CITY OF PALO ALTO

City of Palo Alto (ID # 11722)

City Council Staff Report

Report Type: Consent Calendar **Meeting Date: 11/30/2020**

Summary Title: Adoption of a Pension Funding Policy

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From: City Manager

Lead Department: Administrative Services

Recommendation

Staff recommends that the City Council adopt the Pension Funding Policy.

Summary

The formal adoption of the Pension Funding Policy (Attachment A) represents the culmination of many years of work by the City to proactively address its long-term pension obligations. On June 16, 2020, the City Council unanimously approved the Pension Funding Policy and this report reflects the final step in the adoption of the formal policy to ensure the strategies and goals approved by the City Council are properly memorialized for ongoing City practice.

Background

The City of Palo Alto is highly engaged in discussion and planning efforts to address the costs of current and forecasted pension benefits, including strategies to pre-fund long-term pension obligations. These strategies are increasingly important in the context of the City's overall fiscal sustainability and to ensure obligations are met on an ongoing basis. In FY 2017, the City established an irrevocable IRS Section 115 Pension Trust Fund (PARS) and has proactively contributed more than $30 million above and beyond the required annual payments to CalPERS to this trust fund.

The City has engaged in extensive conversations about how to address the long-term pension obligations as detailed in the timeline below, which includes links to the pertinent City Manager's Reports. This work culminated in the City Council approval of the draft pension policy on June 16, 2020.

- 9/2017 Finance Committee, "Review and Discuss CalPERS Pension Annual Valuation Reports as of June 30, 2016 Including Assumptions, Financial Disclosures and Next Steps" 8509
- 10/2017 Finance Committee, "Review and Recommend Strategies to Address the City's

Pension Liability" 8579
- 12/2017 Finance Committee "FY2019 - FY2028 Long Range Financial Forecast & City Pension Liabilities" 8676
- 1/2018 City Council, "Approval of the FY 2017 Comprehensive Annual Financial Report (CAFR) and Approval of Conforming Amendments to FY 2017 Budget in Various Funds; Acceptance of the FY2019 - FY2028 Long Range Financial Forecast; and Discussion and Potential Direction Regarding Budgeting for City Pension Liabilities" 8754
- 9/2018 Finance Committee, "Accept CalPERS Pension Annual Valuation Reports as of June 30, 2017 and Review and Confirm Pension Funding and Reporting Policy Guidelines" 9604
- 10/2018 City Council, "CalPERS Pension Annual Valuation Reports as of June 30, 2017 and Pension Funding and Reporting Policy Guidelines" 9708
- 10/2018 City Council, "Direct Staff to Amend Budget Assumptions for Pension Benefit Costs and Complete the Workplans to Address the City Council FY 2019 Adopted Budget Referral to Identify $4 Million in General Fund Savings" 9740
- 9/2019 Finance Committee, "Accept CalPERS Pension Annual Valuation Reports as of June 30, 2018" 10641
- 10/2019 Finance Committee, "Review, Discuss, and Recommend Establishment of a Pension Funding Policy" 10645
- 6/2020 City Council, "Review, Discuss, and Recommend Establishment of a Pension Funding Policy" 11407
- 10/2020 Finance Committee, "Accept CalPERS Pension Annual Valuation Reports as of June 30, 2019" 11607

Discussion

The extensive work completed by the City of Palo Alto detailed above has informed the development of a formal Pension Funding Policy to guide the City's continued work to proactively address long-term liabilities. The specific options, elements, and goals to establish and be included in this policy have been reviewed and discussed with the Finance Committee (CMR 10645) and the City Council (CMR 11407). Most recently at the June 16, 2020 City Council meeting, staff provided a draft policy for City Council review and input so that staff could incorporate those revisions for final City Council adoption in a subsequent item for consent. However, at that meeting, in a unanimous vote, the City Council approved the draft Pension Funding Policy outlined in Attachment C of City Manager Report 11407 without revision. That same policy with no further changes is included in this report as Attachment A, for formal adoption by the City Council.

This Pension Funding Policy sets the following goals and principles:

Funding Goal and Timeframe: a target of reaching a 90 percent funded status of the CalPERS determined liability within fifteen years (FY 2036).

Funding Components:

- 'pay go' costs also known as Normal Cost of annual pension costs to be funded with a discount rate of 6.2%, more conservative than CalPERS rate of 7.0%.
- Discretion to the City Manager to make additional contributions from excess Budget Stabilization Reserve (BSR) above the City Council approved target BSR level.

Use of Funds:

- City Manager must identify the impacts on the funding goal and timeframe to modify the transmission of contributions to the PARS Trust Fund.
- Any transmission of funds from PARS to CalPERS will require City Council approval.

Reporting:

- Every three years, staff will consult with an actuary to inform the City Council on the progress the City has made towards its goal
- Staff will report to the City Council through the annual budget process on the status of the PARS section 115 pension trust fund, recommended contributions to the PARS fund, and potential transmission of any funds from PARS to CalPERS for the coming fiscal year

Additional opportunities for proactive contributions will be brought forward for City Council consideration through various budget processes (Mid-year, Year-end, and other City Manager's Reports). Staff will continue to monitor the City's pension funding position and provide the City Council with annual CalPERS valuation reports that detail the required annual payment, fund status, and other plan changes. Currently the City is on pace to meet or exceed the funding goal of 90% - the Miscellaneous plan is projected to meet in 10 years, and the Safety plan is projected to meet in 14 years - however, this presumes that assumptions used in the actuarial analysis are met. For example, it assumes that mortality rates, salary growth, and investment earnings meet actuarial assumption in the future.

Ultimately, the goal of the Pension Funding Policy is to prevent service delivery crowd-out by the increased costs of pension obligations. If the City's efforts to proactively contribute to the long-term pension obligations would result in service delivery impacts in the short-term, the City Manager will identify those impacts and recommendations to mitigate them, as appropriate, through the budget development process.

The Policy will be incorporated into the City's financial documents and Financial Policy section of the annual budget, as well as added to the City's administrative policy manual.

Resource Impact

The adoption of the Pension Funding Policy will result in no immediate resource impact as all policies are currently woven into the City's annual financial planning.

Stakeholder Engagement

As discussed in the background section earlier in this document, the conversations surrounding the adoption of a Pension Funding Policy have been lengthy and extensive. The various Finance Committees over multiple years and the City Council have been engaged with the work since the beginning. In addition, staff has and continues to work with the municipal finanical community as well as CalPERS on any additional information.

Environmental Review

This is not a project under Section 21065 for purposes of the California Environmental Quality Act (CEQA).

Attachments:

- Attachment A: City of Palo Alto Pension Funding Policy

City of Palo Alto - Pension Funding Policy

Determination of an appropriate level for proactive Pension Funding is a policy decision. The overarching goal of a Pension Funding Policy is to ensure that the City of Palo Alto avoids service-delivery crowd-out by increasing annual pension costs. This must be balanced against immediate impacts to service delivery in order to fund proactive contributions.

The City is statutorily required to make the CalPERS Actuarial Determined Contribution (ADC) on an annual basis. The ADC is made up of two parts, the Normal Cost (NC), which represents the pay-as-you-go portion of costs, and the Unfunded Accrued Liability (UAL) payment, which represents the catch-up portion of costs. CalPERS currently calculates both the NC and the UAL based on a discount rate of 7.0%. CalPERS amortizes any difference between investment returns and that discount rate as part of its UAL calculation over 20 years. In a year when CalPERS does not meet its target (loss) the City has to pay more over the next 20 years. In a year when CalPERS exceeds its target (gain) the City would be able to pay less over the next 20 years. The timeframe of 20 years for amortizing gains and losses is recent; they were amortized over 30 years through the June 30, 2018 valuation).

Additionally, the City recognizes the importance of ensuring that pension obligations included in the City's financial reports, such as the Comprehensive Annual Financial Report (CAFR), are consistent with CalPERS. Reports such as the CAFR impact the City's credit rating and thereby influence areas such as bond financing that the City may seek to obtain.

However, the City also recognizes that CalPERS calculated costs are based on a discount rate, annual rates of return, and other variables that might **not** align with actual experience nor perhaps with expected experience. To address these shortcomings, the City is establishing a Pension Funding Policy to guide proactive pension contributions.

This policy provides direction to the City regarding a desired funding target in relation to CalPERS valuations, the timeframe over which to achieve that target, and actions that are required until the target is met. There are contingencies that provide an additional range of options if certain circumstances are met and some that require additional actions if other criteria are satisfied.

Funding Goal and Timeframe: Through this policy, the City's target is to fund 90% of the CalPERS determined liability by FY 2036. The City will strive to reach the target of 90% of the CalPERS determined liability within 15 years. If the City only paid the CalPERS ADC it would take at least 30 years to reach full funding of the CalPERS determined liability. CalPERS' 30-year timeframe to reach full funding is also predicated on every single one of their actuarial assumptions materializing. Thus, a 15-year timeframe to fund 90% of the CalPERS determined liability represents a commitment from the City above and beyond the CalPERS ADC.

Funding Components: In order to achieve the target of 90% funding by FY 2036, the City will calculate what the Normal Cost portion of annual pension costs would be if a discount rate of 6.2% were used instead of the CalPERS rate for the Miscellaneous and Safety Groups across the organization. This additional cost will be included as part of the City's standard budget process and transmitted to the City's Irrevocable section 115 PARS Pension Trust Fund (PARS Trust Fund or PARS). Should the City reach its goal of 90% funding before FY 2036, the City Manager will report the status to the City Council with a recommendation on whether the practice should be continued, modified, or discontinued. *The City Manager must identify the impacts on the funding goal and timeframe to modify the transmission of the additional contributions to the PARS Trust Fund.*

In addition to the contributions required by this Pension Funding Policy, the City will examine additional opportunities for proactive contributions to the PARS Trust Fund. Furthermore, the City Manager will include recommendations on whether funding should be transmitted from PARS to CalPERS as part of the annual budget process. This may change from year-to-year depending on the circumstances and level of funding accumulated. Some years may result in accumulating additional funding in PARS, while others may result in transferring an amount greater than a single year of additional contributions, calculated through the lower discount rate, to CalPERS. *City Council approval is required for use of accumulated funds in PARS either to CalPERS as an Additional Discretionary Payment (ADP) or to offset a portion of the standard ADC.*

An additional action that will **not** require City Council approval is transfer of excess Budget Stabilization Reserve (BSR) above 18.5% to the PARS Trust Fund. The BSR Policy will be amended to confer discretion to the City Manager to make this transfer. The BSR Policy currently confers discretion to the City Manager to transfer excess BSR above 18.5% to the Infrastructure Reserve. Once amended, the BSR Policy will confer authority to the City Manager to proactively fund infrastructure and pension obligation needs through transfers to the Infrastructure Reserve and to the PARS Trust Fund. Additionally, through standard reports to the City Council (such as Year-End, Mid-Year, or another City Manager's Report) the City Manager will include actions for additional contributions from funds other than the General Fund to maintain alignment with the contributions from the General Fund via excess BSR. City Council approval is required for these contributions from funds other than the General Fund.

The City will work to proactively monitor its pension funding position through not only its CalPERS reports but also by continuing to use an outside actuary as a consultant to model different scenarios. The City will continue to transmit the CalPERS reports on an annual basis.

Once every three years, the City will consult with an outside actuary to provide an update on the progress the City has made towards reaching a funding goal of 90% of funding of the CalPERS determined liability by FY2036 and update the City Council. Additional actions may come out of those reports and discussions with the City Council.

Service Delivery Outcomes: The goal of the Pension Funding Policy is to prevent service delivery crowd-out by the increased costs of pension obligations. If the City's efforts to proactively contribute to the long-term pension obligations would result in service delivery impacts in the short-term, the City Manager will identify those impacts and recommendations to mitigate them, as appropriate, through the budget development process.

Fiscal Impacts: If the General Fund's revenues are projected to decline more than 7.5% year-over-year, the City Manager will return to the City Council with recommendations addressing the implications for the City's proactive funding contributions for the coming year through the budget development process.