than the average for the whole system.

Eddie Lee, CalPERS Senior Pension Actuary noted that other states were doing worse than California, but because of the Coronavirus (COVID-19) Pandemic, the State pulled back their contributions to CalPERS. The City was roughly

4-5 percent below the State average. He suggested that the Committee not look at UAL to fund CalPERS but the present value benefits.

Chair Tanaka shared the Pension Tracker from Stanford University that showed debit by household and requested Staff's feedback on it.

Vice Mayor DuBois disclosed that the City needed to be further down the list than what was shown on the Pension Tracker.

Ed Shikada, City Manager emphasized that comparing the City's UAL on a per capita basis was not comparable because a quarter of the City's workforce was in utilities, and many surrounding Cities did not have their own utilities. He asked Mr. Lee what the difference between the present value of Accrued Benefits and the Accrued Liability.

Mr. Lee explained that present value benefits included benefits that a person was going to earn if that person continued to work until retirement. Accrued Liability was only counting the benefits the person already earned as of today.

Vice Mayor DuBois questioned if the Actuarial Forecast predicted when employees were going to retire.

Mr. Lee declared that the Actuarily Forecast does predict when employees were going to retire. The City was not always catching up on the UAL and that was why Cities made additional payments. He asked when the Pension 115 Trust was set up.

Ms. Nose reported the first installment was made in the year 2017.

Mr. Lee concluded that the City should ramp up its contributions to the UAL.

Council Member Kniss wanted to talk about how much money was in CalPERS. The CalPERS Board was very casual and that it was very expensive to get out of the CalPERS system.

Ms. Nose summarized that Staff was projecting numbers for future decades. To get out of the CalPERS System, the projections had to assume that CalPERS was fully funded to meet those future decade benefits.

Council Member Kniss asked what direction Staff was seeking from the Committee.

Chair Tanaka specified that the recommendation was to accept the Report.

Ms. Nose summarized that any action the City Council (Council) wished to take was done through the City's Pension Policy and the Long-Range Financial Forecast.

Council Member Kniss acknowledged that the City of San Jose had a self-funded program.

Mr. Shikada confirmed that was correct.

Mr. Lee commented that the primary reason for the increase in cost was that CalPERS dropped the Discount Rate from 7.5 percent to 7 percent.

Chair Tanaka disclosed that the most alarming information was the historical rate of return and how it was dropping. He noted that the market did not follow that trend.

Ms. Nose stated that it depended on which component of the market was looked at.

Mr. Lee noted that a significant amount of CalPERS assets was invested in fixed income. The Annual Investment Report (AIM) used the assets of occasion and compared those to the corresponding expected Rate of Return.

Mr. Bulow agreed that the reason CalPERS uses a slightly lower Rate of Return was because of the 70/30 ratio; 30 percent of the resources were in bonds with 70 percent in equity. He declared that it was not an apples to apples comparison and that the 7 percent Discount Rate was high.

Mr. Lee noted that CalPERS set a Discount Rate that carries over a long period of time and they were not able to overreact to cause a drop in the market.

Vice Mayor DuBois asked what the City established regarding the Pension Policy and payments coming out of the Pension 115 Trust.

Ms. Nose shared that any payments that came out of the Pension 115 Trust needed to have Council approval and were legally bound to be paid towards pensions costs. The framework of the Pension 115 Trust versus Additional Discretionary Payment was that the Pension 115 Trust helped bridge spikes in the rates. Once the Pension 115 Trust reached a certain funding level, then contributions ended and those payments moved to direct payments to CalPERS.

Vice Mayor DuBois commented that the investment to the Pension 115 Trust was a moderate approach.

Ms. Nose shared that the Pension 115 Trust was outpacing the portfolio that the City was in.

Vice Mayor DuBois wanted the City to be more aggressive in terms of payments to the Pension 115 Trust.

Ms. Nose stated that the City would revisit the investment bracket, but the Council did not set a timeframe of when the City should revisit it. If directed, Staff was able to bring back more options that reflected the City in a more aggressive investment strategy.

Chair Tanaka agreed and requested that information be brought forward at a future meeting.

Ms. Nose suggested that it be brought to the Council when Staff brought back the Pension Funding Policy.

Council Member Kniss reported that CalPERS has roughly $397 billion in its fund. She asked how does that change the City's long term look at the Public Employees' Retirement System (PERS) and the City's involvement. She wanted to know if the City has ever tried to be more involved with CalPERS in terms of their Board.

Ms. Nose specified that CalPERS does coordinate with agencies that are under its umbrella. Council Members or the public can attend the CalPERS Board meeting and provide public comment at any time.

Council Member Kniss restated that the City does not have a lot of control when it comes to CalPERS. She requested that the Committee look at the big picture.

Mr. Lee emphasized that CalPERS employs brilliant employees who are willing to help Cities in California set up a realistic plan. Open dialog between Cities, City Officials, the public, and CalPERS is a key factor to help manage the plans.

Council Member Kniss restated that she wanted to know who is managing CalPERS funds as a whole.

Mr. Lee disclosed that CalPERS has a website that shows what investments CalPERS is in.

David Clement, CalPERS Senior Pension Actuary answered that the City is in good hands and if Council Members want to get more involved they can contact Jason Perez who represents public agencies on the CalPERS Board as well as the League of Cities.

Mr. Shikada interjected that the City is responsible for the payment for future employee benefits.

Chair Tanaka summarized that the City needs to think about the employee expense as well as the Unfunded Pension Liability.

Vice Mayor DuBois circled back to Mr. Lee's statement that the City needs to be prepared for a $100 million payment.

Mr. Lee answered yes. The Miscellaneous Plan UAL is $294 million which is catch-up payments from the past and future benefits will result in a $100 million payment.

Vice Mayor DuBois clarified that the additional $100 million is the difference.

Mr. Lee confirmed yes and it is funding through NC.

Chair Tanaka inquired why the Pension 115 Trust is not factored into the forecast.

Ms. Nose reiterated that the reports are calculated by CalPERS Staff and the City's Pension 115 Trust is a separate funding source.

Chair Tanaka wanted a composite report that shows CalPERS as well as the Pension 115 Trust. He inquired what the impact will be for the 4.7 percent.

Ms. Nose explained that every 1 percent difference in earnings is roughly $1 million annually. With the City contributing at 6.2 percent, the difference is 1.5 percent or roughly $1.5 million.

Chair Tanaka asked if that money is accounted for in the budget.

Ms. Nose answered no, the budget was adopted before the numbers were known.

Council Member Tanaka summarized that the City will have to find $1.5 million.

Ms. Nose remarked that the number will materialize in CalPERS rates in FY 2023 but the City can choose to make adjustment.

Vice Mayor DuBois disclosed his surprise regarding how many Tier 1 employees are with the City.

Council Member Kniss mentioned that she did not understand why the costs go down as a percent of payroll for the Miscellaneous Plan.

Ms. Deschamps restated that the Normal Cost (NC) iwas decreasing with the assumption that employees will be in PEPRA instead of classic plans and substantial UAL bases will drop off.

Chair Tanaka advised that one way to think about employer rates for the Miscellaneous Plan is that for every $1 spent, $0.47 is paid to pension costs on top of that $1.

Mr. Lee agreed with that assumption.

Chair Tanaka affirmed that people are living longer and he asked if that is being factored into the reports.

Mr. Shikada reported that life expectancy is an actuarial factor.

Mr. Lee added that the impacts of COVID-19 have increased the mortality rate.

Council Member Kniss wanted more information regarding COVID-19 impacts and how it will affect the city.

Mr. Lee could not confirm if COVID-19 impacts will be included in CalPERS upcoming Experience Study or Mortality Rate Study.

Ms. Nose confirmed that mortality rates are not the main driver in Employer Rate drops for the Miscellaneous Plan. It has to do with significant UAL bases dropping off.

Vice Mayor DuBois indicated that Employer Rates for the Safety Plan have not changed much from last year.

Chair Tanaka articulated that $0.74 for every $1 is going to pensions in the Safety Plan.

Mr. Lee clarified that for every $1 spent, an additional $0.74 is paid for benefits and surrounding Cities are in a similar boat.

Chair Tanaka asked why the Employer Rates for the Safety Plan graph does not drop like the Employer Rates for the Miscellaneous Plan.

Ms. Deschamps restated that the drop off of two large UAL bases is not present in the Safety Plan graph.

Mr. Bulow mentioned that the numbers can change if there are decreases or increases in the Police and Fire Department.

Chair Tanaka articulated that the projected UAL is understated but Staff believes that the graphs are a fair representation as to what is owed.

Ms. Nose clarified that the graph shows what CalPERS reports plus actuary assumptions that are set through processes and approved through the CalPERS Board.

Chair Tanaka requested what the compounded annual growth is for the UAL.

Ms. Nose explained that Staff looked at it on a year over year basis.

Mr. Lee answered about 9 percent per year.

Chair Tanaka specified that the UAL's growth is moving faster than the Rate of Inflation.

Mr. Bulow disclosed that the City is in a better situation than surrounding Cities because Palo Alto homes are worth more money.

Ms. Nose expressed one positive note is that the Council has taken liabilities and costs seriously and continues to pay attention and address those components. CalPERS continues to receive feedback and modify their plan as well.

Chair Tanaka plugged that moving to a 401k plan would be a better solution.

Ms. Nose opined that it would require a legislative change and that can only happen if the City were on an independent plan.

Chair Tanaka inquired how San Jose was able to move to an independent plan.

Mr. Shikada reported that it happened a long time ago and he did not know the specifics.

Mr. Lee disclosed that Federal Law allows the private sector to cut pensions.

Chair Tanaka asked how close was the City to factoring in the true UAL costs when programs are reviewed.

Ms. Nose noted that the budget fully accounts for the required UAL payments and the NC. Staff and the City manage through additional contributions by assuming a 6.2 percent for NC and the difference is then moved to the Pension 115 Trust.

Chair Tanaka rephrased the question of how does the City account for it on a program level.

Ms. Nose confirmed that the 6.2 percent for the NC is baked into everything. Staff does not know what the "Unfunded Unfunded Liability" is because Staff does not know when assumptions will occur.

Mr. Shikada added that is it reflected in what programs are Staffed and what programs are outsourced.

MOTION: Council Member Kniss moved, seconded by Vice Mayor DuBois to recommend to the City Council that the Finance Committee accept the June 30, 2019 CalPERS Annual Valuation reports for the Miscellaneous and Safety Pension Plans and updates on pension funding policy activities.

MOTION PASSED: 3-0

Future Meetings and Agendas

Council Member Kniss asked if the meeting on November 3, 2020, had been canceled.

Ed Shikada, City Manager confirmed that is correct and the next meeting will be on November 17, 2020.

Kiely Nose, Chief Financial Officer and Director of Administrative Services expected that the meetings on November 17, 2020, December 1, 2020, and December 15, 2020, to have full agendas.

Adjournment: The meeting was adjourned at 7:52 P.M.