



Los Altos Pension Obligations

Background, Risks and Alternatives

October 8, 2013
Special Project
Financial Commission

Objectives of the Study

- City Council asked the Financial Commission to review the situation
 - Does a problem exist for the City?
 - What actions or alternatives should be considered?
- Explain elements of pension plan liabilities
- Define the costs and risks of keeping the status quo
- Highlight available alternatives

Background and Scope

- California public pension reform has become a prominent issue
 - Bankruptcy filings of cities with financial stress
 - Increasing pension liabilities
 - County Civil Grand Jury reports
 - Reform championed by Governor Brown
 - New accounting standards

Background and Scope

- City of Los Altos participates in the California Public Employees' Retirement System (CalPERS)
 - Defined benefit plans
 - Los Altos has 118 active and 161 retired employees participating

Financial Commission Study

- Reviewed City pension plans
- Surveyed current literature related to pension reform
- Studied CalPERS publications relevant to City plans
- Met with outside experts
 - John Shoven, Professor of Economics, Stanford University
 - Tony Oliveira, Former Board Member of CalPERS
 - CalPERS representatives
- Received information and support from City staff

Legislative and Economic Setting

- Senate Bill 400 passed in 1999
 - Followed strong investment performance by CalPERS
 - Intended to improve recruiting and retention of government employees
 - More generous benefits, going forward and retroactively
- Market investment returns did not meet expectations
 - “Dotcom” bubble burst in 2000, financial crisis began 2008
 - Less than projected investment performance

Legislative and Economic Setting

- CalPERS has been increasing contribution rates
 - Because generally assets are less than present value of liabilities
- Public Employees' Pension Reform Act (PEPRA) passed
 - Effective January 1, 2013
 - More sustainable plan formulas for most new employees

Pension Administration by CalPERS

- CalPERS has managed City pension plans since 1960
 - Authority and fiduciary responsibility under State Constitution
 - Must comply with Public Employees' Retirement Law (PERL)
 - Manages retirement plans of over 1500 agency members
 - \$255 billion under management
 - Payments to 1/2 million beneficiaries
- City assets and liabilities are pooled with those of similar agencies for efficient management
- All cities, including the City of Los Altos, are ultimately responsible for meeting all their future benefit obligations

Defined Benefit Plans under CalPERS

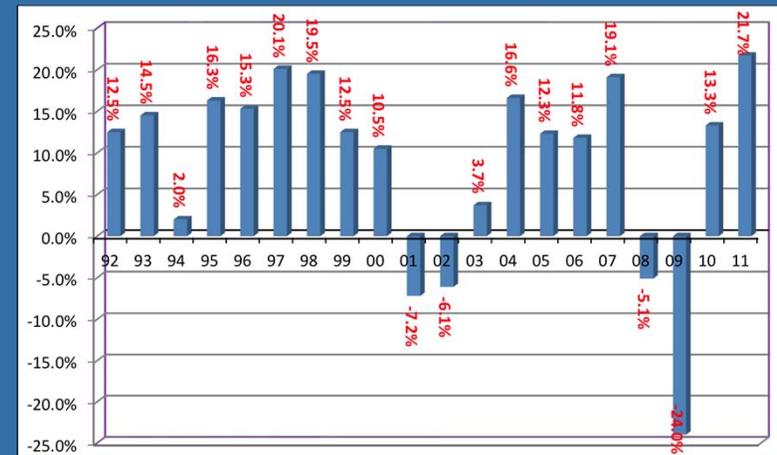
- Future retirement payments are relatively defined, but based on actuarial assumptions and analysis
 - Plan risks include the effect of retirees living longer than actuarially assumed
- Assets are invested with certain assumptions about investment returns
 - Current assumed rate of return is 7.5%
- Contributions are made from agencies each year to fund the plans
 - Rates are typically annually adjusted to account for changes in assumed salary projections, benefit levels and investment returns
 - CalPERS current review of funding risks, investment policy and actuarial methods expected to result in higher rates

CalPERS Defined Benefit Plans - Investment Risk

- Actual investment returns reflect risk and volatility
- Substantial swings in asset value, including large declines in some years, can be expected
- CalPERS returns have averaged 3.8%, 7.2%, 7.7% and 9.5% over the last 5, 10, 20 and 30 years, respectively
- In aggregate, as of 6/30/11, CalPERS plans were only 74% funded

CalPERS History of Investment Returns

The following is a chart with historical annual returns of the Public Employees Retirement Fund for each fiscal year ending on June 30. Beginning with June 30, 2002 the figures are reported as gross of fees.

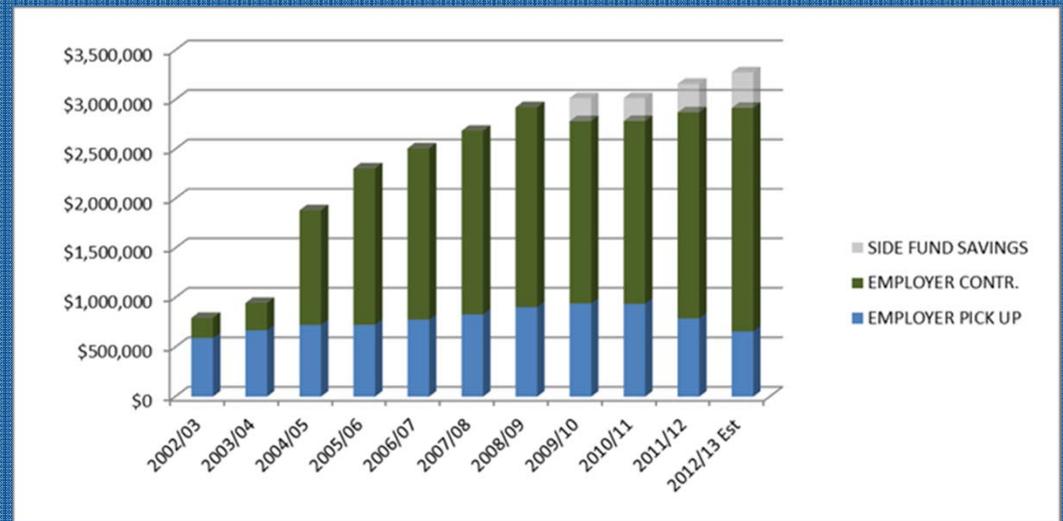


Los Altos Plans and Participation

- Miscellaneous
 - 73 active employees and 110 retired
 - Employer rate rose from 15% in FY 12/13 to 16% in FY 13/14
- Safety
 - 45 active employees and 51 retired
 - Employer rate rose from 25% in FY 12/13 to 27% in FY 13/14
- In FY 13/14, CalPERS will require an employer base contribution of \$2.3 million based on payroll estimated at \$12 million
- An employee contribution portion, approximating \$600,000, has been funded by the City in past years, a practice that is being phased out through new State laws and collective bargaining and negotiation

Los Altos Pension Costs Rising

- Pension costs are about 10% of General Fund revenue, but are growing faster than revenue
- Total cost (including employee portion paid by City) rose from \$1.8 million in FY 04/05 to about \$3 million in FY 12/13
- Costs would be even higher except for payoff of “side funds” and impact of new employee tiers
- Los Altos rates could increase by 30-40% over the five years starting FY 15-16



Note: Plans “overfunded” in 2003/04 and 2004/05

Los Altos Plans - Funded Status

- CalPERS information about the funding status of plans is somewhat outdated, with latest available analysis as of June 30, 2011
- At that date, Los Altos plans were 77% funded
 - Market value of assets was \$69 million
 - Value of actuarially estimated liabilities, assuming 7.5% investment returns, was \$90 million.
 - Net unfunded actuarial liability was \$21 million
- Termination of CalPERS plans is possible, but would require “buyout” of obligations
 - In this scenario CalPERS applies a lower “risk-free” investment return rate based on Treasury rates
 - Estimated Los Altos liabilities for termination purposes were \$131 million, for a net buyout amount of \$62 million

Peer City Comparisons

- Financial and actuarial reports of peer cities were reviewed
- Los Altos is in a comparable position to its peers with regard to relative pension costs and balances
- While somewhat comforting, this does not mitigate the risks to Los Altos

Peer City Comparisons Results

Data and Ratios For Peer Cities						
Data Description	Los Altos	Campbell	Los Gatos	Menlo Park	Saratoga	
Pop.-2011 est. (Bureau of Census)	29,431	39,968	29,884	32,412	30,401	
City Revenue-2012-13 (Budgets) (000s)	\$ 39,468	\$ 50,187	\$ 48,978	\$ 65,112	\$ 26,905	
CalPERS Reports						
Total Participants - 6/30/11	423	521	590	743	259	
Total Market Valuation Assets 6/30/11(000s)	\$ 69,239	\$ 99,460	\$ 98,176	\$ 115,768	\$ 26,749	
Total Actuarial Liability 6/30/11(000s)	\$ 90,331	\$ 134,306	\$ 136,003	\$ 148,663	\$ 33,071	
Total Unfunded Mkt. Liab. 6/30/11 (000s)	\$ 21,092	\$ 34,846	\$ 37,827	\$ 32,895	\$ 6,322	
Total Funded Status 6/30/11	77%	74%	72%	78%	81%	
Total Unfunded Termination Liab (000s)	\$ 61,637	\$ 97,185	\$ 99,299	\$ 98,147	\$ 18,121	
Total Proj. Payroll - 2013/14 (000s)	\$ 12,206	\$ 15,592	\$ 15,109	\$ 21,449	\$ 5,351	
Total Proj. Contribution - 2013/14 (000s)	\$ 2,330	\$ 4,036	\$ 4,388	\$ 4,363	\$ 733	
Total Contrib. % Proj. PR - 2013/14	19%	26%	29%	20%	14%	
Commission Analysis						
Unfunded Market Liability / Resident	\$ 717	\$ 872	\$ 1,266	\$ 1,015	\$ 208	
Unfunded Market Liab. - % Proj. Contrib.	905%	863%	862%	754%	863%	
Unfunded Termination Liabi. / Resident	\$ 2,094	\$ 2,432	\$ 3,323	\$ 3,028	\$ 596	
Total Payroll / City Revenue	31%	31%	31%	33%	20%	

Impact of New Government Accounting Rules

- New Governmental Accounting Standards Board (GASB) pension-related accounting rules beginning FY 13/14
- Affect Los Altos and most of its peers
- Detailed disclosure required on pension plans, including large obligations reflected on City balance sheet and income statement
- Will be revealing, although the existence of these liabilities is generally understood
- Not yet known whether these disclosures will affect City credit ratings or ability to borrow

Pension Sensitivity and Risk Analysis

- Valuing pension liabilities requires use of a “discount rate”
 - Future assumed benefit payments discounted to a present value based on assumptions of investment return
- Current CalPERS assumed discount rate (its assumed investment return rate) is 7.5%
- Changes to the discount rate have a dramatic impact on the payroll contributions that would be required

FY2013/14 Employer Total Payroll Contribution Rate Sensitivity Analysis			
As of June 30, 2011	8.50% Discount Rate (1% Higher)	7.50% Discount Rate (current rate)	6.50% Discount Rate (1% Lower)
Safety (Pool)	11.4%	27.0%	46.5%
Misc (Pool)	7.3%	15.9%	26.7%

- As shown in CalPERS analysis, a reduction of 1% in the discount rate would require employer contribution requirements to increase over 50%

Alternatives and Observations

- City has taken commendable steps to address pension risk
 - Prudent management of staffing
 - Introduction of second tier plans to reduce benefit costs
 - Reducing employer contributions to the employee portion of plan costs
 - Implementing PEPRA reduced benefit levels for new employees
 - Pay-off of side fund liability to CalPERS
 - Establishing \$600,000 reserve fund in case of financial shock from CalPERS rate increases

Alternatives and Observations (cont'd)

- Alternatives within the CalPERS system
 - Develop sustainable plan terms with employees for mutual benefit
 - Continue to manage both direct and indirect payroll costs
 - Advocate constructive legislative change via organizations like the League of California Cities
 - Periodically revisit the cost/benefit of remaining in the CalPERS system

Alternatives and Observations (cont'd)

- Alternatives outside the CalPERS system
 - Given a buyout cost of approximately \$62 million, exiting CalPERS is not feasible today
 - Situation could change positively, for example with sustained future years of high investment returns

Alternatives and Observations (cont'd)

- Should exiting CalPERS become fiscally feasible:
 - The process of re-defining and developing alternate arrangements would be lengthy, involved and quite complex
 - Alternative plan arrangements such as defined contribution plans or hybrid plans with both defined benefit and defined contribution elements will need study
 - Employer participation in Social Security given minimum retirement benefit levels will require evaluation
 - It is key to note that, under current law, defined benefit plans can only be replaced by new benefit arrangements deemed equal or better value and that substantial changes to retirement plans may impact employee hiring and retention

Concluding Remarks

- Because of City actions to date, and an improved economic environment, Los Altos does not appear to face any near-term financial crisis as a result of its pension obligations
- However, the City must be prepared for significant increases in pension contributions under CalPERS, a cost strain which could potentially impact the delivery of City services
- The funding status of City pension plans is subject to significant ongoing risk due to the volatility of market returns
- The City should maintain vigilance in mitigating risks and evaluating how changes in the pension landscape could affect long-term financial sustainability

Los Altos Pension Obligations

Background, Risks and Alternatives

Questions & Answers