**Attachment 1**

CITY OF MOUNTAIN VIEW

# MEMORANDUM

Finance and Administrative Services Department

**DATE:** April 27, 2017

**TO:** City Council

**FROM:** Patty J. Kong, Finance and Administrative Services Director

**VIA:** Daniel H. Rich, City Manager

**SUBJECT:** **CalPERS Discount Rate Change Funding Strategy**

## BACKGROUND

As discussed in the Midyear Budget Status Report, on December 21, 2016, the CalPERS Board approved the lowering of the discount rate from 7.5 percent to 7.0 percent. The reduction is to be phased in over three years beginning in Fiscal Year 2018-19 for local governments with the full impact reached in Year 7 (Fiscal Year 2024-25) due to the five-year ramp-up and ramp-down methodology previously adopted. The reduction will be phased in as follows:

| | |
|---|---|
| Fiscal Year 2018-19: | 7.375 percent |
| Fiscal Year 2019-20: | 7.25 percent |
| Fiscal Year 2020-21: | 7.0 percent |

The lowering of the discount rate will result in higher actuarial liabilities, which means the City, as well as other CalPERS agencies, will see significant increases in our normal costs and unfunded actuarial liabilities (UAL) annual payments. CalPERS has indicated the reduction will ultimately result in employer normal costs rate increases between 1.0 percent and 3.0 percent of payroll for most miscellaneous plans and increases of 2.0 percent to 5.0 percent for most safety plans. In addition, CalPERS is estimating an increase of 30.0 percent to 40.0 percent in UAL annual payments by Fiscal Year 2024-25.

## ANALYSIS

Staff has updated and revised the preliminary estimate based on CalPERS guidelines and an estimating model created by California Society of Municipal Finance Officers (CSMFO). The increase for the General Operating Fund is projected as follows (dollars in thousands):

| | **Year 1** **2018-19** | **Year 2** **2019-20** | **Year 3** **2020-21** | **Year 4** **2021-22** | **Year 5** **2022-23** | ***Year 6*** ***2023-24*** | ***Year 7*** ***2024-25*** |
|---|---|---|---|---|---|---|---|
| Estimate Safety Total Increase | $407 | 880 | 2,063 | 2,624 | 3,224 | 3,858 | 4,806 |
| Misc. Total Increase | 277 | 608 | 1,463 | 1,931 | 2,429 | 2,960 | 3,759 |
| **Total GOF Increase** | **$684** | **1,488** | **3,526** | **4,555** | **5,653** | **6,818** | **8,565** |

NOTE: Years 1 through 5 are based on information provided by CalPERS. Years 6 and 7 are based on staff estimates as CalPERS data is not yet available.

As shown above, the annual pension cost is estimated to increase $684,000 in Fiscal Year 2018-19 and rise to a projected increase of $5.7 million in Fiscal Year 2022-23. These estimates have been included in the Five-Year Financial Forecast. The costs will continue to rise for an additional two years with the ramp-up implementation to an ultimate *annual ongoing* increase projected at $8.6 million.

There are a variety of ways to plan for the impending rise in the City's CalPERS costs, some of which are as follows:

- Set aside funds now in a reserve fund for the expected cost increases to help soften the cost increases in future years.
- Place funds in a pension trust (e.g., PARS), again then using the funds to phase in cost increases.
- Pay down a sizable portion of the unfunded liability immediately to reduce the eventual cost increase for the amortization of the unfunded liability.

Setting aside funds now for the expected cost increase to phase in the costs allows the City to gradually build up to the ultimate cost increase, but does not address the unfunded liability. The City has made additional payments to CalPERS toward the unfunded liability over three fiscal years of $9.0 million ($7.5 million GOF and $1.5 million Other Funds). The unfunded liability has continued to grow due to changes in the discount rate, actuarial assumptions and methodology, and actual results not meeting assumptions.

The City's funded status as of June 30, 2015, the date of the most recent valuation, is 71.7 percent combined for both safety and miscellaneous. This compares to the funded status as of June 30, 2014 of 74.3 percent. The unfunded liability is estimated to be $191.4 million as of June 30, 2016 and increase to $194.0 million by June 30, 2017. The CalPERS valuations are two years behind so that rates can be provided to agencies well in advance for budgeting purposes. This also means that the contributions that were made in Fiscal Years 2015-16 and 2016-17 have not yet been reflected in the City's actuarial valuations. CalPERS will be providing the City's actuarial valuations for Fiscal Year 2018-19 this summer, which will include the implementation of the discount rate change for Fiscal Year 2018-19 and a forecast of rates for the following five years.

Staff recommends a strategy of continuing to make lump-sum payments toward the City's unfunded pension liability. Funds placed with CalPERS earn an assumed rate of 7.0 percent (currently 7.5 percent). If the unfunded liability can be reduced, this should also reduce the annual unfunded actuarial liability payment. The goal would be to reach at least an 80.0 percent funded status level. The City's General Fund represents approximately 81.0 percent of the CalPERS unfunded liability. Therefore, it is also recommended the Other Funds contribute their proportionate share toward this liability.

There are two strategies recommended to reach the funded status target of 80.0 percent. The first is to make a significant contribution, from a combination of available resources. These would be one-time available funds in order to make a one-time lump-sum pay down of the unfunded pension liability. For the current and next fiscal years, there are an excess of revenues over expenditures in the General Operating Fund. These are considered one-time as the surplus is not projected to continue for the duration of the Five-Year Financial Forecast. Staff recommends the following sources of funding:

| | |
|---|---|
| • GOF for Fiscal Year 2017-18 | $4.0 million |
| • GF Reserve | 6.3 million |
| • Compensated Absences Reserve | 1.9 million |
| • Capital Improvement Reserve | (2.2 million) |
| • Other Funds | 2.3 million |
| TOTAL | $12.3 million |

Currently, City policy is that the GF Reserve is 25.0 percent of GOF expenditures. Therefore, the balance grows each year as the budget grows. Over the last five years, the GF Reserve has increased from $23.9 million to $27.7 million. Changing the GF Reserve policy from a hard 25.0 percent to a range of 20.0 percent to 25.0 percent, with

20.0 percent being the minimum, could free up $6.3 million that would otherwise be needed to refill this reserve to the policy level of 25.0 percent. While it is prudent to maintain a healthy reserve, the GF Reserve has not been utilized extensively over the past 25 years and staff is comfortable with a 20.0 percent level.

A survey of cities indicates reserve levels ranging from 5.0 percent to 50.0 percent. One component of the ratings by Standard and Poor's (S&P) for the City is the level of City reserves. It is unknown if a policy change would impact the City's rating; however, there are several other AAA-rated cities (including Campbell, Milpitas, Palo Alto, and Sunnyvale) with a GF reserve level of 20.0 percent or less. Another factor S&P takes into consideration is the City addressing its unfunded obligations (e.g., pension, retirees' health, etc.).

On April 4, 2017, staff presented to the Council Finance Committee (CFC) the CalPERS unfunded liability strategy and the recommendation to reduce the GF Reserve and Compensated Absences levels. The CFC unanimously supported the concept of reducing the unfunded pension liability, but requested alternatives to the changes to the GF Reserve and Compensated Absences Reserve policies. Alternatives proposed to achieve the same total contribution to CalPERS are as follows (dollars in thousands):

| | Status Quo | Recommended | Option 1 | Option 2 |
|---|---|---|---|---|
| GOF Balance Estimated | $18,410 | 18,410 | 18,410 | 18,410 |
| PERS/OPEB/SPAR | (6,000) | (6,000) | (6,000) | (6,000) |
| Estimated Available Balance for FY 2017-18 | 12,410 | 12,410 | 12,410 | 12,410 |
| Recommended Allocations | | | | |
| Limited Period Exp.—New | 2,709 | 2,709 | 2,709 | 2,709 |
| Capital Outlay—New | 352 | 352 | 352 | 352 |
| General Fund Reserve | 3,160 | (3,171) | 3,160 | 3,160 |
| Compensated Absences Reserve | 2,412 | 550 | 2,412 | 2,412 |
| CIP Reserve | 1,777(1) | 3,970(1) | -0- | (3,000) |
| CalPERS | 2,000 | 6,000 | 6,000 | 6,000 |
| Retirees' Health (OPEB) | -0- | 2,000 | 777(2) | 777(2) |
| SPAR | -0- | -0- | (3,000) | -0- |
| Total Uses | $12,410 | 12,410 | 12,410 | 12,410 |

(1) Recommend any balance remaining be allocated to the Capital Improvement Reserve up to $4.0 million based on the actual balance available after the fiscal year-end close.
(2) Recommend any balance remaining be allocated to Retirees' Health up to $2.0 million based on the actual balance available after the fiscal year-end close.

Recommendation—Reduce the funding level of the GF Reserve from 25.0 percent to a range of 20.0 percent to 25.0 percent of net (net of budget savings) adopted expenditures and Compensated Absences Reserve from fully funded to a minimum of 80.0 percent funded.

Option 1—In lieu of using the GF and Compensated Absences Reserves, this strategy fully funds those reserves and instead utilizes $4.0 million that would be available for capital projects, transfers $3.0 million from the Strategic Property Acquisition Reserve (SPAR), and reduces the contribution to Retirees Health to the balance available up to $2.0 million, currently estimated at $777,000. There is an additional $2.0 million each recommended to the Retirees' Health and SPAR in the GOF Fiscal Year 2017-18 budget.

Option 2—Same as Option 1, but transfer $3.0 million from the CIP Reserve instead of funding the additional $3.0 million from the SPAR.

A combination of the options could also be selected to achieve the goal of $10.0 million from the General Fund. If the Council chooses to use the GF Reserve or the Compensated Absences Reserves, then staff would return with modifications to Council Policy A-11, Financial and Budgetary Policy.

Google Amphitheatre Lease Parking Revenues

Currently, Google subleases Parking Lots C and D from SFX (Live Nation) and this agreement ends mid-December 2017. In March 2017, the City Council approved Google's request for a three-year extension of the sublease through December 2020 for a $600,000 one-time payment to the City, which was received in early April 2017. The $600,000 is recommended to be transferred to the CIP Reserve. It is anticipated the Certificate of Occupancy for the Charleston East development will be issued before the end of the three-year period and commencing no later than January 1, 2021, Google will begin a five-year lease of the parking lots at that time starting at approximately $2.3 million annually (with 4.0 percent annual increases).

As this is limited-period revenue, another recommended strategy to pay down the City's unfunded pension liability is to use $2.0 million annually of this revenue received from Google over the five years of the lease for an additional $10.0 million contribution to CalPERS. The $10.0 million could be borrowed from another reserve(s) to make a lump-sum payment, or the contributions could be made annually from 2021 to 2025 as the revenue is received, or they could be placed in a reserve for this purpose and used after 2025 when the total funds are accumulated. Staff will return prior to the commencement of the five-year lease with a recommendation for the funds.

With the recommended contributions, the City would be effectively contributing over 10.0 percent of the unfunded liability with the goal of raising the funded status level to over 80.0 percent, which was the funding status prior to this last recession when the pension fund sustained substantial losses. By making significant payments earlier than required, and reducing the unfunded liability, the City will receive a better rate of return than if it were to keep the funds in our reserves and will save on long-term obligations.

Beginning in Fiscal Year 2021-22, the balance of the annual lease payment can be transferred to the CIP, another reserve, or other limited-period uses. Over the five-year period, the funds not recommended for CalPERS, is anticipated to total $2.2 million.

## SUMMARY

The City continues to face challenges in its pension obligation as CalPERS sustained substantial investment losses during the Great Recession, makes changes in actuarial methods and demographic changes, and reductions in the discount rate. These factors have all contributed to the continued rise in the City's pension obligation, not only in its unfunded liability, but also in its annual pension expense. It is possible CalPERS will continue to make policy changes that will negatively impact City costs. Staff is recommending a strategy to achieve a funding level of approximately 80.0 percent. To achieve this funding level there are a variety of sources, one-time or limited-period available funds, recommended to contribute significant lump-sum payments toward this unfunded liability.

Staff is requesting direction from Council for the following:

1. Approve staff's recommendation to make significant lump-sum contributions toward a goal to achieve a funding level of approximately 80.0 percent.

2. Of the sources of reserve funds available provide direction:

   a. Recommended—Reducing the policy level of the GF Reserve from 25.0 percent to a range of 20.0 percent to 25.0 percent and reducing the policy level of the Compensated Absences Reserve from being fully funded to a minimum level of 80.0 percent funded.

   b. Option 1—Fully fund the GF Reserve and Compensated Absences Reserve and reduce funding of the Capital Improvements Reserve and Retirees' Health Reserve from the available balance, and transfer $3.0 million from the Strategic Property Acquisition Reserve; current balance is $9.5 million.

c. Option 2—Same as Option 1, but transfer $3.0 million from the Capital Improvement Reserve; estimated balance is $14.8 million.

3. The future Google parking lease revenues are recommended for an additional $10.0 million in payments to CalPERS toward the City's pension obligation. The balance above the $10.0 million, anticipated to be $2.2 million after five years, is recommended to be transferred to the CIP.

If the City can contribute the funds as recommended in this memo, this is estimated to raise the funding level up to over 80.0 percent initially and reduce the unfunded liability by over 10.0 percent. It is estimated this would reduce the annual amortization of the UAL payment by approximately $2.6 million by time of the full implementation in Year 7.

PJK/2/FIN
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