



City of Palo Alto

City Council Staff Report

(ID # 7553)

Report Type: Consent Calendar

Meeting Date: 1/23/2017

Summary Title: Pension Trust Supplemental Funds

Title: Authorization to Establish a Supplemental Pension Trust With the Public Agency Retirement Service (PARS) and Approve Budget Amendments in the General Fund and the General Benefits Fund

From: City Manager

Lead Department: Administrative Services

Recommendation

Staff recommends that the City Council:

- 1) Adopt a “Resolution of the Council of the City of Palo Alto Approving the Adoption of the PARS Public Agencies Post-Employment Benefits Trust Administered By Public Agency Retirement Services (PARS) (Attachment A) and approve an initial deposit of \$2.1 million in General Fund proceeds into the General Fund subaccount of the City’s PARS Public Agencies Post-Employment Benefits Trust
- 2) Authorize the City Manager or his/her designee as the City’s Plan Administrator for the Trust Program
- 3) Approve and authorize City Manager to execute an “Agreement for Administrative Services” between PARS and the City of Palo Alto to administer the Trust (Attachment B)
- 4) Amend the Fiscal Year 2017 Budget Appropriation Ordinance for
 - a. The General Fund
 - i. Increase the Non-Departmental Transfers to the General Benefit Fund in the amount of \$2,055,000; and
 - ii. Decrease the General Fund Budget Stabilization Reserve in the amount of \$2,055,000.
 - b. The General Benefits Fund
 - i. Increase the estimate for Transfers in from the General Fund in the amount of \$2,055,000; and

- ii. Establish an appropriation for PARS Public Agencies Post-Employment Benefits in the amount of \$2,055,000.

Background

The City of Palo Alto has two pension trusts with the California Public Employees’ Retirement System (CalPERS): one to fund public safety employees and one for miscellaneous employees. The trusts are funded by employer and employee contributions and by investment earnings on those contributions. In order to reach necessary funding levels to pay employee pensions, CalPERS establishes a set of actuarial assumptions to achieve those levels.

One of the most critical assumptions in attaining full funding goals is the rate of return on investments in the trusts. CalPERS’ current annual rate of return (ROR) assumption is 7.5 percent. Assuming this rate of return is attained, then funding of the pension obligations would be derived 66 percent from investment gains and 34 percent from contributions. If the 7.5 percent rate of return is not realized, then contributions from employers and employees will have to increase.

Unfortunately, this ROR has not been achieved by CalPERS in the past two years (2.4 percent in FY 2015 and 0.6 percent in FY 2016) and the outlook from the investment community and actuaries for a 7.5 percent annual rate of return is increasingly pessimistic. In fact, the average actual rates of CalPERS returns in the table below have fallen below expectations in several time periods.

Time Period	Rate of Return
Three years	6.86 percent
Five Years	6.77 percent
Ten Years	5.08 percent
Twenty Year	7.03 percent

As a consequence of the above performance; a long, low interest rate environment; and movement toward a more “risk averse” portfolio; the CalPERS board has approved a plan to reduce the assumed ROR from 7.5 percent to 7.0 percent over a three year period. The ROR will decrease as follows: in July 2017 to 7.375 percent; in July 2018 to 7.25 percent; and in July 2019 to 7.0 percent.

CalPERS’ gradual decrease in the ROR assumption will result in higher contribution rates for employers and employees. This will compound existing funding challenges since the two City trusts already are below the ideal level of 80 percent funded. The miscellaneous group stands at 68.5 percent and the public safety group stands at 68.6 percent. As the ROR decreases, these funding levels will drop placing the City further behind in meeting pension obligations.

As a consequence of the above factors, the City Council directed staff to develop options to address unfunded pension liabilities and specifically to examine directing General Funds to a tax-exempt Section 115 Trust for pension costs.

Discussion

During the past two fiscal years, \$2.1 million in General Fund monies have been set aside for pension liabilities and staff recommends establishing a section 115 irrevocable trust with the Public Agency Retirement Services (PARS) in which to place these funds. This amount represents about 10 percent of the current annual contribution by the General Fund. By proactively establishing a 115 trust, the City will prefund pension costs and begin to address GASB 68 Net Pension Liabilities (NPL). See Attachment A, Resolution approving trust and Attachment B, Agreement for Administrative Services between the City and PARS. While these trust funds must be dedicated toward pension obligations, they serve multiple purposes such as:

- Act as a reserve fund to offset potential volatility in CalPERS annual contribution or rate requirements
- Allow more control and flexibility in investment allocations
- Realize higher investment returns than by maintaining monies within the City's portfolio that is restricted by State regulations to fixed income instruments
- Diversifies investments in pension and retiree medical trusts
- Act as a set-aside and available for use in reducing the City's pension obligations
- Solidifies the City's triple A credit rating by demonstrating proactive action in meeting pension obligations

Staff recommends implementing the trust for all City funds. As of June 30, 2015 (the latest actuarial valuation from CalPERS, which is in arrears), the unfunded pension liability totals \$338.4 million for all funds. The General Fund's share of the total is \$222.0 million or 65.6 percent. The trust will then maintain a sub account for each City fund having a pension liability. This allows specific contributions by fund for its share of the unfunded liability. With Council authorization a deposit of \$2.1 million will be made to the General Fund sub account. Staff would then return during the FY 2018 proposed budget process with recommendations for additional funding by other funds. In addition to surpluses from these funds, it may be necessary to increase enterprise fund rates or fees to increase their sub-accounts within the Trust.

Establishing a pension trust is especially important for the General Fund (GF) which faces significant demands on its resources and is most sensitive to swings in its tax revenue sources. For example, if the annual GF pension contribution is \$14 million in a fiscal year and a \$2 million deficit surfaced in that year, the General Fund, with Council's approval, could draw upon the PARS GF trust balance to send \$2 million directly to CalPERS and reduce the GF payments to PERS by \$2 million. This would balance the budget and provide time to make informed decisions on fixing a one-time or ongoing budget deficit.

In addition to instituting a trust, staff will return to Council with recommendations on how to grow the trust and to more aggressively address the ongoing growth in the City's unfunded pension liability. One option for increasing Trust assets is to allocate any year-end excess revenues among infrastructure, unfunded pension and retiree medical liabilities. Discussions along these lines could occur at year end with allocations dependent upon needs at that time.

Staff will return with other options to address pension liabilities as part of the FY 2018 proposed budget. For example, Council could consider negotiating an increase in employee contributions to the employer share of pension contributions. One scenario is having public safety employees pay an additional 1 percent per year over a three year period to total to an additional 3 percent contribution. Miscellaneous employees could increase their share toward the required contribution by 0.5 percent per year over a two year period to total 1 percent. Action during this period is critical in light of CalPERS' newly adopted ROR dropping to 7.0 percent over the next three years and as CalPERS rates to the City increase.

It is somewhat uncertain at this time as to whether GASB will treat the 115 Trust as a strict offset to the Net Pension Liability under GASB 68 in the City's future financial statements. Nevertheless, it does appear appropriate at this time to mention in the financial statements that the Trust could be counted as an offset the City's pension obligation. Hopefully, by the time the City's FY 2017 financial statements are issued, GASB will have clarified its position on the application of trust assets to the Net Pension Liability.

The Section 115 Trust offered by PARS has five portfolios (see Attachment A) from which to choose in making investments of City funds. Each portfolio has different risk profiles with different amounts invested in equities and other instruments. As the amount of equities in portfolios increases, volatility and risk increases. As the amount in equities decreases, volatility and risk decreases. The portfolios range from "Capital Appreciation" with 72 percent of funds invested in equities to "Conservative" with 15 percent invested in equities. Equities can include domestic and international stocks. Staff recommends selecting the "Moderately Conservative" portfolio which currently has 30 percent in equities as of September 30, 2016. Returns as of this date in this portfolio were as follows:

1-Year Returns	=	7.28 percent
3-Year Returns	=	4.48 percent
5-Year Returns	=	6.67 percent

Staff has learned that 85 percent of jurisdictions participating in PARS's Section 115 Trust have selected the "Moderately Conservative" portfolio which is the second most conservative portfolio among the five offered.

Resource Impact

Funds in the amount of \$2.1 million will be withdrawn from the GF Budget Stabilization Reserve and transferred to a Section 115 Trust fund for the purpose of meeting employee pension obligations. Staff will provide further funding options for the other Funds as part of the FY18 Proposed Budget.

This funding has been set aside in the General Fund Budget Stabilization Reserve during the FY 2015 year end and the FY 2017 Adopted Operating Budget. Therefore, no change to the previously reported current funding level of approximately 21 percent of the FY 2017 expense budget is necessary.

Policy Implications

Actions taken from this report are consistent with prior Council direction.

Environmental Review

Establishing a Section 115 Trust for pension obligations with PARS is not subject to CEQA review.

Attachments:

- Attachment A: Resolution Adopting PARS Post Employment Benefits Trust
- Attachment B: Agreement for Administrative Services Between the City and PARS
- Attachment C: PARS Investment Rate of Returns (as of 9-30-2016)

NOT YET APPROVED

Resolution No. _____

Resolution of the Council of the City of Palo Alto Approving
the Adoption of the PARS Public Agencies Post-Employment
Benefits Trust Administered By Public Agency Retirement Services (PARS)

R E C I T A L S

A. PARS has made available the PARS Public Agencies Post-Employment Benefits Trust (the "Program") for the purpose of pre-funding pension obligations and/or OPEB obligations.

B. The City of Palo Alto ("City") is eligible to participate in the Program, a tax-exempt trust performing an essential governmental function within the meaning of Section 115 of the Internal Revenue Code, as amended, and the Regulations issued there under, and is a tax-exempt trust under the relevant statutory provisions of the State of California.

C. The City's adoption and operation of the Program has no effect on any current or former employee's entitlement to post-employment benefits.

D. The terms and conditions of post-employment benefit entitlement, if any, are governed by contracts separate from and independent of the Program.

E. The City's funding of the Program does not, and is not intended to, create any new vested right to any benefit nor strengthen any existing vested right.

F. The City reserves the right to make contributions, if any, to the Program.

NOW THEREFORE, BE IT RESOLVED THAT:

SECTION 1. The City Council hereby adopts the PARS Public Agencies Post-Employment Benefits Trust, effective _____, 2016.

SECTION 2. The City Council hereby appoints the City Manager, or his/her successor or his/her designee, as the City's Plan Administrator for the Program.

SECTION 3. The City's Plan Administrator is hereby authorized to execute the PARS legal and administrative documents on behalf of the City and to take whatever additional

NOT YET APPROVED

actions are necessary to maintain the City's participation in the Program and to maintain compliance of any relevant regulation issued or as may be issued; therefore, authorizing him/her to take whatever additional actions are required to administer the City's Program.

SECTION 4. The Council finds that this is not a project under the California Environmental Quality Act and, therefore, no environmental impact assessment is necessary.

INTRODUCED AND PASSED:

AYES:

NOES:

ABSENT:

ABSTENTIONS:

ATTEST:

City Clerk

Mayor

APPROVED AS TO FORM:

APPROVED:

Senior Asst. City Attorney

City Manager

Director of Administrative Services

AGREEMENT FOR ADMINISTRATIVE SERVICES

This agreement (“Agreement”) is made this 23 day of January, 2017, between Phase II Systems, a corporation organized and existing under the laws of the State of California, doing business as Public Agency Retirement Services and PARS (hereinafter “PARS”) and the City of Palo Alto (“Agency”).

WHEREAS, the Agency has adopted the PARS Public Agencies Post-Employment Benefits Trust for the purpose of pre-funding pension obligations and/or OPEB obligations (“Plan”), and is desirous of retaining PARS as Trust Administrator to the Trust, to provide administrative services.

NOW THEREFORE, the parties agree:

1. **Services.** PARS will provide the services pertaining to the Plan as described in the exhibit attached hereto as “Exhibit 1A” (“Services”) in a timely manner, subject to the further provisions of this Agreement.
2. **Fees for Services.** PARS will be compensated for performance of the Services as described in the exhibit attached hereto as “Exhibit 1B”.
3. **Payment Terms.** Payment for the Services will be remitted directly from Plan assets unless the Agency chooses to make payment directly to PARS. In the event that the Agency chooses to make payment directly to PARS, it shall be the responsibility of the Agency to remit payment directly to PARS based upon an invoice prepared by PARS and delivered to the Agency. If payment is not received by PARS within thirty (30) days of the invoice delivery date, the balance due shall bear interest at the rate of 1.5% per month. If payment is not received from the Agency within sixty (60) days of the invoice delivery date, payment plus accrued interest will be remitted directly from Plan assets, unless PARS has previously received written communication disputing the subject invoice that is signed by a duly authorized representative of the Agency.
4. **Fees for Services Beyond Scope.** Fees for services beyond those specified in this Agreement will be billed to the Agency at the rates indicated in the PARS’ standard fee schedule in effect at the time the services are provided and shall be payable as described in Section 3 of this Agreement. Before any such services are performed, PARS will provide the Agency with a detailed description of the services, terms, and applicable rates for such services. Such services, terms, and applicable rates shall be agreed upon in writing and executed by both parties.
5. **Information Furnished to PARS.** PARS will provide the Services contingent upon the Agency’s providing PARS the information specified in the exhibit attached hereto as “Exhibit 1C” (“Data”). It shall be the responsibility of the Agency to certify the accuracy, content and completeness of the Data so that PARS may rely on such information without further audit. It shall further be the responsibility of the Agency to deliver the Data to PARS in such a manner that allows for a reasonable amount of time for the Services to be performed. Unless specified in Exhibit 1A, PARS shall be under no duty to question Data received from the Agency, to compute contributions made to the

Plan, to determine or inquire whether contributions are adequate to meet and discharge liabilities under the Plan, or to determine or inquire whether contributions made to the Plan are in compliance with the Plan or applicable law. In addition, PARS shall not be liable for non performance of Services to the extent such non performance is caused by or results from erroneous and/or late delivery of Data from the Agency. In the event that the Agency fails to provide Data in a complete, accurate and timely manner and pursuant to the specifications in Exhibit 1C, PARS reserves the right, notwithstanding the further provisions of this Agreement, to terminate this Agreement upon no less than ninety (90) days written notice to the Agency.

6. **Records.** Throughout the duration of this Agreement, and for a period of five (5) years after termination of this Agreement, PARS shall provide duly authorized representatives of Agency access to all records and material relating to calculation of PARS' fees under this Agreement. Such access shall include the right to inspect, audit and reproduce such records and material and to verify reports furnished in compliance with the provisions of this Agreement. All information so obtained shall be accorded confidential treatment as provided under applicable law.
7. **Confidentiality.** Without the Agency's consent, PARS shall not disclose any information relating to the Plan except to duly authorized officials of the Agency, subject to applicable law, and to parties retained by PARS to perform specific services within this Agreement. The Agency shall not disclose any information relating to the Plan to individuals not employed by the Agency without the prior written consent of PARS, except as such disclosures may be required by applicable law.
8. **Independent Contractor.** PARS is and at all times hereunder shall be an independent contractor. As such, neither the Agency nor any of its officers, employees or agents shall have the power to control the conduct of PARS, its officers, employees or agents, except as specifically set forth and provided for herein. PARS shall pay all wages, salaries and other amounts due its employees in connection with this Agreement and shall be responsible for all reports and obligations respecting them, such as social security, income tax withholding, unemployment compensation, workers' compensation and similar matters.
9. **Indemnification.** PARS and Agency hereby indemnify each other and hold the other harmless, including their respective officers, directors, employees, agents and attorneys, from any claim, loss, demand, liability, or expense, including reasonable attorneys' fees and costs, incurred by the other as a consequence of, to the extent, PARS' or Agency's, as the case may be, negligent acts, errors or omissions with respect to the performance of their respective duties hereunder.
10. **Compliance with Applicable Law.** The Agency shall observe and comply with federal, state and local laws in effect when this Agreement is executed, or which may come into effect during the term of this Agreement, regarding the administration of the Plan. PARS shall observe and comply with federal, state and local laws in effect when this Agreement is executed, or which may come into effect during the term of this Agreement, regarding Plan administrative services provided under this Agreement.

11. **Applicable Law.** This Agreement shall be governed by and construed in accordance with the laws of the State of California. In the event any party institutes legal proceedings to enforce or interpret this Agreement, venue and jurisdiction shall be in any state court of competent jurisdiction.
12. **Force Majeure.** When a party's nonperformance hereunder was beyond the control and not due to the fault of the party not performing, a party shall be excused from performing its obligations under this Agreement during the time and to the extent that it is prevented from performing by such cause, including but not limited to: any incidence of fire, flood, acts of God, acts of terrorism or war, commandeering of material, products, plants or facilities by the federal, state or local government, or a material act or omission by the other party.
13. **Ownership of Reports and Documents.** The originals of all letters, documents, reports, and data produced for the purposes of this Agreement shall be delivered to, and become the property of the Agency. Copies may be made for PARS but shall not be furnished to others without written authorization from Agency.
14. **Designees.** The Plan Administrator of the Agency, or their designee, shall have the authority to act for and exercise any of the rights of the Agency as set forth in this Agreement, subsequent to and in accordance with the written authority granted by the Governing Body of the Agency, a copy of which writing shall be delivered to PARS. Any officer of PARS, or his or her designees, shall have the authority to act for and exercise any of the rights of PARS as set forth in this Agreement.
15. **Notices.** All notices hereunder and communications regarding the interpretation of the terms of this Agreement, or changes thereto, shall be effected by delivery of the notices in person or by depositing the notices in the U.S. mail, registered or certified mail, return receipt requested, postage prepaid and addressed as follows:
 - (A) To PARS: PARS; 4350 Von Karman Avenue, Suite 100, Newport Beach, CA 92660; Attention: President
 - (B) To Agency: City of Palo Alto; 250 Hamilton Avenue 4th Floor, Palo Alto, CA 94301; Attention: Chief Financial OfficerNotices shall be deemed given on the date received by the addressee.
16. **Term of Agreement.** This Agreement shall remain in effect for the period beginning January 23, 2017 and ending January 23, 2020 ("Term"). This Agreement may be terminated at any time by giving thirty (30) days written notice to the other party of the intent to terminate. Absent a thirty (30) day written notice to the other party of the intent to terminate, this Agreement will continue unchanged for successive twelve month periods following the Term.
17. **Amendment.** This Agreement may not be amended orally, but only by a written instrument executed by the parties hereto.
18. **Entire Agreement.** This Agreement, including exhibits, contains the entire understanding of the parties with respect to the subject matter set forth in this Agreement.

In the event a conflict arises between the parties with respect to any term, condition or provision of this Agreement, the remaining terms, conditions and provisions shall remain in full force and legal effect. No waiver of any term or condition of this Agreement by any party shall be construed by the other as a continuing waiver of such term or condition.

- 19. **Attorneys Fees.** In the event any action is taken by a party hereto to enforce the terms of this Agreement the prevailing party herein shall be entitled to receive its reasonable attorney's fees.
- 20. **Counterparts.** This Agreement may be executed in any number of counterparts, and in that event, each counterpart shall be deemed a complete original and be enforceable without reference to any other counterpart.
- 21. **Headings.** Headings in this Agreement are for convenience only and shall not be used to interpret or construe its provisions.
- 22. **Effective Date.** This Agreement shall be effective on the date first above written, and also shall be the date the Agreement is executed.

AGENCY:

BY: _____

TITLE: City Manager_____

DATE: _____

PARS:

BY: _____
Tod Hammeras

TITLE: Chief Financial Officer_____

DATE: _____

EXHIBIT 1A
SERVICES

PARS will provide the following services for the City of Palo Alto Public Agencies Post-Employment Benefits Trust:

1. Plan Installation Services:

- (A) Meeting with appropriate Agency personnel to discuss plan provisions, implementation timelines, actuarial valuation process, funding strategies, benefit communication strategies, data reporting, and submission requirements for contributions/reimbursements/distributions;
- (B) Providing the necessary analysis and advisory services to finalize these elements of the Plan;
- (C) Providing the documentation needed to establish the Plan to be reviewed and approved by Agency legal counsel. Resulting final Plan documentation must be approved by the Agency prior to the commencement of PARS Plan Administration Services outlined in Exhibit 1A, paragraph 2 below.

2. Plan Administration Services:

- (A) Monitoring the receipt of Plan contributions made by the Agency to the trustee of the PARS Public Agencies Post-Employment Benefits Trust (“Trustee”), based upon information received from the Agency and the Trustee;
- (B) Performing periodic accounting of Plan assets, reimbursements/distributions, and investment activity, based upon information received from the Agency and/or Trustee;
- (C) Coordinating the processing of distribution payments pursuant to authorized direction by the Agency, and the provisions of the Plan, and, to the extent possible, based upon Agency-provided Data;
- (D) Coordinating actions with the Trustee as directed by the Plan Administrator within the scope this Agreement;
- (E) Preparing and submitting a monthly report of Plan activity to the Agency, unless directed by the Agency otherwise;
- (F) Preparing and submitting an annual report of Plan activity to the Agency;
- (G) Facilitating actuarial valuation updates and funding modifications for compliance with GASB 45/75, if prefunding OPEB obligations;
- (H) Coordinating periodic audits of the Trust;
- (I) Monitoring Plan and Trust compliance with federal and state laws.

3. PARS is not licensed to provide and does not offer tax, accounting, legal, investment or actuarial advice.

EXHIBIT 1B
FEES FOR SERVICES

PARS will be compensated for performance of Services, as described in Exhibit 1A based upon the following schedule:

An annual asset fee shall be paid from Plan Assets based on the following schedule:

<u>For Plan Assets from:</u>			<u>Annual Rate:</u>
\$0	to	\$10,000,000	0.25%
\$10,000,001	to	\$15,000,000	0.20%
\$15,000,001	to	\$50,000,000	0.15%
\$50,000,001	and	above	0.10%

Annual rates are prorated and paid monthly. The annual asset fee shall be calculated by the following formula [Annual Rate divided by 12 (months of the year) multiplied by the Plan asset balance at the end of the month]. Trustee and Investment Management Fees are not included.

EXHIBIT 1C
DATA REQUIREMENTS

PARS will provide the Services under this Agreement contingent upon receiving the following information:

1. Executed Legal Documents:
 - (A) Certified Resolution
 - (B) Adoption Agreement to the Public Agencies Post-Employment Benefits Trust
 - (C) Trustee Investment Forms

2. Contribution – completed Contribution Transmittal Form signed by the Plan Administrator (or authorized Designee) which contains the following information:
 - (A) Agency name
 - (B) Contribution amount
 - (C) Contribution date
 - (D) Contribution method (Check, ACH, Wire)

3. Distribution – completed Payment Reimbursement/Distribution Form signed by the Plan Administrator (or authorized Designee) which contains the following information:
 - (A) Agency name
 - (B) Payment reimbursement/distribution amount
 - (C) Applicable statement date
 - (D) Copy of applicable premium, claim, statement, warrant, and/or administrative expense evidencing payment
 - (E) Signed certification of reimbursement/distribution from the Plan Administrator (or authorized Designee)

4. Other information pertinent to the Services as reasonably requested by PARS and Actuarial Provider.

PARS/HighMark Capital Management Returns

As of September 30, 2016

Portfolios	% Equity	1-Year Returns	3-Year Returns	5-Year Returns
Capital Appreciation	72.00%	10.61%	6.36%	10.81%
Balanced	58.00%	8.97%	5.40%	9.55%
Moderate	49.00%	8.60%	5.17%	8.51%
Moderately Conservative	30.00%	7.28%	4.48%	6.67%
Conservative	15.00%	6.20%	3.88%	4.98%

*Past performance does not guarantee future results.