FINANCE COMMITTEE
SUMMARY MINUTES

Special Meeting
September 20, 2022

The Finance Committee of the City of Palo Alto met on this date in the Community Meeting Room and by virtual teleconference at 5:30 P.M.

Present In-Person: DuBois (Chair), Filseth, Kou

Present Virtually:

Absent:

Call to Order

Oral Communications

Agenda Items

1. Accept California Public Employees' Retirement System (CalPERS) Pension Annual Valuation Reports as of June 30, 2021

Administrative Services Director/CFO Kiely Nose introduced Jessie Deschamps and Paul Harper from the Office of Management and Budget.

Jessie Deschamps, Budget Manager, presented the item to the Finance Committee. The CalPERS reports provided an update on status of the City's pension plans, minimum employer contributions for the coming year, and communicated significant changes in assumptions and policies. Significant changes from the CalPERS Asset Liability Management (ALM) Review Process and Experience Study in November 2021 included reduced discount rate from 7.0% to 6.8% per CalPERS Risk Mitigation Policy, new actuarial assumptions of price inflation from 2.5% to 2.3%, new asset allocation to target 1/3 investment in private assets, and adjustments to Public Employee's Pension Reform Act (PEPRA) employee contributions with a 1% increase in miscellaneous rates. Highlights for the current report ending June 30, 2021 and overall status include the reduced discount rate from 7.0% to 6.8%, significant investment gain of 21.3% subject to the 5-year ramp up, and increasing the funded status by 10% to 73.3% total. Supplemental contributions to the 115 Pension Trust were not included in the CalPERS reports, with $49.4 million in principal contributions through fiscal year 2023 expected to be made with a moderately conservative portfolio earning 11.5% for the period ending June 30, 2021. If applied to the CalPERS fund, overall funded status would increase 3%. Significant changes expected to impact future reporting include the preliminary 6.1% investment loss for the period ending June 30, 2022, and expected to impact the City in fiscal year 2025, current labor contract expirations in fiscal year 2023 with negotiation parameters of wage increases beginning March and July 2022, and increased full-time staffing for fiscal year 2022-23. Projected Unfunded Accrued Liability (UAL) for both miscellaneous and safety plans decreased by 19% from 2020 to 2021, and overall funded status increased 10% per year from 63.5% to 73.3%. Staff calculated the estimated impact from preliminary losses in 2022. Staff recommends that the Committee accept the June 30, 2021, CalPERS Valuation Reports, engage in additional meetings to review pension policy updates and use of OPEB funds, and review and recommend the City Council accept propositions related to fiscal year 2024 Budget Development Guidelines and Long-Range Financial Forecast.

Council Member Filseth asked since the CalPERS protocol of reducing the discount rate from 7.0% to 6.8% was active if the CalPERS discount rate would stay at 6.8% or revert to 7.0%.

David Clement, CalPERS Actuary, clarified a Risk Mitigation Policy was currently in place. If a certain threshold is met, the discount rate is lowered 5 basis points. There is no mechanism to increase the discount rate currently.

Council Member Filseth asked if a 6.8% return was projected from now onwards.

David Clement explained that was the current long-term assumption.

Council Member Filseth noted the UAL contribution for safety and miscellaneous decreased from fiscal year 2023 to 2024 and asked if that was a function of the 21.5% return.

Administrative Services Director Nose explained the UAL will change because the value of assets changes significantly. She noted that because payroll number decreased, the percentage of payroll increased even though UAL decreased. She clarified payroll is looked at as of the date of valuation.

CalPERS Actuary Clement further clarified the normal cost is decreasing due to the anticipation of PEPRA members replacing Classic members. The ultimate rate should be in 15-years. The UAL as a percentage of payroll is decreasing in the valuation due to the impact gradually being put into rates over the 5-year ramp-up period, not including the negative 6.1% return in fiscal year 2022.

Council Member Filseth asked what assumptions CalPERS has for future increases in liability.

CalPERS Actuary Clement clarified CalPERS' inflation assumption dropped from 2.75% to 2.3% before the present inflation period. It will be revisited in 4-years.

Council Member Filseth remarked the 2015 projection of contributions for the miscellaneous plan was 35% while the actual contribution was around 44.5%. Finance Committee normal cost rates differ from CalPERS, resulting in a normal cost delta which the City picks up. PEPRA calls for the normal cost to be split between the City and labor groups so the normal cost delta also needs to be split.

Administrative Services Director Nose noted while that is between the Committee and labor groups, there are agreements to varying degrees in all labor group contracts for them to pick up part of the employer contribution. Employer contribution is not identified as part of normal cost or UAL.

Council Member Filseth asked how much of the employer contribution is attributed retroactively versus picking up the current normal cost.

Administrative Services Director Nose clarified the employer contribution is not broken out. The City receives the savings as an employer and can pay less, allowing an additional contribution to be made for the lower normal cost.

Chair DuBois asked if the estimated performance for 2022 in the 115 Trust was known and if the rate of 6.1% was for the City's CalPERS investment.

Budget Manager Deschamps stated the rate was 11.5% for the period ending June 30, 2021. For the period ending July 31, 2022, the 1-year return rate is -8.12%.

Chair DuBois asked if the different designations in tiers for council members and council appointees were correct.

Administrative Services Director Nose said tier placement depends on what members have prior to their service on the Council. The matter will have to be further investigated.

Chair DuBois asked if the swings in monetary difference for total UAL are due to investments being down in a down year, how concerned the

Committee should be when the UAL curve is going up, and if it is expected to go back down.

Administrative Services Director Nose believed the differences to be like what the Committee saw in earlier biannual OPEB reports, where an anomaly occurred between a good portfolio performance with great returns and lower increases in medical costs swinging the actuarial OPEB evaluation from needing to contribute to being able to pull money out of the trust. It is unknown whether this is a trend or a blip. Massive fluctuations are seen if the data is run on an isolated basis and these kinds of ripples over a 20- or 30-year period are only intended to be ripples. The Committee needs to be cautious about reacting to a ripple versus a trend.

Chair DuBois noted, to Council Member Filseth's previous point, the Committee expected to be further along than they are.

Administrative Services Director Nose noted the reports do not factor in the pre-funding or the proactive funding by the Committee in the 115 and the CalPERS estimate is a baseline. Calculations are currently being made to determine final figures after the nearly $50 million set aside in the 115 Trust is added. The matter will be further discussed in October and November.

Chair DuBois asked if there will be steep increases in benefit costs.

CalPERS Actuary Clement explained returns are taken and translated into the contribution amount, then smoothed out over a 5-year period. Between 2020 and 2021, the UAL rate went down due to a huge investment return. The 2021 return was 14% higher than assumed. A portion of that was taken out and lowered the discount rate to 6.8%, changing UAL to pay for it with a portion of the investment gain. In the following year, 7% was expected but 6.1% was lost, resulting in a 13% swing. In 2022, the UAL rate will gradually go back up.

Chair DuBois inquired if an increase in benefit costs is predicted.

CalPERS Actuary Clement further clarified UAL is the difference between the accrued liability and the assets, with benefits being part of the accrued liability and their cost increasing over time. Expected accrued liability is calculated by taking the accrued liability of the prior year given interest for a full year added to the normal cost, with benefit payments subtracted from the total.

Chair DuBois asked if an additional payment should be made to CalPERS and if it would be better to do that in a down year.

CalPERS Actuary Clement explained when making Additional Discretionary Payments (ADPs), if it is made in the middle of the year, half a year's interest will be applied. Palo Alto has not done that in the last 10 years. Instead, all the extra money has gone into the 115 Trust.

Chair DuBois asked if losses are already expected, would an ADP bend the UAL curve or mitigate loss.

Administrative Services Director Nose affirmed that it would. By making an ADP to CalPERS, it would increase assets. CalPERS would take the value of assets and in the next actuarial report, if nothing changed and all the actuarial assumptions were met as expected, since the additional ADP was made, assets would be higher than expected and the percentage of payroll would go down.

Chair DuBois asked, in terms of time in the market, if the market went up and money was also put into assets the UAL would go up even more.

Administrative Services Director Nose remarked Chair DuBois' question was a good policy question that will need to be addressed in the next few months, especially with the development of the budget for 2024.

Chair DuBois inquired if it would be appropriate to make an ADP recommendation now rather than waiting until the budget period.

Administrative Services Director Nose presented 2 potential options for moving forward and noted they could be made in conjunction rather than independently. One option is to recommend Staff split the excess BSR evenly between the 115 Trust and the Capital Improvement Fund per established Council pension funding policy and in anticipation of coming losses in the next year. Second, recommend the Council adopt or direct Staff to plan for fiscal year 2024 with that extra payment in mind. The rates presented will be the fiscal year 2024 budget rates so the difference in timing of payments will not materialize until July 1, 2023.

Chair DuBois noted the money needed for the ADP payment is currently in the 115 Trust and inquired when making the payment would be appropriate.

Administrative Services Director Nose added more discussions will be held in the coming months on pension and OPEB plans, and discussed the ADP payment option benefits. If the market is expected to go up, making the ADP payment could offer the benefit of greater returns since the CalPERS portfolio is more aggressively invested than the 115 Trust. The other option is to split 115 funds into both conservative and aggressive portfolios with less chance of risk but also less chance of reward.

Chair DuBois suggested while the market is down and the needed funds are available, the Committee might want to consider investing.

Council Member Filseth noted he agreed with Director Nose's comments on disregarding market timing and focusing on long-term implications instead. The calculated UAL does not matter so much as managing the normal cost. If true normal cost is covered, then future UAL will not go up. There is no policy regarding how fast to pay down UAL but an ADP could be made to pay down future UAL. Steps such as additional actuarial analysis should be taken to ensure normal cost is covered. Additionally, the Committee should focus on CalPERS pension management over portfolio management. Discussion ensued.

Chair DuBois inquired how big the Committee wanted the 115 Trust to get before making an ADP payment to CalPERS.

Council Member Filseth noted it would be important to make policy decisions based on running a pension system and not the specific portfolio.

Chair DuBois stated it was suggested to have the full year's payment in the 115 Trust and to make an ADP if there are additional funds left over.

Council Member Filseth reiterated the Committee must look at normal cost and suggested CalPERS create 2 actuarial books based on different sets of data.

Administrative Services Director Nose noted Staff is currently working on aggregating the reports based on 10- and 20-year ALM assumptions through the CalPERS online pension modeling tool. The tool allows Staff to change discount assumptions and provide revised projections based on the population of data. The data will be used to build the fiscal year 2024 budget and determine the additional contribution amount to the 115.

Council Member Filseth remarked with that data, the Committee could make operational decisions regarding the 115 Trust versus CalPERS as opposed to managing a portfolio paid on liability.

Vice Mayor Kou asked if the Committee has control over funds in the ADP payment to CalPERS.

Administrative Services Director Nose clarified the Committee has more control over the actual portfolio or menu of investments of the 115 rather than CalPERS since CalPERS makes the assumptions for the full portfolio. However, when an ADP is made, those funds can be allocated to pay off a chosen basis year.

Chair DuBois inquired what paying off a basis year would mean and why it would be done.

Administrative Services Director Nose explained if advance payments are made, there will be less interest charged. A negatively positioned year could be chosen and paid off, resulting in less interest payments over the 20-year amortization period.

CalPERS Actuary Clement further explained the Committee has choices regarding which base year the ADP payment is applied to. The longest base was recommended to be paid due to it having the most interest. If a reduction in short-term contributions needs to be made, the ADP should be applied to the shorter bases. Once the ADP is sent to CalPERS, the money cannot be sent back, taken out, or invested differently.

Vice Mayor Kou asked what the goal of the Committee is.

Ms. Nose, Administrative Services Director, stated the Committee needs to look at taking the next steps regarding the pension funding policy. While the Committee has not met its end goal, some initial goals have been met.

Chair DuBois asked how much money is in the 115 Trust.

Administrative Services Director Nose stated there will be almost $50 million by June 30, 2023. Once the fund has reached its set 1-year amount, the Committee should look at strategically paying off basis years.

Chair DuBois inquired by making an ADP payment to CalPERS, if there was a commitment expected the next year.

Administrative Services Director Nose affirmed there was no commitment expected. Staff will work with the Committee between now and December on updates to the pension policy and what possible next steps are, including whether to keep investing in the 115, make ADPs, or establish a second 115 at a more aggressive investment rate. These policy calls will depend on the Committee’s opinions on risk, investment, CalPERS, and administrative fees.

Council Member Filseth asked for clarification on the implications of paying off a given basis year versus other alternatives. When choosing policies, it is important to consider whether it will make an impact or fix issues. While it is possible for the Committee to rate pension funds to pay for short-term cash needs, the Committee should consider making an ADP to CalPERS to reduce the possible misuse of funds.

Kiely Nose, Administrative Services Director relayed Staff's intent in establishing the 115 Trust was to diversify the City's available tools and provide strategic options for the City to prepare for economic volatility. Staff envisioned multiple strategies such as 115s, ADPs, and refinancing when establishing the pension funding policy with the Council. The policy provides guidance to Staff on how to use these tools as well as their intended use. The 115 does not need to be very large but it would be important to have a reasonable amount of funds for it to act as a rate stabilization reserve for its intended use.

Chair DuBois asked about the exact number for overall funded rates in 2022.

Administrative Services Director Nose noted the overall funded status is not 30% but instead closer to 70%. While it increased 10%, the levels are expected to drop in the 2022 results. Mr. Clement was asked if the results would be approximately commensurate.

CalPERS Actuary Clement stated the rates will go back down, with the miscellaneous plan decreasing from 75% to 65% and safety from 69% down to 60%.

Council Member Filseth noted the decrease in rates to make sense and reiterated the need to cover normal cost.

Chair DuBois inquired if there would be an opportunity for the Committee to make a recommendation to the Council on the excess BSR or potential payment strategy.

Administrative Services Director Nose clarified there would be 2 opportunities to inform and advise the Council. The first, when the Council reviews the pension funding policy and the red lines associated with it. The second, when the Committee reviews the Annual Comprehensive Financial Report (ACFR) and determines the actual amount of excess funds.

Council Member Filseth asked for the pros and cons of keeping money in the 115 Trust versus making an ADP to CalPERS.

Chair DuBois stated a con of making an ADP to CalPERS would be picking a bad basis year where the City has to pay a lot of interest.

Council Member Filseth noted the City is in a unique position due to sufficient fund contributions to the 115 resulting in more money put aside than needed for CalPERS payments. The City has historically not needed to worry about cashflow implications or a liquidity problem as a result of this and careful management from the finance team.

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Vice Mayor Kou asked Director Nose if the City were to refinance if that would make the economic hole bigger.

Administrative Services Director Nose responded that if all conditions were controlled, a refinancing option would not make the hole bigger and true savings could be realized. More money in the market earlier means more opportunities to gain returns on it over a longer period.

CalPERS Actuary Clement noted if the Committee chose to refinance, the interest paid after refinancing would be less than the interest paid on the current basis. While the hole could get bigger, refinancing would not be a direct cause.

Chair DuBois recalled Director Nose's earlier point of the inability to reallocate funds once paid to CalPERS and suggested the Committee model refinancing and ADPs independently, then make payments every year based on the data and without commitment.

Administrative Services Director Nose added that if the Committee chooses to make an ADP to CalPERS directly, there would be less ability for future officials to choose to allocate funds differently.

MOTION: Chair DuBois moved, seconded by Council Member Filseth to recommend the City Council accept the June 20, 2021 CalPERS Annual Valuation reports for the Miscellaneous and Safety Pension Plans.

MOTION PASSED: 3-0

Future Meetings and Agendas

Adjournment: The meeting was adjourned at 6:47 P.M.