OFFICE OF THE CITY MANAGER

CITY OF
PALO
ALTO

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FEB 03 2017
CIVIL GRAND JURY

January 30, 2017

Tamara L. Davis
Deputy Manager, Jury Services
Santa Clara County Civil Grand Jury
Superior Court of California
191 North First Street
San Jose, CA 95113

Dear Deputy Manager Davis,

Thank you for your follow-up letter (December 21, 2016) regarding the 2011-2012 Santa Clara County Civil Grand Jury report entitled "An analysis of Pension and Other Post-Employment Benefits." Your letter went to our former mayor. I am responding on behalf of Greg Scharff who is the City's current mayor.

The City of Palo Alto continues to grapple with pension obligations and how, if unaddressed, they will potentially impact the delivery of City services and taxpayers.

Your letter poses the following questions:

1) **"How the town views the various recommendations?"**
As stated in then Mayor Yeh's letter of September 10, 2012, the City agreed with the recommendations. Recommendation Six did not apply and the City agreed with Recommendation 7 in principle. The recommendations align with the City's plan for addressing pension obligation impacts. Attachment A is an update to four of the recommendations and it displays the additional steps the City has taken to address the significant unfunded pension liability it faces.

2) **"Whether the recommendations were accepted?"**
As stated above, the City agrees with the recommendations. To further clarify the City's response to Recommendation 7, we agree in principle. As administrator of the Pension Trust, CalPERS has specific and challenging provisions for exiting their plan. Exit criteria include a rate of return assumption weighted according to the average of the 10-year and 30-year U.S. Treasury yields. As of the June 30, 2015 actuary report (the City's latest), CalPERS used a 3.25% hypothetical rate, which would translate into the City having to immediately deposit $667 million for miscellaneous employees and $388 million for safety employees, a total over $1 billion to exit the plan. In addition, the City would have to then establish deferred compensation plans. Based on this extraordinary cost, the City is not considering exiting CalPERS' defined benefit pension plan.

3) "Is there a plan for future action?"

Yes! In addition to the updated information provided in Attachment A, for FY 2017 the Council approved reserving $2.1 million in General Funds or 10 percent of the current annual required contribution

to start offsetting the unfunded pension liability. The Council directed staff to explore options for ongoing funding of pension liabilities for all City Funds. On January 23, 2017, Council approved establishment of an IRS Section 115 Irrevocable Trust into which the City will deposit the $2.1 million. Monies available from other funds will be deposited in January as well. Additional funding options will be presented to Council as part of the FY 2018 proposed budget process. Moreover, staff is exploring options and their implications to reduce the current 30-year amortization of the CalPERS trust with the goal of paying down the unfunded liability much faster.

The Council and staff consider pension and retiree medical unfunded liabilities as high priority issues to resolve. There have been several open public meetings to discuss the liabilities, the challenges they present, and the options to address them. The City has hired the actuarial firm Bartel Associates to assist in reviewing options and funding mechanisms. Mr. Bartel has delivered several presentations to educate Council and answer its questions.

Over the past two years CalPERS' rate of return has been extremely disappointing. This has resulted in the pension unfunded liability growing significantly. In December 2016, the CalPERS Board decided to lower the rate of return assumption from 7.5% to 7% over the next three years resulting in higher payments being required starting in July 2018. The City agrees with the decision to lower the rate of assumption, but questions whether the 7% goal is achievable. Therefore, the City will continue to explore options to proactively address its unfunded pension liability.

Respectfully,

James Keene
City Manager

Enclosure
Letter from Tamara L. Davis dated December 21, 2016

cc: Greg Scharff, Mayor
City Council Members
Lalo Perez, Chief Financial Officer
Molly Stump, City Attorney
Rumi Portillo, Chief People Officer

ATTACHMENT A

Recommendation 1: City's should adopt pension plans to extend the retirement age beyond the current retirement plan ages.

The Public Employees' Pension Reform Act of 2013 (Act) was implemented by the City and represents a third tier among City pension plans. In addition to lowering the benefit and extending the age for pension eligibility, the Act included language requiring miscellaneous and public safety employees to pick up half of the normal cost, or 6.25% and safety 11.50%, respectively. These expense shares were based on a 7.5% investment rate of return assumption. With the December 2016 Board decision to lower the rate of return assumption to 7% over three years, employees in the third tier will face an increase in their contribution rates. Miscellaneous contributions will rise from 6.25% to 7% and safety from 11.5% to 13.25%. As employee turnover occurs over time, the City will have more and more staff in lower level pension plans. Currently 38% of the miscellaneous workforce and 21% of public safety personnel are in second or third tier pension plans.

Recommendation 4A: The Cities should require all employees to pay the maximum employee contribution rate of a given plan.

The City has successfully negotiated with all but 6 employees (currently in negotiations) in the Fire Chiefs Association (FCA) to fully pay the Employee Contribution rate.

Recommendation 4B: Cities should require employees to pay some portion of the Past Service Cost associated with the unfunded liability in proportion to the Benefits being offered.

The City recently negotiated with all public safety employees (pending negotiation with the 6 FCA members) to pay 1% of the Employers Contribution rate for the next three years for a total of 3% in ongoing years. Most of the miscellaneous employees will pay an additional .5% for the next two years for a total of 1% ongoing. The City is negotiating with remaining miscellaneous employees in an association called UMPAPA (utilities management employees) to pay the same amount.

Recommendation 5: Cities should immediately work toward implementing policy changes and adopting measure aimed at making full OPEB ARC payments as soon as possible.

In addition to making the full OPEB ARC payment annually, the City has negotiated with a majority of employees that it will make a monthly flat monthly contribution with employees picking up the balance. Over the last three years, this has resulted in employees picking up one-half of the annual increase and employees moving to lower cost medical plans. This resulted in substantial premium savings for the City. The City is negotiating with remaining employee groups on moving to a flat monthly amount and is confident it will reach this goal.