

TO: Financial Commission

FROM: Russell J. Morreale, Staff Liaison

SUBJECT: Draft Pension Study Report

RECOMMENDATION:

Review and discuss the draft “Los Altos Pension Obligations: Overview, Risks and Alternatives” report and identify next steps

BACKGROUND

In FY 2011/12, Council requested that the Financial Commission study the matter of pension plans given their relevance to the fiscal status of the City and the heightened level of attention the topic was receiving in the public arena. In navigating this important and timely project, the Commission assigned a special project subcommittee made up of Commission Chair Donald Korn and Commissioners Kevin Thompson and Roger Sievers. The results of their study and effort on this project are the subject of the public discussion at this meeting.

DISCUSSION

After considerable deliberation and research, the subcommittee members have prepared a draft report for Commission review and comment. Once approved by the Commission, the final report will be forwarded to City Council for its consideration.

Attachments:

1. Draft “Los Altos Pension Obligations: Overview, Risks and Alternatives”

Attachment 1

Draft “Los Altos Pension Obligations: Overview, Risks and Alternatives”

Los Altos Pension Obligations: Overview, Risks and Alternatives

2013 Financial Commission Report to the City Council

I. EXECUTIVE SUMMARY

Background

California public pension reform has captured public interest and headline news due to a combination of factors. These include California County Civil Grand Jury reports and findings, reform legislation of Governor Brown, financial difficulties of government agencies (including bankruptcy filings), and increasing California Public Employees' Retirement System (CalPERS) pension liabilities. In addition, new governmental accounting rules have been issued with a focus on pension obligations.

As do the majority of California cities, the City of Los Altos (City) participates in the CalPERS Defined Benefit (DB) pension plans. These long-standing retirement benefits cover a variety of employee groups and associations. The City's participation currently covers 118 active and 161 retired employees.

Objective and Scope

In light of the pension environment noted above, the Los Altos City Council asked the Financial Commission to review the situation, determine whether a problem exists from a fiscal perspective, and if so, what actions or alternatives should be considered in response. The objective of this paper is to explain the elements of the pension plans and liabilities, summarize the costs and risks of maintaining the status quo, and indicate what alternatives may be available. The goal is to produce information, conclusions and actionable recommendations for the Los Altos City Council.

The topic of Other Post-Employment Benefits (OPEB) costs, related to employee health care, is not addressed in the scope of this review. It is another issue that has emerged in the fiscal planning of the City.

Findings

City actions to reduce pension costs and liabilities, coupled with reform legislation, new governmental accounting standards and market recovery, have eased the pension concerns that existed at the outset of this study in FY 2011/12. The cost of providing pension benefits for Los Altos employees is manageable at this time. However, the City should be prepared for the likelihood of forthcoming significant contribution rate increases in the near term.

Recently quantified long-term pension obligations are large and growing, now exceeding plan assets. Concerns remain that during the next decade or longer, volatility in pension costs as a result of market fluctuations and risks, trending increases in contribution rates, and evolving legislation and CalPERS policies could influence the City's fiscal standing. These concerns remain despite the constructive effects of recent pension legislation and local reforms. The status of City pension plan funding levels is dependent upon sustained positive CalPERS investment

returns, the prudent maintenance of salary and benefit levels by the City and the evolution of future pension rates.

Although technically possible, it is not a feasible option at this time to withdraw from the CalPERS DB plans. Nevertheless, the City has taken and should strive to continue with further steps to mitigate the ongoing costs and risks of the plans by:

1. arriving at sustainable employer/employee cost-sharing contribution levels
2. carefully monitoring staffing and salary levels
3. supporting constructive legislative changes to the retirement law

The City has taken many steps within the CalPERS system to lower the cost of providing pension benefits. It now has developed new tiers of employee pension formulas that effectively reduce the benefit cost and contribution of the City to the employee share as the result of recent collective bargaining processes. Future changes in pension arrangements should involve careful consideration and study with a focus on the impact on recruitment, labor relations and organizational costs of such changes.

II. LEGISLATIVE BACKGROUND AND ECONOMIC SETTING

Pension reform and sustainability, or crisis and bankruptcy? These have been the key words and questions framing the debate over meeting the cost of state and local government pension obligations.

Senate Bill 400 (SB400), a California legislative change that allowed for higher government pension benefit formulas, passed overwhelmingly in 1999. That action was influenced by the excellent investment performance of CalPERS and difficulty in recruitment and retention of government employees. It permitted more generous pension benefits, both prospectively and retroactively, but contributed to the level of unfunded liability now experienced in the pension system.

The end of the “dotcom” bubble in 2000, followed by the financial crisis of 2008, reversed the investment performance of CalPERS from annual growth to shrinkage of assets. Despite generally good investment performance in a majority of past years, the current market value of the pension assets managed by CalPERS on behalf of the City is less than the value of the pension liabilities for the City. Consequently, CalPERS has required additional pension contributions to amortize the unfunded pension liability and is considering other actuarial changes to more quickly re-coup investment losses and meet new accounting standards.

In California, several years of effort produced AB 340 resulting in the impactful Public Employees’ Pension Reform Act (PEPRA) legislative reforms effective January 1, 2013. PEPRA created new and more sustainable DB formulas for most *new* public employees, and established new rules and limits regarding pension payments. This will not meaningfully lower pension costs for most employers in the near term, but ultimately will reduce such costs as new employees are hired and existing employees and retirees eventually leave the system. However, the hiring of employees under PEPRA and within the second tier plan of the City will result in immediate financial savings to the City.

The ongoing conservative fiscal approach of the City, along with its location in Silicon Valley with relatively stable real property values, has enabled it to successfully operate through the worst financial crisis in decades. It met the increased pension demands from operating funds and reserves. A number of cities that were less prudent and/or not so fortunate have faced the threat of financial instability and for a few, the reality of bankruptcy.

In response to concerns with the cost trends in retirement benefits, the 2011-2012 Santa Clara County Civil Grand Jury obtained data on pensions, and other retirement benefits, from the cities within the County. Its June 13, 2012 report and findings noted the high proportion of retirement benefit payments were attributable to the volatile investment results of CalPERS. The Grand Jury expressed concern that the CalPERS actuarial rate of return assumption was unrealistically high and recommended that cities take steps to contain and reduce benefits. It suggested that defined contribution plans (DC) in place of existing DB plans be considered as a way to lower public employer costs, unpredictable unfunded liabilities and taxpayer risks. It also concluded that the escalating costs of providing benefits could otherwise lead to reduction in necessary services and the ultimate costs to taxpayers would be “an unbearable burden.”

The publicity surrounding the bankruptcy of Stockton, San Bernardino and Vallejo has shown the undesirable consequences of imprudent public policies and fiscal management exacerbated by increasing pension costs and the loss of redevelopment funds. These cases are raising profound legal and Constitutional questions, such as whether contracts under state laws protecting employee pension rights can be impaired or abrogated by a federal judge in a city bankruptcy proceeding under Chapter 9 of the United States Bankruptcy Code. Years of litigation are likely. The outcome could bring new pension legislation, most likely at the state level, as well as new CalPERS contractual arrangements, that could impact the features of pension plans and the benefits ultimately received.

III. CalPERS PENSION ADMINISTRATION AND RISK FACTORS

Organization and Authority

The primary pension plans of the City are DB plans administered and invested by CalPERS under a contract going back to 1960. CalPERS offers a tax qualified plan for employees and a governmental plan as defined in the U.S. Internal Revenue Code. The CalPERS Board of Administration has plenary authority and fiduciary responsibility for the investment of monies and the administration of the System pursuant to the State Constitution. It has tax-exempt status and is not subject to administrative direction by any department, commission, board, bureau, or agency of the State. CalPERS is a component unit of the State of California for financial reporting purposes in accordance with Governmental Accounting Standards Board (GASB) Statement No. 39.

Employee Participation

Under the Public Employees' Retirement Law (PERL) and CalPERS rules and procedures, employees are necessarily designated in various categories for actuarial purposes and benefit provisions. Two major state-wide categories pertinent to local government are Safety and Miscellaneous. PERL further distinguishes between employees represented by collective bargaining agreements and non-represented employees.

With the passage of PEPRRA, CalPERS further classifies employees to distinguish a variety of eligible pension benefit levels. “Existing members” are those employees hired prior to January 1, 2013 in City-adopted tiers, “Classic members” are employees who previously participated in a CalPERS pension system with reciprocity and were hired on or after January 1, 2013. “New members” are those hired on or thereafter who do not fit the Existing or Classic member criteria. The way these distinctions apply should be kept in mind in estimating the impact of CalPERS changes in actuarial policies and PEPRRA provisions on the future costs of pensions to the City.

Fiduciary Role and Fund Magnitude of CalPERS

The Public Employees Retirement Fund (PERF), established in 1932, is the largest of a number of pension and benefit funds of various types managed by CalPERS and the largest state fund in the U.S. As of June 30, 2011, the State of California, and the City, some 1,500 other public agencies and 61 school systems members contributed to PERF. CalPERS acts as the common investment and administrative agent. The retirement benefits provided by PERF are funded by individual employee member and public employer contributions and by earnings on investments. PERF net assets held in trust for benefits at June 30, 2011 were \$242B, pension contributions for the year totaled \$11B, net investment income was \$44B and deductions for benefits totaled \$15B. The number of beneficiaries increased from 505,862 to 528,343. On a per-member and beneficiary basis, the cost of administering PERF benefits during FY 2010/11 was about \$219 per individual.

The actuarial policy of CalPERS has utilized level contribution rate financing principles with adjustments as necessary so that the system will pay all promised benefits when due - “the ultimate test of financial soundness.” At June 30, 2011, PERF had a funded status of 73.6%.

Funding Risk

In April 2013, the Office of the Chief Actuary and the Pension and Health Benefits Committee of CalPERS analyzed the risks associated with funding the retirement system. This analysis took into account the current actuarial methods and assumptions, investment policy, and the occurrence of changes in the pension environment, including recent bankruptcies. CalPERS estimated that, using its current actuarial methodology, a “Sample Public Agency Miscellaneous Plan” would have a 47% probability of employer contribution rate increasing more than 5% of payroll year-to-year at some point in the next 30 years, and a 78% probability of the rate increasing more than 3% of payroll. Higher respective probabilities were estimated for Safety Plans.

The conclusion is that there is considerable risk in the funding of the system. Moreover, CalPERS recognized that employers are subject to additional financial pressures on many fronts that can affect their ability to pay required contributions. It also acknowledged, “Municipal bankruptcies pose a substantial risk to the system.” Hence, CalPERS actuaries are reviewing and monitoring on a plan-by-plan basis, and the Board is considering short-term increases in employer contribution levels to “de-risk the funding of the system.” To minimize any adverse impact on employers, CalPERS suggests that any changes to actuarial and investment policies will likely be made gradually to allow for planning and adjustment.

Longevity Risk

One such change is likely to be an increase in contribution rates to compensate for the effect of retirees living longer than the lifetime estimates in current actuarial tables. It is believed that this is the subject of a new, upcoming CalPERS actuarial study.

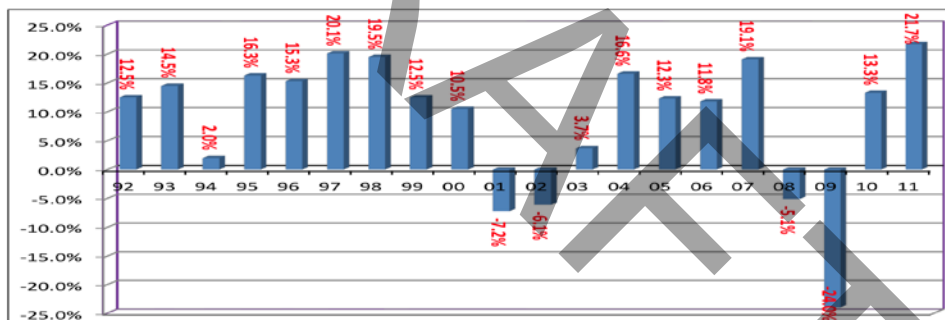
Investment Risk

Investment performance of CalPERS was reported to be a return of 0.1% for FY 2011/12. For FY 2012/13, it was 12.5%, benefitting from both strong equity and fixed income markets. PERF assets at June 30, 2013 were indicated to be nearly \$255 billion, slightly more than at June 30, 2007, preceding the financial crisis and Great Recession. The chart below indicates many years of sound performance but also risk-bearing volatility given some years of reported losses.

Also under study by CalPERS is Asset Liability Management, an approach to DB pension fund management aimed at ensuring *that the Pension Fund is sustainable over multiple generations*. A technique of matching assets and liabilities, for example, could reduce wide swings in portfolio value but it typically can imply a lower rate of return and increasing employer contribution rates.

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.



Current Concerns

The CalPERS analysis concluded that, in the future with its new policies, there will be upward pressure on employer contribution rates for an extended period of time and significant contribution volatility, a situation that may be very difficult for employers to bear. Indications are that “employers will be under continuing financial stress for many years unless there is a period of exceptional returns in the markets.” *Should such stress cause agencies to elect to terminate their contracts with CalPERS, the analysis noted there could be severe negative consequences for many plan members, since most pensions are now only 40%-60% funded on a hypothetical termination basis.*

IV. LOS ALTOS PENSION PROGRAMS AND OBLIGATIONS

Overview

The City participates in the CalPERS multiple-employer public employee DB pension plan. It provides service retirement, industrial disability retirement, cost-of-living adjustments and death benefits to plan members and beneficiaries.

While annual pension costs are now only about 10% of General Fund revenue, they have grown faster than revenue over the last decade as have pension liabilities. Annual pension contribution rates are set by CalPERS and are significantly impacted by CalPERS investment results --factors outside the City's control. A decade ago, the pension funds of the City were overfunded, with assets greater than the present value of liabilities. Now, liabilities exceed available pension assets, primarily due to negative investment rates of return experienced during the recent financial crisis.

The annual cost of providing DB pensions to City employees under CalPERS has increased substantially in recent years. It increased from approximately \$1.8 million in FY 2004/05 to about \$3.0 million in FY 2012/13.

The analyses and "de-risking" policy changes by CalPERS discussed above are indicative of prospectively more conservative actuarial and investment policies. While constructive for the long term, CalPERS has noted that such changes could bring significant pension contribution rate increases for a number of years and volatility for the foreseeable future.

Employment and Pensions

Los Altos currently has 118 active full-time employees, down from 128 a decade ago. There are 130 full-time authorized positions, but due to budget limits, the City Manager is holding 12 positions vacant at this time. The City currently has 45 active and 51 retired in Safety, 73 active and 110 retired in Miscellaneous. Formulas for pension benefit levels are typically specified in terms of the percent of eligible final pay. These formulas vary according to the employee tier wherein, at a designated age of retirement, they are then multiplied by the number of years of service subject to certain limits. Thus, an employee with a "3% @ 50, single highest year" benefit retiring at age 50 with 25 years credited service would get an annual pension equal to 75% of the highest year's eligible earnings. Contract provisions of CalPERS typically include a 2% per year cost of living increase.

For FY 2012/13, the employer pension contribution rate of the City was 15% for existing Miscellaneous and 25% for existing Safety employees. Rates have risen to 16% and 27%, respectively for FY 2013/14. CalPERS will require about \$2.3M from Los Altos to fund pension plans based upon payroll estimated at \$12M. Employees are also required to make payments into their pension plan in varied levels depending upon the plan and agreements in place. In past years, the City paid all or most of the share of the required employee contribution. This practice is being phased out through discussions with non-represented employees and with represented employees through collective bargaining process.

To limit pension cost and reduce future liabilities, the City, again through the collective bargaining process and discussions with non-represented employees, proactively amended its contract with CalPERS to incorporate Tier 2 benefit provisions for employees hired after October 2011. This reduced the benefit level from 2.7% @55 to 2% @60 for new Miscellaneous group hires and from 3% @50 to 3% @55 for new Safety hires. In addition, the Tier 2 employees pay the entire employee contribution rate of 7% or 9%, respectively. The final year retirement calculation was also amended from the highest final year to a three-year average. All hires since the effective date in October 2011 are in the Tier 2 and all prior to that date in Tier 1. Tier 1 employees are now partially paying into their employee contribution.

The City prepared for changes under PEPPRA for qualified employees hired on or after January 1, 2013. New hires will contribute at least 50% of the normal pension cost from their earnings. As the new PEPPRA rules are phased in, together with employee agreements, the City share of retirement contributions is declining and employee payments to CalPERS will increase up to legislated limits.

Rate Projections

In April 2013, CalPERS informed all public agency employers of expected employer rate contribution rate increases through 2020. For Los Altos, the overall impact of the blended projected rates could result in pension costs rising on the order of 30 to 40% over a five-year period through 2020. Such projections are subject to changes in payroll levels, realized investment performance, CalPERS methods and the demographic experience of the pool.

Actuarial Valuation

In 2003, CalPERS required plans with less than 100 members to be included in risk pools to smooth rates and decrease volatility. Both the Safety and Miscellaneous pension plans of the City are in risk pools with actuarial reports presented in aggregate. With new actuarial and GASB accounting procedures being implemented, CalPERS will henceforth be providing the City with details specific to its own pension plans.

As of the June 30, 2011 actuarial valuation date, the market value of assets (MVA) of City employee pension funds held in trust and invested by CalPERS was \$69M and the actuarially determined liabilities \$90M using a Rate of Return (ROR) assumption of 7.5%. This represents a funded status of 77% and an unfunded actuarial liability in the CalPERS-managed City plans of \$21M.

CalPERS provided for the first time the Hypothetical Termination Liability (HTL) of the City. However, under current actuarial protocol and practice, this report was not available to the City until October 2012, more than 15 months after the date of valuation. The HTL was approximately \$131M determined by discounting liabilities to present value at the 30-year Treasury bond rate of 4.82%. Subtracting the MVA (\$69M mentioned above) showed a difference, or Unfunded Termination Value (UTV), of about \$62M.

The UTV represents the amount the City hypothetically would have had to pay CalPERS to “buy out” or terminate its contract resulting in the transfer of all City pension plan assets and liabilities existing as of the termination date to CalPERS. It is expected that both assets and liabilities will have higher valuations as of the FY 2011/12 and FY 2012/13 valuation dates, but those actuarial reports are not yet available.

Future actions that can be taken by CalPERS could have a profound impact on the pension obligations of the City. These include: (1) modifying the actuarial ROR assumed on the investment of pension funds; (2) changing the methods used in determining the actuarial valuation of plan assets and liabilities; and (3) implementing full-asset allocation of the funds invested.

CalPERS actuarial rates are set with a two-year lead time based on lagged investment performance, i.e. rates for FY 2013/14 are based on 2011 results. Investment performance is a key factor in determining the ongoing cost of the pension plans. To the extent that market returns fall below assumed ranges, CalPERS can be expected to require increased pension fund contributions by the employer to restore funding ratios.

The current ROR is 7.5%. The higher the ROR becomes, the lower the actuarially required contribution rate. Moreover, use of too high a rate to discount liabilities makes the present value of the pension obligations unrealistically low and may give a misleading picture of the funded status of the plan. Results are very sensitive to ROR assumptions that are subject to change by CalPERS.

Side Fund Payoff

Included in the employer contribution rates is the amortization of the side funds. This was created to account for the difference between the funded status of the pool and the funded status of the City plans at the time of joining the risk pool. A feature of the actuarial accounting is that the side fund earns or is charged with the actuarial ROR. In 2009/10, with market returns substantially below the actuarial ROR, it was beneficial for the City to begin making accelerated payments to reduce the side funds.

The City made side fund payments over the last several years to completely pay off its side fund liabilities using reserves and General Fund monies totaling approximately \$5.5M. The City estimates the payoff has produced pension cost savings on the order of \$250K per year over the last four years reducing the operating expenses as reported in the budget by such amount.

Indirect CalPERS Rate Impacts

Since 1996, the City has outsourced Fire Services to the Santa Clara County Central Fire Protection District (County Fire). The current 10-year contract expires December 31, 2016, with the obligation of the City being the payment amounts in the contract under a payment formula established in 2006 when the agreement was renewed. The total annual cost under the contract is approaching \$6M per year, roughly 20% of City operating budget. The future contract may be affected by a variety of factors including pension costs.

V. PEER CITY COMPARISONS

A review of actuarial reports was completed to compare peer city pension obligations and other relevant data. The following table shows key metrics for peer cities on pension sustainability.

Los Altos appears to be in a favorable or comparable position as compared to most of the peer cities. While perhaps comforting, these findings do not mitigate the risks that exist with maintaining DB plan benefits.

The City's ratio of pension fund assets to payroll (AVR) is a measure of how sensitive an agency's contribution rate will be due to investment returns. The peer cities show an AVR averaging 5.9; the ratio for the City is 5.7%. These peer cities also show a funded status (MVA divided by actuarial liabilities) below 80% except Saratoga. For a broader perspective, the national funded status ratio for public funds in 2012 was 74%.

Los Gatos has above average pension contribution requirements versus its peers when compared to CalPERS projected payroll. Menlo Park had a relatively high ratio of payroll to city revenue while Saratoga a relatively low ratio.

Saratoga displays very low unfunded termination liability per resident. This most likely is attributable to the fact that that city has no Safety employees and directly associated pension costs because it contracts for both its fire and police services from Santa Clara County.

Data and Ratios for Peer Cities Comparisons

| | Los Altos | Campbell | Los Gatos | Menlo Park | Saratoga (1) |
|---|-----------|------------|------------|------------|--------------|
| Pop.-2011 est. (Bureau of Census) | 29,431 | 39,968 | 29,884 | 32,412 | 30,401 |
| City Revenue-2012-13 (Budgets) | \$ 39,468 | \$ 50,187 | \$ 48,978 | \$ 40,190 | \$ 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 Market Liability 6/30/11 | 77% | 74% | 72% | 78% | 81% |
| Total Unfunded Termination Liab (2) (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% |
| Market Value Assets / Payroll (AVR) | 5.7 | 6.4 | 6.5 | 5.4 | 5.0 |
| Unfunded Termination Liabi. / Resident | \$ 2,094 | \$ 2,432 | \$ 3,323 | \$ 3,028 | \$ 596 |
| Total Payroll / City Revenue | 31% | 31% | 31% | 53% | 20% |
| (1) Saratoga only has Miscellaneous CalPERS Participants | | | | | |
| (2) "In August 2011, the CalPERS Board adopted an investment policy and asset allocation strategy that more closely reflects expected benefit payments of the Terminated Agency Pool." Essentially, this liability reflects more realistic market return assumptions. | | | | | |

VI. IMPACT OF NEW GOVERNMENTAL ACCOUNTING STANDARDS

Government accounting standards regarding pensions will change effective as soon as FY 2013/14, requiring much more detailed disclosure of pension liabilities. For the City, as with most of its peers, these pension obligations are very large in the context of its financial statements and will be required to be recorded therein. On the other hand, the existence of these liabilities is generally understood. It is not yet known whether these new disclosures will affect the credit ratings of the City and other public agencies, or affect the ability to borrow.

The two new GASB pension-related Standards referred to above include Statement No. 67, "Financial Reporting for Pension Plans-an amendment of GASB Statement No. 25" and "Accounting and Financial Reporting for Pensions-an amendment of GASB Statement No. 27." These accounting changes represent a new watershed in measuring and disclosing pension costs, assets and liabilities. GASB 67 affects CalPERS, as the Fiduciary /Agent for multi-employer pension plans. GASB 68 applies to governmental entities like the City, a municipal employer that sponsors an employee pension plan. Each will incorporate the new accepted methodology for calculating the discount rate to be used for reporting the value of liabilities, and the expected rate of return to use regarding investment of pension assets. Both standards will require supplemental reporting and public disclosures of pension plan details and the inclusion of 10 years of certain specified historical data.

VII. PENSION SENSITIVITY ANALYSIS

The impact of Discount Rates: Valuing pension liabilities requires estimating benefits that will be paid in the future and "discounting" those benefits to the present. The resulting pension liability is very sensitive to the discount rate (equivalent in its nature to a rate of return). For example, the estimated liability today for a pension benefit of \$32K for one year, payable fifteen years hence, is approximately \$10K using an 8% discount rate, but more than \$15K using a 5% rate. Put differently, using a more conservative 5% rate increases the estimated liability by about 50% relative to an 8% rate.

The impact on contribution rates: The following table from the City's FY 2010/11 actuarial reports displays FY 2013/14 employer payroll contribution rates under three different discount rate scenarios, i.e. 1% lower and 1% higher than the current valuation discount rate. This sensitivity analysis gives an indication of the potential required employer contribution rates if the PERF were to hypothetically realize investment returns of 6.50%, 7.50%, or 8.50% over the long-term.

| FY2013/14 Employer Total Payroll Contribution Rate | | | |
|--|------------------------------------|---------------------------------------|-----------------------------------|
| As of June 30, 2011 | 6.50% Discount Rate (1% Higher) | 7.50% Discount Rate (current rate) | 8.50% Discount Rate (1% Lower) |
| Safety | 46.50% | 27.00% | 11.40% |
| Misc | 26.70% | 15.90% | 7.30% |

As the above table indicates, if CalPERS lowers assumed investment returns to 6.5%, from the current 7.5%, the City's blended pension total contribution rate would increase by more than 50%. This would escalate pension costs to approximately 30% of payroll, compared to roughly

19% currently. Given a \$12M payroll base, this would represent an increase of more than \$1M per year. Conversely, this sensitivity analysis indicates a large decrease in employer contribution rates should investment returns average 8.5% instead of the 7.5% assumed. Dramatic swings in pension costs can occur with a single percentage point change in ROR.

To place this in budgetary perspective, an increase amounting to 5% of payroll for Los Altos would exceed \$500,000 per year. In April 2012, the Financial Commission Debt Capacity Analysis advised that, given trends known at that time, an additional cash cost of \$500,000 annually was the maximum affordable increase the City could reasonably support.

Hypothetical Unfunded Termination Liability (UTL)

Beyond contribution rates, the recently announced UTL, or the cost of buying out of the CalPERS plans, is also a value that is impacted significantly by a change in the assumed discount rate. In the case of termination values, as previously noted above, CalPERS utilizes the 30-year Treasury bond as the discount rate. This value is currently significantly lower than the CalPERS standard actuarial ROR used in setting plan contribution rates.

With U.S. Treasury rates through June 30, 2013 remaining close to the June 30, 2011 values, the Commission has projected, taking into account estimated changes in asset values, liabilities, benefit payments and contributions, that it is likely that the UTL is now at least as large as the \$62M cited by CalPERS.

Conversely, it is important to note that, if and when, Treasury rates increase back to normal historical levels, it is quite likely that the UTL will drop sharply other things being equal.

VIII. ALTERNATIVES AND OBSERVATIONS

Potential Responses

The City has already taken commendable steps to mitigate the costs and risks associated with its pension programs. These include adding a second tier of pension benefits for newly hired employees, reducing employer contributions to the employee cost of pension benefits, paying off side-fund liabilities, and starting to implement PEPPRA for new employees. Also in FY 2013/14, it approved a \$600K financial operating reserve reducing the risk of short-term financial shock. The City should recognize that continued vigilance and additional long-term actions are needed to continue to reduce pension cost and unfunded liability.

Under California law, DB pensions can only be replaced by new benefit arrangements deemed of equal or better value. Before making any substantial change to retirement plans, the advantages and disadvantages, including the effect on employee hiring and retention, would need to be carefully considered. There is the possibility that future CalPERS policy changes will provide DB plans that are less risky, but still affordable, for the City.

Recommendations for the City within the CalPERS system are:

Develop sustainable pension plan terms with employees for mutual benefit. Discussions with employees can be held to increase employee contributions, consistent with the contribution rate provisions of PERL and PEPRA that promote the cost-sharing of pension costs.

Manage payroll cost in consideration of pension costs and risks in decisions about staffing and associated salary levels.

Advocate Constructive Legislative Change by staying involved with organizations seeking to improve public pension plans, e.g. the League of California Cities. Pension law may be ripe for major legislative changes as a result of the bankruptcy litigation in the cities of Stockton and San Bernardino. Legislative change may result in CalPERS offering more flexible arrangements, including various types of hybrid DB-DC plans to reduce cost and risk to contracting agencies.

Continue to validate the costs vs. benefits of remaining in CalPERS. Given that more than \$60M currently would be required for the City to terminate the contract with CalPERS, there is no realistic near-term option to exit the system. Even if feasible, such an action would involve quite a lengthy and complex process to evaluate, develop and implement alternative retirement systems. Such alternatives may also bear significantly higher administrative costs and investment management fees.

Recommendations outside of the CalPERS System:

Alternative retirement plan arrangements are possible. If leaving CalPERS became a feasible course of action, alternative retirement plan arrangements that could be considered include new DB, DC, and/or hybrid plans. In doing so, it is important to note that employers are required to participate in Social Security unless they provide an alternate plan with a minimum level of retirement benefits.

Concluding Remarks

City actions, PEPRA, new GASB standards, and economic recovery have improved the pension situation in comparison with the potentially large, but essentially unknown, risks at the outset of this study. Today, Los Altos does not appear to be facing any near-term financial crisis as a result of its pension obligations. Still, significant increases in pension contributions under CalPERS are considered likely in the near term.

Unless CalPERS offers less risky and more affordable plans in coming years, the City should consider steps to further reduce its significant risk exposure. It should move to reduce the weight of DB plans in its employee benefits menu and seek long-term arrangements for which all funding obligations are fully satisfied in the period they are incurred. Provision of City services should rigorously be examined to determine the cost/benefit of direct versus indirect means to accomplish the work. In summary, the City should maintain vigilance in mitigating risks and understanding how any changes in the pension landscape could affect its long-term financial sustainability.