



CITY OF PACIFIC GROVE
300 Forest Avenue, Pacific Grove, California 93950

AGENDA REPORT

TO: Honorable Mayor and Members of City Council
FROM: Bill Peake, Council Member
MEETING DATE: February 17, 2016
SUBJECT: Pension Finances
CEQA STATUS: Does not constitute a "Project" under California Environmental Quality Act (CEQA) Guidelines

SUMMARY

On August 12, 2015 an Ad hoc Committee consisting of Mayor Kampe and Councilmembers Fischer and Peake was appointed to analyze issues for future presentation to CalPERS. The attached document is a result of committee efforts. Additional committee reports can be found in this meeting agenda under Reports from Council Members.

The document concept and actuarial expertise was provided by John Bertko. Don Murphy provided valuable editing. Patty Maitland graciously answered many questions and provided CalPERS materials. Their assistance is much appreciated.

Please have members of the public contact the City Clerk if they are interested in a town hall presentation.

ATTACHMENTS

1. Pension Finances City of Pacific Grove, February 17, 2016

RESPECTFULLY SUBMITTED:

Bill Peake

Bill Peake, Council Member

PENSION FINANCES CITY OF PACIFIC GROVE

BILL PEAKE, COUNCIL MEMBER

FEBRUARY 17, 2016

Acknowledgements:

- John Bertko, FSA, MAAA
- Don Murphy, Planning Commissioner

Disclaimer: Any views or opinions presented in this document are solely those of the author and do not necessarily represent those of the City of Pacific Grove.

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Summary

No single number or statistic can adequately describe the City's pension finances. Admittedly it is a complex subject. Given that, this document attempts to break it down into digestible pieces. And at the risk of over-simplifying, a few salient thoughts are provided below.

The City makes payments every year to: 1) cover current employee pension benefits earned in that year; 2) reduce unfunded pension liability; and 3) repay the pension bond. This year, these payments total \$3.8 million or 21% of General Fund revenue. That is a significant part of the City's discretionary budget and has limited other City services.

Annual pension costs will slowly increase by \$1.7 million during the next six years, to \$5.5 million by Fiscal Year 2021-22. The increase is driven by CalPERS requirement that the City pay off a \$23 million unfunded pension liability.

As a result, absorbing this increase over the next few years will severely strain the City's ability to pay for resident services and maintain city infrastructure. Additional cost cutting and revenue measures (including taxes) need to be considered to manage the increase.

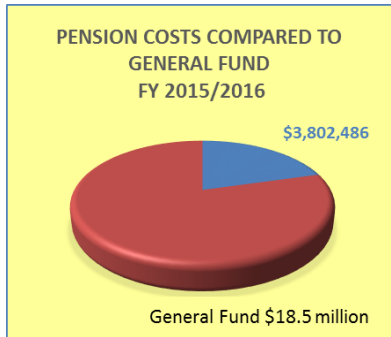
After this ramp up in costs, unfunded liability payments should flatten and eventually end in 30 years. Also pension bond payments will drop by \$0.5 million in Fiscal Year 2022-23 and end in 2029. As a consequence, future pension cost increases will be significantly less than they are today.

The longer term outlook for managing pension costs is also eased due to: lower pension benefits for new City employees, a smaller city workforce, and fewer retirees receiving higher benefits. And there is the possibility of statewide pension reform providing more flexibility to cities' retirement programs.

You are encouraged to read further to form your own opinion. Please send any questions or comments to me at bpeake@cityofpacificgrove.org or 300 Forest Avenue, Pacific Grove, CA 93950.

1. How much do pensions cost?

Pacific Grove's Fiscal Year 2015-16 pension cost is \$3.8 million (fiscal year is from July 1 to June 30). Of that, 30% is for police and fire (safety employee) pensions, 21% is for non-safety (miscellaneous) employee pensions and 49% is the pension obligation bond payment. City payments to California Public Employee Retirement System (CalPERS) for employee pensions are called 'employer contributions'.



Pension costs are 12% of all city revenues (\$32 million) or 21% of General Fund revenues (\$18.5 million).

In addition to employer contributions described above, employees also make payments to CalPERS. Employees contribute from 9% to 12% of their salaries to their pension plans.

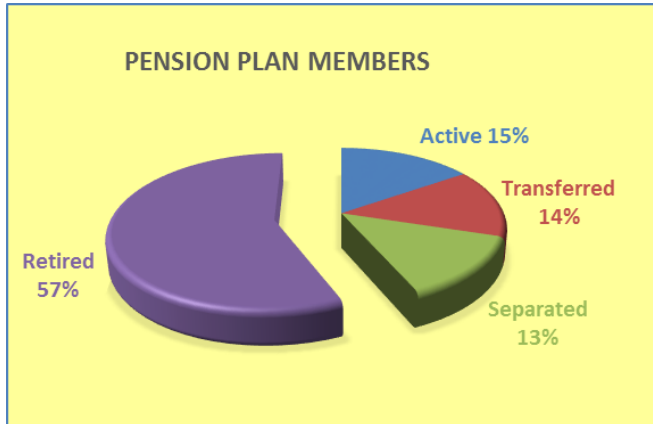
References:

1. CalPERS Annual Valuation Reports as of June 30, 2013 for Classic and PEPRSA Safety and Miscellaneous Plans of the City of Pacific Grove
2. City of Pacific Grove Recommended Operating and Capital Project Budget Fiscal Year 2015-16

2. Who receives pension benefits?

Payments are made on behalf of 416 pension plan members (as of June 30, 2014). Members are employees or former employees and beneficiaries who have pension benefits administered by CalPERS.

The status of members are:

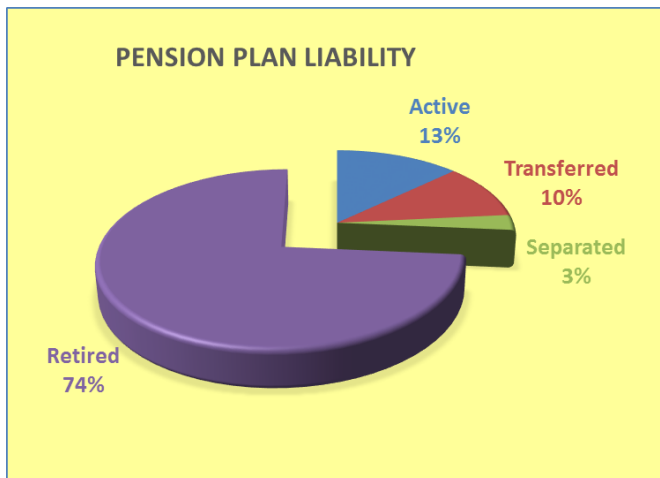


'Active' means current employees.

'Transferred' are former Pacific Grove employees working for other cities/agencies within CalPERS.

'Separated' are former Pacific Grove employees working for non-CalPERS employers and/or have not yet reached retirement benefits age.

City pension plan liability is distributed among members in proportions shown below.



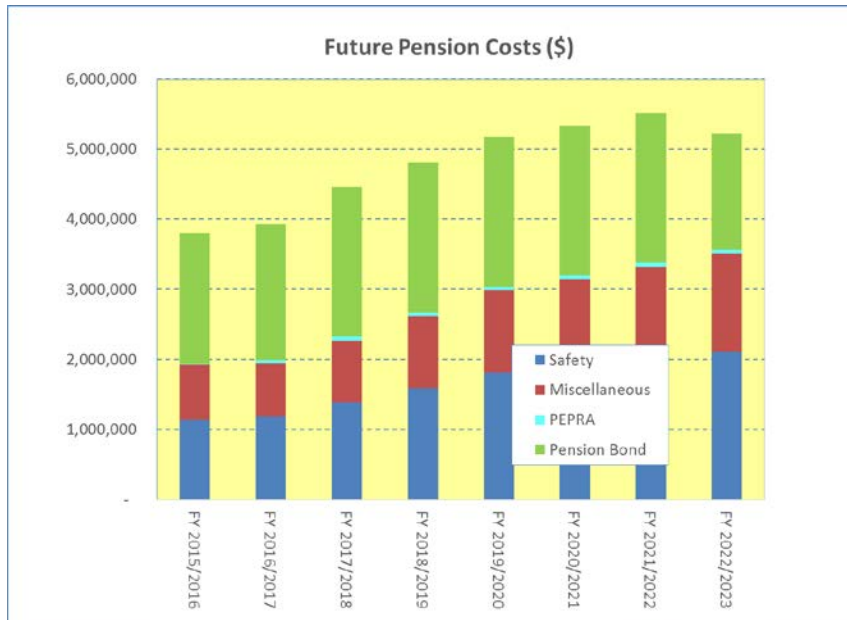
References:

1. CalPERS Annual Valuation Reports as of June 30, 2014 for Classic and PEPRSA Safety and Miscellaneous Plans of the City of Pacific Grove
2. City of Pacific Grove Recommended Operating and Capital Project Budget Fiscal Year 2015-16
3. Barbara Ware, CalPERS letter to Bill Kampe, Mayor, and Tom Frutchey, City Manager, November 20, 2015

3. How fast are pension costs rising?

Pension costs are expected to rise approximately \$1.7 million during the next six years before finally beginning to fall. This rise is significant when compared to General Fund revenue. The rise is mainly a result of a CalPERS policy to ramp up payments for paying off unfunded pension liability. Unfunded pension liability payments are amortized over 30 years.

Pension costs begin to fall in Fiscal Year 2022-23 due to a smaller pension bond payment. The pension bond is completely paid off in 2029 resulting in a \$1.6 million decrease in pension costs.



A word of caution about this forecast. Pension costs can be unpredictable. Some cost variables are within city control, such as the number of full-time workers, wages and benefits. But others result from CalPERS decisions and may change over time. Those variables include return on asset investments, actuarial assumptions and methods, and management goals of the pension system.

Market performance, over which the City and CalPERS have little control, plays a large role in future pension costs. CalPERS, however, does control the investment asset mix. For example, more fixed-income assets provide a more stable income, but would likely have a lower average yield.

Details on the five-year pension cost forecast can be found in Appendix – Pension Cost Forecast.

References

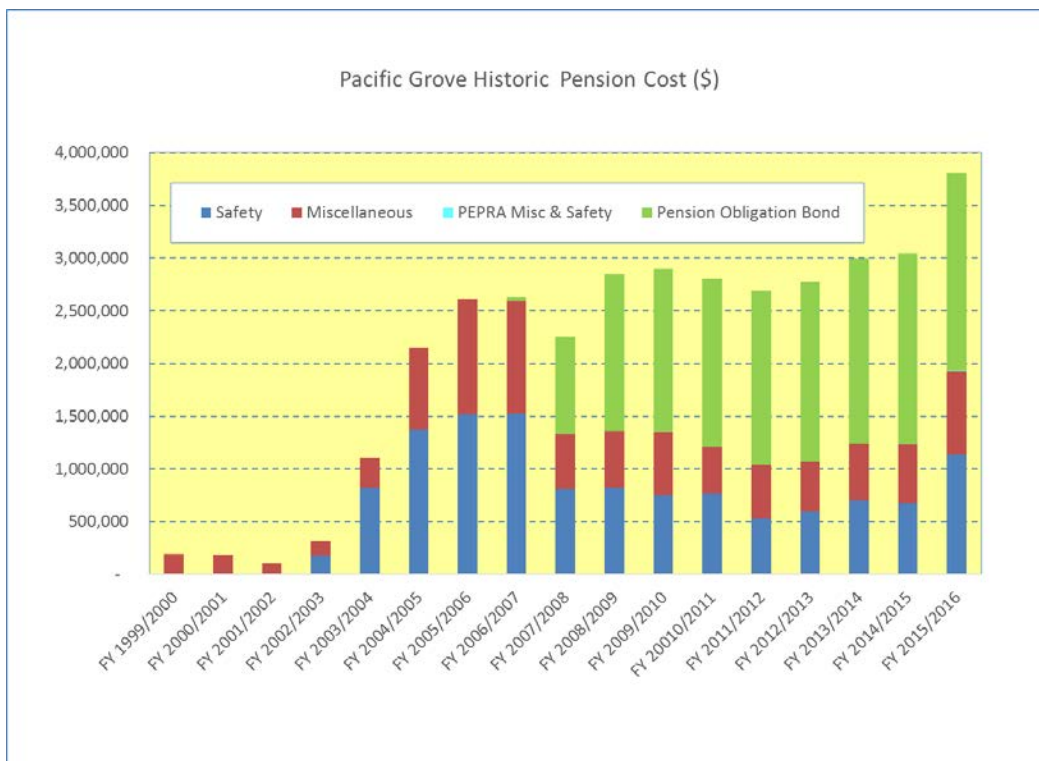
1. CalPERS Actuarial Valuation as of June 30, 2014 Classic and PEPR Safety and Miscellaneous Plans of the City of Pacific Grove
2. City of Pacific Grove Independent Auditor's Report and Financial Statements, June 30, 2013

4. How did pension costs get so high?

The largest increases in city pension costs occurred after a series of missteps by CalPERS and the City.

At the end of the 1990s, the stock market was at an all-time high, the tech industry created a “bubble” and optimism reigned among investors. At that time CalPERS reduced city payments because pension assets generally exceeded liabilities. CalPERS assumed future investment returns that in retrospect were too high, which in turn underestimated future liabilities. Thus, sufficient annual contributions were not collected from cities and workers.

The City meanwhile did not question adequately the estimate of future pension liabilities and hired more employees and increased pension benefits retroactively. For example, in 2002, the City increased pension benefits with the mistaken assumption of a minimal increase in annual CalPERS payments. Only later, in 2004-06, was the implication of these actions realized. See below for a history of the rise in pension costs.



Pension costs rose by \$700,000 in Fiscal Year 2015-16 as a result of a CalPERS decision to reduce unfunded pension liabilities.

Changes in demographic (actuarial) assumptions are also driving up pension costs. The most significant of these is the improvement in post-retirement mortality — acknowledging greater life expectancies and expected continued improvements in life expectancy.

References and details of the past City pension payments can be found in Appendix - Pension Payment History.

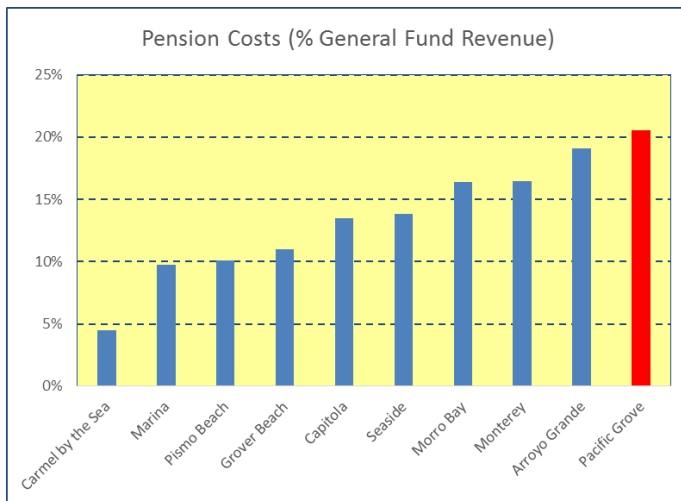
5. How do PG pension costs compare to other cities?

The characteristics — size, services, economy, etc. — of California cities differ widely. Because of this, a group of ten central coast cities with similar characteristics was chosen for comparison: Arroyo Grande, Capitola, Carmel by the Sea, Grover Beach, Marina, Monterey, Morro Bay, Pismo Beach, and Seaside.

In terms of population, area, location, city services, and revenue, Pacific Grove is about average for the group. In many aspects of pension finances it also appears average. For example: pension benefit formulas such as 3% pay per year of service after age 50 is common for police in most cities. Another metric is the number of pension plan members per 1,000 residents. The range for all cities is 14 to 75 and Pacific Grove is about average at 27.

Where Pacific Grove departs from average includes the ratio of retirees to current employees. Pacific Grove has the highest ratio at nearly three retirees per current employee. This ratio will decrease as the number of retirees declines through attrition.

Pacific Grove is above average in the percentage of its budget devoted to pension payments (including pension obligation bonds). At 12% of all city revenue, Pacific Grove is the highest. At 21% of General Fund revenue, Pacific Grove is also the highest. (Comparison uses June 30, 2013 costs.)



Pacific Grove’s unfunded pension liability is near the top of the group when compared to total City annual revenue (75%) and General Fund annual revenue (130%). These metrics do not include the remaining pension obligation bond payments, but if they did, Pacific Grove would still be the highest.

References and additional details are in Appendix – Comparison to Other Cities.

6. What has been done to reduce pension costs?

Actions the City has taken since 2006 to reduce pension costs include:

1. Reduced the workforce, e.g. early retirement and layoffs (see Appendix – City Staffing)
2. Contracted services, e.g. fire, golf, building inspection, museum
3. Shared services, e.g. police chief (but since reverted to full time chief)
4. Negotiated staff concessions, e.g. small raises and larger employee pension payments
5. New hires have lower pension benefits as a result of the California Public Employees' Pension Reform Act of 2013 (PEPRA)
6. Reduced CalPERS membership by changing full-time to part-time positions

The City Council passed Resolution 10-055 on July 21, 2010, to place Measure R on the Nov. 2, 2010, ballot to allow for voter-approval of retirement benefits. The City Council also approved Ordinance 10-021 on Aug. 18, 2010, limiting City employee retirement benefit payments to 10% of pay. A Monterey County Superior Court judge on June 18, 2013, found both to be in violation of the Contracts Clause of the California Constitution.

A citizens' initiative for the Nov. 5, 2013, ballot proposed a pension measure to void Ordinance 02-18. The purpose was to reverse the 3% at 50 pension benefit approved by that ordinance in 2002. A Monterey County Superior Court judge ruled on June 26, 2014, that the proposed ballot measure was unlawful.

A state initiative: "The Pension Reform Act of 2014" was proposed by Mayor Bill Kampe, et.al. It sought to supersede court decisions construed as limiting the ability to modify pension and retiree healthcare benefits for work not yet performed by government employees. Due to an unfavorable title and summary written by the state Attorney General's office that diminished the initiative's chances of success, the initiative was withdrawn.

References:

1. Tom Frutchey, personal communication, 2015
2. Kevin Howe, Monterey County Herald, Police file suit over retirement cap, Nov. 17, 2010
3. Monterey County Superior Court Statement of Decision, Case No. M109123, June 18, 2013
4. Ballotpedia.org/ Pacific Grove City Initiative To Void Ordinance 02-18 Pension Increase (November 2014)
5. Ballotpedia.org/ California Pension Reform Initiative (2014)

7. What else can be done to reduce pension costs?

The City has some ability to control the size of its payroll and the amount of future pension benefit accruals. They were described previously. The simplest and easiest steps to do this have already been taken. Further steps would affect only future liabilities and costs, not lower current obligations.

The City can work with state legislators, the League of California Cities, and other California agencies (cities, counties) to promote pension reform legislation. The Public Employees' Pension Reform Act of 2013 (PEPRA) was a good step forward. Additional reform could include increased flexibility in providing public employee retirement benefits to new employees, such as allowing a defined contribution retirement plan.

Two November 2016 ballot initiatives were proposed to (1) put new public employees into a defined contribution pension plan and (2) cap employer contributions to pension plans. Both initiatives have been supported by Mayor Bill Kampe. Recently, however, proponents of the measures postponed their attempt to place to a state-wide vote until 2018.

A better understanding of actuarial assumptions and methodology used by CalPERS may help the City reduce pension costs. A dialog with CalPERS was initiated in late 2015 to start this process.

More emphasis on reporting and consideration of pension liabilities could improve future City decision-making. Examples where this might occur are:

- Approval of staffing levels during budget cycle
- Labor agreements
- Hiring (employee pension rights are acquired when a job offer is accepted)

The Governmental Accounting Standards Board has recognized the need for to improve pension accounting and financial reporting by state and local governments. It recently issued Statement No. 68 (GASB 68) that generally requires pension liabilities be explicitly included in agency financial statements. CalPERS can provide GASB 68 data to the City.

References:

1. Jon Ortiz, Sacramento Bee, California pension overhaul advocates move forward after Kamala Harris issues analyses, December 10, 2015
2. Ballotpedia.org/California Public Vote on Pensions Initiative (2016)
3. Barbara Ware, letter to Bill Kampe, November 20, 2015
4. 'Measure to curb California public pensions is pulled – for now', The Sacramento Bee, January 18, 2016
5. P. Maitland, Annual Financial Audit Report for the Fiscal Year Ended June 30, 2015, Pacific Grove City Council Agenda Item 13A Report, November 18, 2015
6. http://www.gasb.org/jsp/GASB/Pronouncement_C/GASBSummaryPage&cid=1176160219492

8. Have pension benefits or costs been challenged?

Attempts by California cities and counties to reduce costs through modification of pension benefits have been unsuccessful. When reductions have been adopted, they have been successfully challenged in court on the basis of the California Contract Clause. The so-called 'California Rule' gives constitutional protection to pension benefits when an employee first accepts employment.

As an example, in 2012 San Diego voters approved a defined contribution pension plan for new public employees. The California Public Employment Relations Board (PERB) recently ordered the city to ignore the 2012 ballot measure. The issue is expected to go before a PERB review panel and end up in the courts.

Even though several California cities have recently gone through bankruptcy proceedings, no city has yet reduced its payment to CalPERS. CalPERS has argued that state law prevents lowering city or county pension payments through bankruptcy. However, during Stockton's bankruptcy proceedings, the chief federal bankruptcy judge suggested that pension benefits may be impaired in federal court. To date Stockton has not elected to do so.

References

1. R.A. Blum, et.al., Pension Reform Act Implementation Issues, League of California Cities, 2013 Spring Conference, Napa, May 9, 2013
2. Editorial Can employees' pension benefits be cut?, Los Angeles Times, October 30, 2014
3. David Garrick, 'Labor relations board rules against San Diego's pension cutbacks', Los Angeles Times, January 1, 2016
4. <http://www.perb.ca.gov/decisionbank/pdfs/2464M.pdf>

9. What is CalPERS?

The California Public Employee Retirement System (CalPERS) resides in the Government Operations Agency of the Executive Branch of state government. Its stated mission is: Provide responsible and effective stewardship of the System to deliver promised retirement and health benefits, while promoting wellness and retirement security for members and beneficiaries.

CalPERS is overseen by a 13 person Board of Administration. Six directors are elected by CalPERS members, i.e. current or former public employees, usually with labor union support. Three directors are appointed; two by the Governor and one by the Legislature. The remaining four directors are ex officio: State Treasurer, State Controller, Director of Ca. Dept. Human Resources and State Personnel Board designee. Board terms are 4 years. Tenure on the current Board ranges from 1 to 16 years.

The California Constitution and Government Code vests in the CalPERS Board of Administration management and control of the Public Employees' Retirement System among other state benefit and retirement programs. Article 16, Section 17 of the state Constitution reads: "retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system ..." Further it states: "A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty."

The Board of Administration appoints: chief executive officer, chief investment officer, chief actuary, and general counsel. The executive officers have responsibility for: forming and implementing policy and managing pension funds. CalPERS has a staff of 2,765, including actuaries and pension administrative staff, and its annual operating budget is approximately \$2 billion.

CalPERS has a long history of engagement in state policies on retirement and health benefits for its members and beneficiaries. CalPERS policies are well promoted so as to ensure they are considered by state and federal policymakers. It is CalPERS policy to defend and promote defined benefit programs.

CalPERS administers pension and benefit plans for 3,093 public agency and school district employers. 1,716,000 people are enrolled in CalPERS pension and benefit plans.

CalPERS total funds market value was \$289 billion as of December 31, 2015.

References:

1. www.calpers.ca.gov
2. CalPERS Facts at a Glance, November 2015
3. CalPERS Legislative and Policy Engagement Guidelines, March 18, 2015

10. What is the relationship between Pacific Grove and CalPERS?

The City of Pacific Grove signed a contract effective Feb. 1, 1957, to participate in the State Employees' Retirement System. Since then, the contract has been amended eight times and includes changes to safety and/or miscellaneous employee retirement benefits. The most recent amendment in 2014 was a result of CourseCo's management and operation of the golf course.

The contract stipulates:

1. All city employees are members of the Public Employees' Retirement System subject to all provisions of the Public Employees' Retirement Law.
2. City shall make CalPERS payments, i.e. contributions, as determined by actuarial valuation.
3. City shall make additional payments as determined by CalPERS and required by Retirement Law.

CalPERS provides to the City annual actuarial valuation reports describing: market value of assets, accrued actuarial liabilities and payments to CalPERS for the upcoming fiscal year. Valuations are as of the end of the fiscal year (June 30) and are usually available 16 months later. Recent city valuation reports can be found on the CalPERS website under the heading 'Employers' followed by 'Search Actuarial Reports' then enter 'Pacific Grove'. The procedure for downloading a risk pool report (Section 2) is explained on the first page of the city valuation report.

References:

1. Pacific Grove City Council Agenda Report 'Second reading of ordinance to amend the CalPERS contract to provide §20903 2-year service credit', May 7, 2014
2. www.calpers.ca.gov

11. Has any city ever left CalPERS?

A relatively small number of public agencies have terminated their contract with CalPERS. CalPERS manages a Terminated Agency Pool (TAP) to hold assets for payments to retirees and beneficiaries from terminated agencies.

CalPERS valuation reports provide each city with a hypothetical termination liability. Termination liability and market value of assets determine the cost to terminate the CalPERS contract. CalPERS makes conservative actuarial assumptions, which include a lower discount rate reflecting only current (low) yields on safe investments, to arrive at the termination liability.

The discount rate is dependent on 10-year and 30-year US Treasury yields in effect at the time of termination (which are at historically low levels today, which mean that the termination liability is much higher than the long-term pension liability calculated using long-term yield assumptions).

As a result, Pacific Grove's termination liability, i.e. payment, could be in excess of \$100 million. At this cost, it is not practical to consider this termination option.

References:

1. CalPERS Investment Committee Meeting Agenda Item, 'Terminated Agency Pool Program Update', December 15, 2014
2. US Bankruptcy Court Eastern District of California, Case No. 12-32118-C-9, City of Stockton, CA Debtor, Opinion Regarding Confirmation and Status of CALPERS, February 4, 2015
3. CalPERS Annual Valuation Reports as of June 30, 2014 for Classic and PEPRA Safety and Miscellaneous Plans of the City of Pacific Grove

12. How is pension liability determined?

Pension liabilities are the “present value” of future obligations to pay pensions to each qualified recipient who has earned this payment due to vesting as a member in CalPERS after five years of service.

For a retiree, the present value calculation is done by taking the stream of benefits (e.g., \$1,000 paid each month following retirement at age 65 to the beneficiary’s month of death) and “discounting” the benefits using mortality and interest to determine today’s value. So a present value of \$1,000 to be paid five years from now to a retiree might be only \$695 today, assuming a discount rate of 7%.

Another way of stating this is that if the City needs to pay \$1,000 five years from now, it would set aside the “present value” of \$695. Assuming the City could earn 7% each year on average, then the City would have \$1,000 to pay the obligation in 5 years.

Thus, a retiree who has a pension of \$1,000 per month would create a pension liability of a stream of discounted pension obligations that could be \$1,000 for January 2016, \$994.17 for February 2016, \$988.37 for March 2016, etc. for the remainder of his or her life. The sum of these obligations is the pension liability for that person as of Jan. 1, 2016.

Interest rates are likely to vary greatly over the decades of the calculation. But, an average interest rate is used such as 7.5% per year (this is the current value used by CalPERS, with its enormous portfolio of diverse assets). When this interest rate assumption decreases, then “discounting” is less, so the pension liability increases. The present value is also “discounted” to account for the likelihood of dying at each age in the future. While mortality is very low for someone in his/her 60s, but at age 90 mortality becomes very high (e.g., a one-third chance of dying in any year above age 95).

For an active employee, the pension benefit must be projected to retirement age from his/her current age, using (1) an assumption about how much salary will increase over the next decade (or more), (2) expected retirement age (e.g., 60 for many employees but can be lower) and (3) pension benefit formula such as 3% of highest salary @50 years of age. Once this expected benefit payout is calculated, then the payment stream is discounted to the present value as described above. Note mortality assumptions are factored in here.

For the City, the present value for each retiree and each employee who is accruing pension benefits is summed up to calculate the overall pension liability for the City.

However, if assumptions change, such as: pension benefits increase, discount rate decreases, life expectancy increases, then the City’s pension liability can increase unpredictably and to a significant degree.

13. How is pension cost determined?

The annual pension cost for an employer (city) is a complex calculation starting with several items:

- The total pension liability, using the present value calculation described in “12. How is pension liability determined?”
- Total assets accumulated to pay for pensions at that point in time (assets may be sufficient, more than needed or insufficient due to both prior funding and likely future earnings of these assets)
- The actuarial method used to calculate an amount to contribute to the assets each year. Different possible methods take different “paths” to sufficient funding, some requiring greater contributions in earlier years, some requiring a constant amount, others requiring a constant percentage of salaries of active employees and still others which may “back-load” payments so that higher payments are made in future years.

Usually, once an “actuarial funding method” is chosen, then the employer and consultant (CalPERS actuaries in the case of the City) maintain that funding method for many years.

CalPERS uses the “Entry Age Normal Cost Method” to determine the annual contribution for each individual employee. This method is meant to have the pension plan member’s annual cost (the annual amount to be funded by a contribution of employer and employee contributions) set to be a level amount (either as a level dollar amount or a level percentage of salary) from date of hire to assumed date of retirement.

In addition to normal cost, cities are responsible for any shortfall in funding or any gains from, say, underestimating earnings on assets or differences in other assumptions, like mortality. Recently CalPERS adopted a dollar methodology to amortize any gains or losses over 30 years.

Thus, if earnings on the City’s assets were to be too low in a given year by, say, \$100,000, then this shortfall (difference from the assumed rate of return) would be amortized over 30 years (akin to a 30-year mortgage) and an additional contribution of around \$967 each year for the 30 years (interest accumulation would make up the additional \$70,000 over the 30 year period to get a total of \$100,000).

14. How does risk pooling affect pension costs?

Risk Pooling mainly “smoothes out” the City’s funding contribution so it doesn’t jump up or fall off abruptly from year to year. In the end, costs/liabilities are determined only by City employees/retirees and their pension formula. Over the very long run pooling probably doesn’t help or hurt City pension costs to a significant degree.

Risk pooling is the process of combining assets and liabilities across employers to create large, risk sharing pools. The purpose of pooling is to protect small employers against large cost fluctuations due to unexpected demographic events. CalPERS sponsored legislation that mandated all employers with less than 100 active plan members must join a risk pool. Risk pooling was implemented with the June 30, 2003 actuarial valuations. Once in a risk pool an employer can never leave the pool.

The pool’s pension liability is comprised of all of the individual employee or retirees’ pension plan liabilities. The plan (or city’s) liability is calculated by plan member (employee) given actuarial methodology and assumptions described earlier. After joining the pool, the pool’s gains or losses and impact of assumption changes are allocated to the individual plans within the pool.

Allowances are made to account for differences in employer retirement benefits such as optional cost-of-living-allowances (COLA). Plans (or cities) with higher COLA benefits pay a surcharge to the pool’s normal contribution rate. Risk pooling was reviewed in 2012 in an attempt to demonstrate equitable treatment for all agencies.

In risk pooling, all assets accumulated by the City are invested with the assets from all other agencies in the pool. These assets comprise the giant CalPERS Public Employees Retirement Fund (PERF). In general, the bigger the pool of funds, the more diverse kinds of assets are held (e.g., bond funds, stock funds, real estate, hedge funds, international assets, etc.). By pooling diverse assets together, it is believed that the overall performance of the asset pool will have higher returns, be more stable, and thus less subject to year-to-year variation.

References:

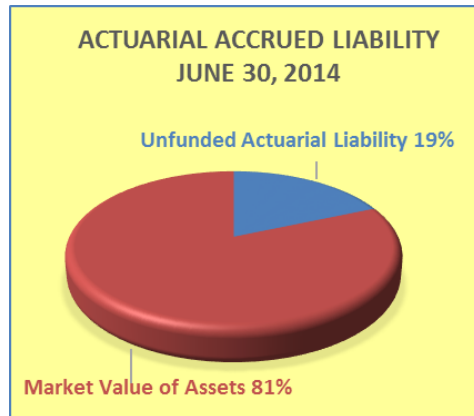
1. CalPERS Risk Pooling Review Report, June 2012
2. CalPERS Circular Letter, ‘Changes to Pension Risk Pooling as a Result of Pension Reform’, June 5, 2014
3. CalPERS Risk Pooling, August 11, 2015

15. What is unfunded liability?

Unfunded liability is the difference between the total pension liability due to be paid out to all current retirees and to active employees at their retirement and the assets held by CalPERS that have been accumulated by the City over the last few decades.

As of June 30, 2014 (the latest date for which data is available) Pacific Grove's:

- Actuarial Accrued Liability is \$124,030,197
- Market Value of Assets is \$101,006,685
- Unfunded Liability is \$23,023,512



In a perfect world, the unfunded liability in any year would be near zero; however, with the ups and downs of the stock and bond market and due to past funding practices, there frequently is an unfunded liability (i.e., a shortfall of assets to cover all pension liabilities) today for many cities and other government entities that use CalPERS (and similarly in other states).

This unfunded liability must be reduced over a long period of time – before the payment obligations are due. This may be done by: (1) additional funding, (2) higher than assumed asset returns or (3) reductions in benefit accruals for current active employees. Details follow.

(1) CalPERS obtains additional funding by increasing payments from public agencies, i.e. employers such as the City.

(2) To a large degree CalPERS cannot control asset return.

(3) Reductions in benefit accruals for active employees is not viable unless promises made to public employees and retirees are broken.

16. What is OPEB?

Unlike other California cities, management of Pacific Grove's OPEB is not contracted to CalPERS and healthcare post-retirement benefit is capped. Thus, OPEB liability has not risen dramatically as in other cities. In many cities OPEB liability is \$300,000 per retiree. Compared to this value, Pacific Grove's OPEB liability is relatively small.

Other post-employment benefits (OPEB) is an accounting/actuarial concept that allows for the reporting of employer liability due to retirement benefits other than pensions. OPEB can include medical, pharmacy, dental, vision, life, long-term disability and long-term care benefits and deferred compensation.

City employees are eligible for post-retirement medical benefits upon reaching the age of 50 with a minimum of 5 years of service. The City contributes the minimum amount provided under Government Code Section 22825 of the Public Employees Medical and Hospital Care Act (\$115 per month in 2013).

The City also pays an additional \$150 per month for the first five years after retirement, or until age 65, whichever is sooner (Police officers require 20 years of service to receive the 5-year benefit.) Retirees must contribute any premium amounts in excess of the City contributions described above.

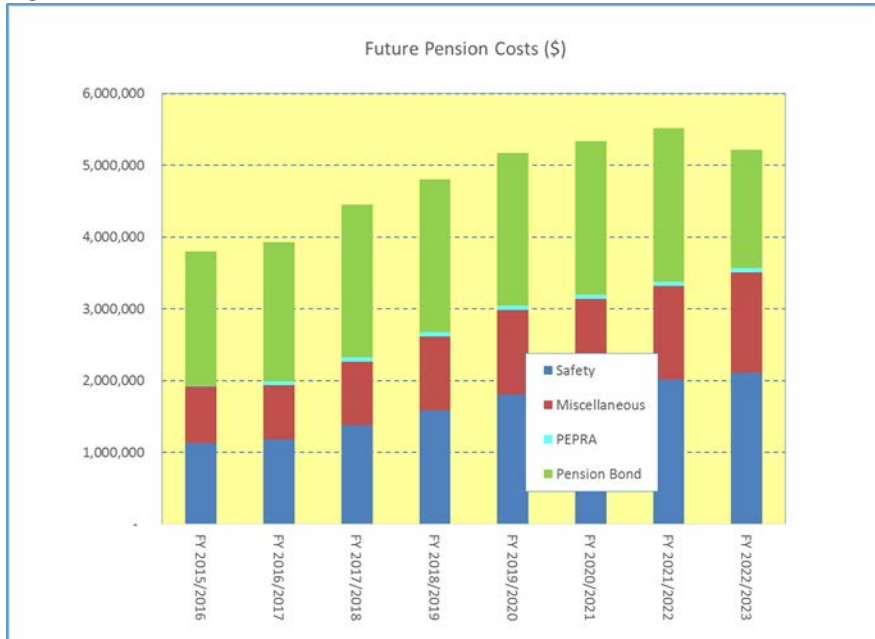
The City administers the retirement healthcare plan and does so on a pay-as-you-go accounting basis. For Fiscal Year 2014-15 OPEB cost was \$214,713. As of June 30, 2015, OPEB unfunded actuarial accrued liability was \$2,854,479.

References:

1. www.en.wikipedia.org/wiki/Other_postemployment_benefits
2. Chavan and Associates, LLP, 'City of Pacific Grove Annual Financial Report June 30, 2015', Note 9, November 12, 2015

Appendix – Pension Cost Forecast

Figure 1. Pension Cost Forecast



The pension cost forecast shown above has 5 components: Classic Safety Plan, Classic Miscellaneous Plan, PEPRSA Safety Plan, PEPRSA Miscellaneous Plan, and pension obligation bond. Costs for the two PEPRSA plans are small and are combined in the figure.

A predictable cost component is the pension obligation bond payment. In fiscal year 2015-16 the payment is \$1,875,000. In two years it will reach a maximum. Starting fiscal year 2022-23 it will start to decline. The bond payment ends in 13 years on June 30, 2029.

Both classic plans have 2 components: normal cost (which are for current employees or 'active members') and an unfunded liability cost (which eventually will raise the funding level to 100%). The normal cost is calculated from a percentage of salary: 19.5% for Classic Safety and 8.9% for Classic Miscellaneous. It is assumed that salaries increase on average 2% annually. Unfunded liability payments are calculated by 30-year amortization of the unfunded liability.

Other assumptions in this forecast are:

- No change in pension benefits
- Return on investments (and discount rate) is 7.5%
- All other actuarial assumptions are realized

Market performance, i.e. return on investments and discount rate, has a significant impact on future costs. The City and CalPERS have little control over this. CalPERS, however, does control the investment asset mix. For example, more fixed-income assets provide a more stable income but would have a lower average yield.

The discount rate is the rate at which future benefits, i.e. pension payments to retirees and future pension payments to current employees are discounted to the present, thus determining pension liability in today's dollars. If the assumed discount rate decreases then liability increases. When liability increases the city's pension payment also increases.

On Nov. 18, 2015, CalPERS approved lowering of the discount in small amounts over the next 30 years from the current rate of 7.5% to 6.5%. This action will increase City pension payments, but it is unknown when those increases will occur and by how much.

References

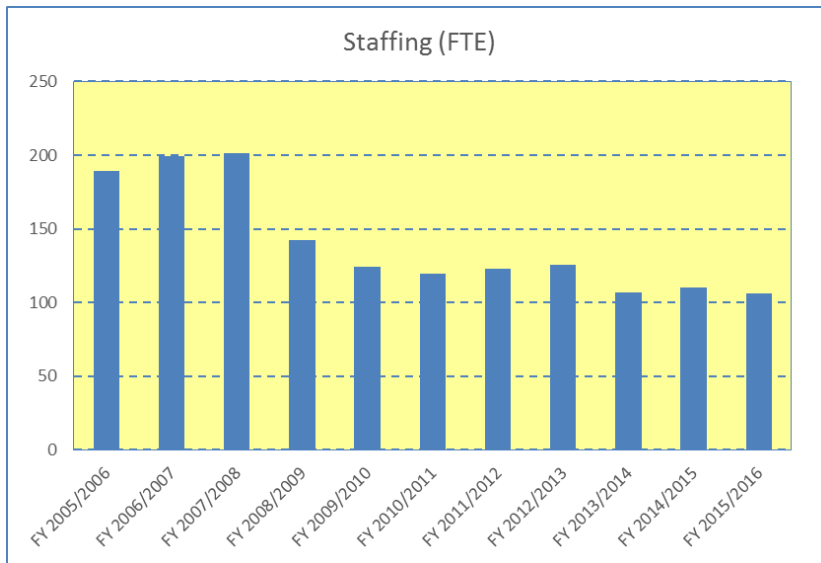
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2. City of Pacific Grove Independent Auditor's Report and Financial Statements, June 30, 2013
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5. CalPERS Finance and Administration Committee Agenda, November 17, 2015

Appendix – City Staffing

Over the last decade the number of city workers has decreased as a result of an effort to reduce city operating expenses. This also has had the effect of reducing pension costs and pension liability.

The figure below illustrates the number of approved city workers in units of full-time equivalent (FTE). Thus it includes part-time employees who are not CalPERS members. In Fiscal Year 2015-16 approved full-time employees, who are CalPERS members, were 74 or 69% of the total staff in FTE.

Actual city staff numbers may be less than approved staff as shown below. Numbers shown do not include Hyperbaric Chamber staff or volunteers.

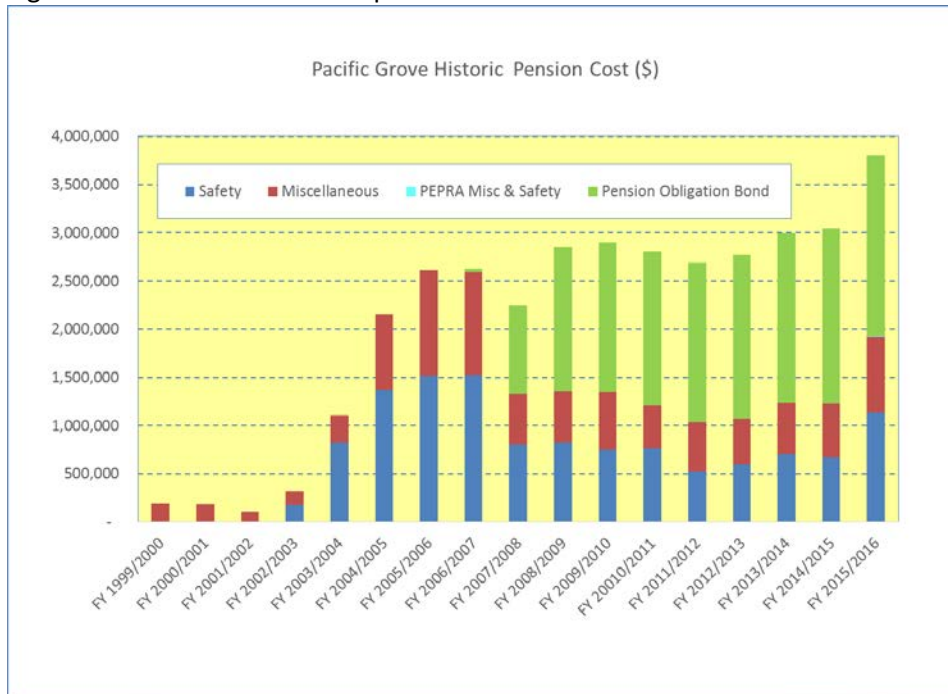


Reference: City of Pacific Grove Budget Reports Fiscal Year 2005-06 to Fiscal Year 2015-16

Appendix – Pension Payment History

Readily available City valuation reports date back to June 30, 1998. This gives us a 15 year historical perspective and a good starting point to gain insights into when and how pension costs have risen so dramatically. In 1998, city pension payments, i.e. employer contributions, were small. In Fiscal Year 1999-2000 the total payment was less than \$200,000.

Figure 1. Pacific Grove historic pension cost



As seen in Figure 1, pension costs rose significantly in Fiscal Year 2003-04 and the following two years. Contributing causes are: poor CalPERS investment returns, participation in risk pools, and increased pension benefits. Note the pension obligation bond payments partially offset CalPERS pension plan payments. The following charts do not include bond payments, but Figure 1 does.

Pension costs again increased significantly in Fiscal Year 2015-16. This is largely due to changes in the manner CalPERS administers the classic risk pools, as noted above.

City valuation reports, created by CalPERS, provide the actuarial status of each of the city’s pension plans as of the end of the fiscal year, i.e. June 30. The reports are usually issued in October of the following year, that is, 16 months after the end of the fiscal year. Pension costs for the following fiscal year (starting 2 years after the valuation date) are also reported.

Pacific Grove now has four pension plans. They are: Safety Plan (Rate Plan 348), Miscellaneous Plan (Rate Plan 347), PEPRA Safety Plan (Rate Plan 25299), and PEPRA Miscellaneous Plan (Rate Plan 26278). The PEPRA plans are new, have few members and fund liabilities are small.

Many factors influence pension cost, among them are: size, age, pay, and seniority of the workforce; contractual city pension benefits; investment performance of pension assets; actuarial assumptions and

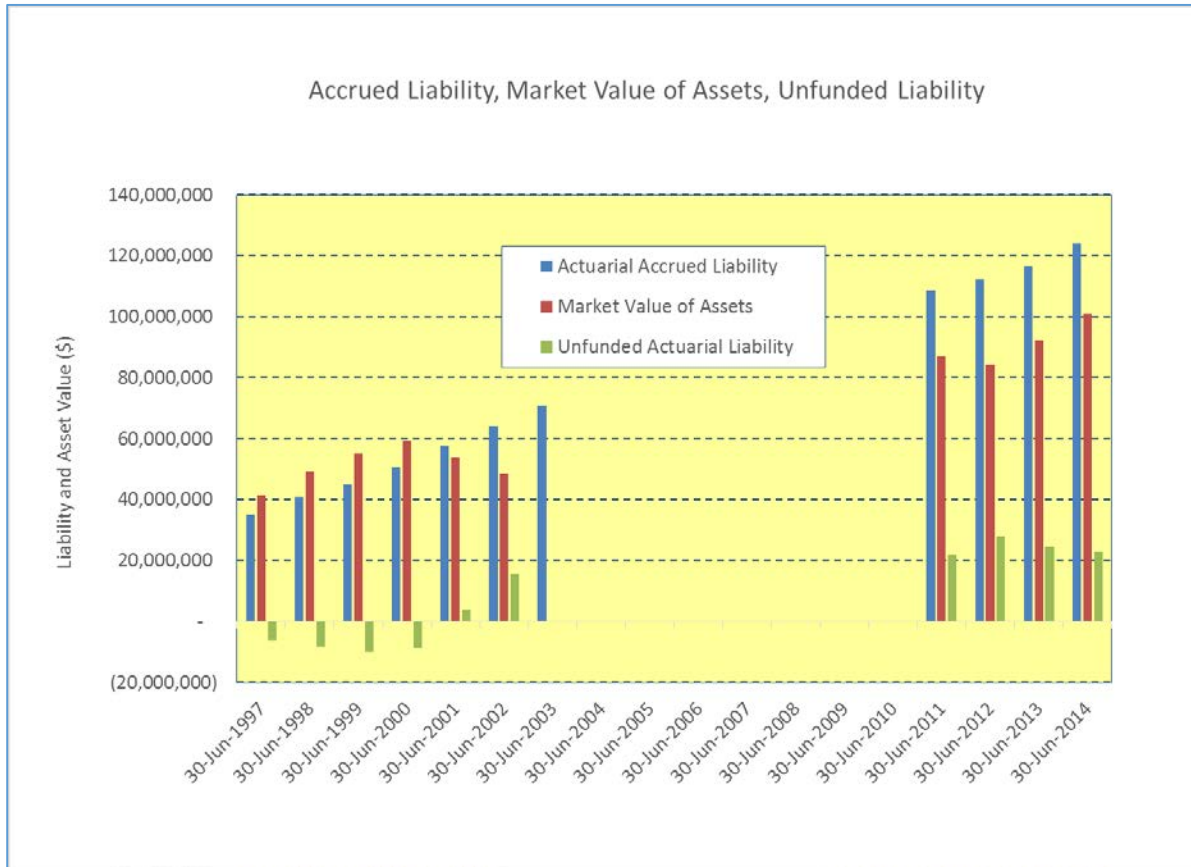
methods; and CA public employees' retirement law. It is beyond the scope of this document to provide an analysis of the impact of each of these factors.

Key events in chronological order are:

- Fiscal Year 2003-04 — Safety Plan 348 retirement benefit factor increased from 2% to 3% at 50 years and service retirement benefit cap is increased to 90% of final year compensation
- Fiscal Year 2005-06 — Participation in Safety 3% at 50 Risk Pool and Miscellaneous 2% at 55 Risk Pool becomes mandatory
- June 1, 2006 — Pacific Grove issues taxable pension obligation bonds in the principal amount of \$19,365,355 to pay down CalPERS unfunded accrued actuarial liability.
- Fiscal Year 2008-09 — 24 full time city employee positions were eliminated; a fire services contract with Monterey was implemented and fire department employees transferred to Monterey
- January 1, 2013 — Public Employees' Pension Reform Act of 2013 (PEPRA) took effect
- April 2014 – CourseCo becomes golf course operator with subsequent staff reductions
- Fiscal Year 2015-16 — Structural changes made to the classic risk pools including: unfunded liability to be collected in dollar amounts and allocated based on total liability instead of payroll

In Figure 2 we see why pension payments were low at the beginning of this 15 year retrospective. Pacific Grove pension assets were larger than accrued actuarial liability until June 30, 2001. During these years payments were reduced because the plans were funded in excess of 100%. However, this changed with the market downturn in 2001.

Figure 2. Accrued Actuarial Liability, Market Value of Assets and Unfunded Liability



Unfunded liability shown in is simply the difference between liability and assets. It is negative in the first four years. Unfortunately, no data is available from 2004 to 2010. However, it appears pension liability continually increased at a steady rate, as did market value of assets, which did so at a slower pace.

In Figures 3 and 4 it is seen that retired plan members has grown steadily. Active plan members' decreased in Fiscal Year 2008-09 due to positions eliminated or transferred. There are now more retirees than employees.

Figure 3. Pension Plan Members and Status

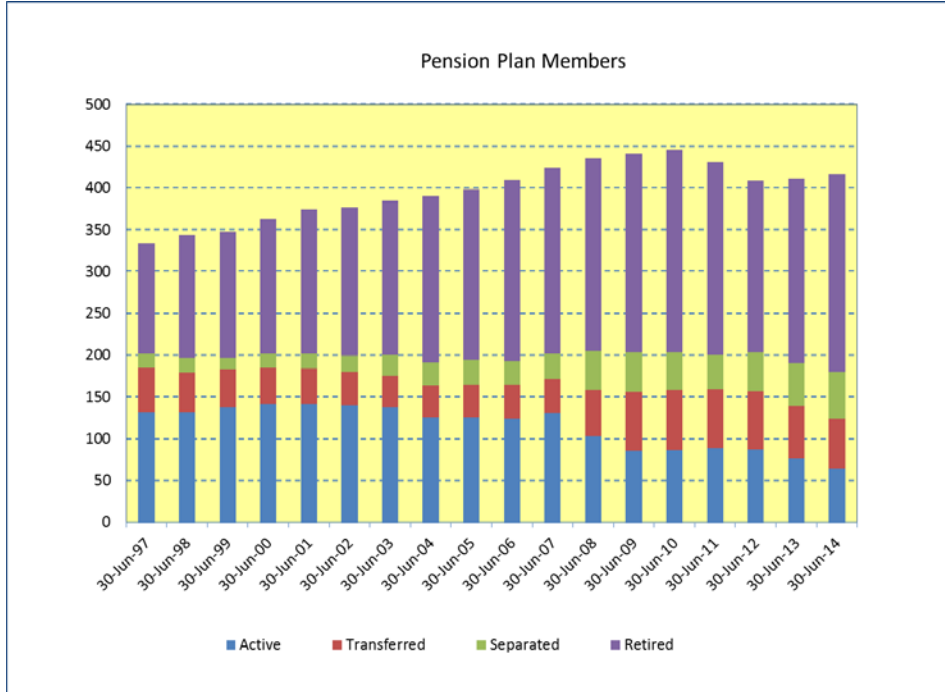
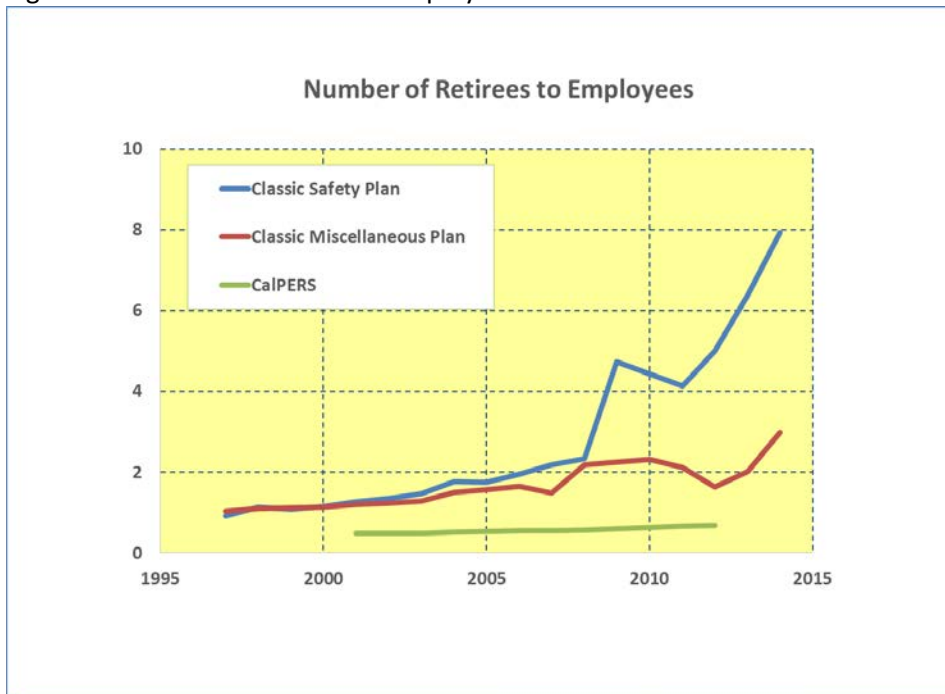


Figure 4. Number of Retirees to Employees



CalPERS investment returns have a significant impact on unfunded pension liability and consequently pension payments. CalPERS ten and twenty year geometric returns over 1994 – 2013 are 7.0% and 7.6%, respectively. The CalPERS discount rate moves inversely to the accrued actuarial liability. The discount rate is equal to the expected investment return. Lower discount rates result in higher liability.

Figure 5. CalPERS Investment Returns

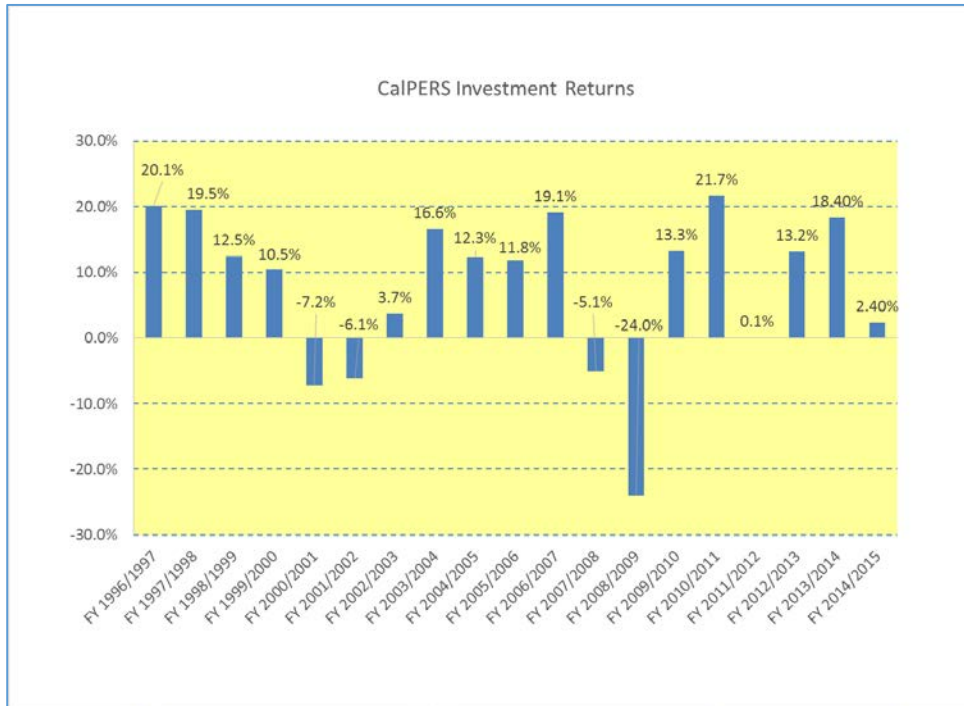
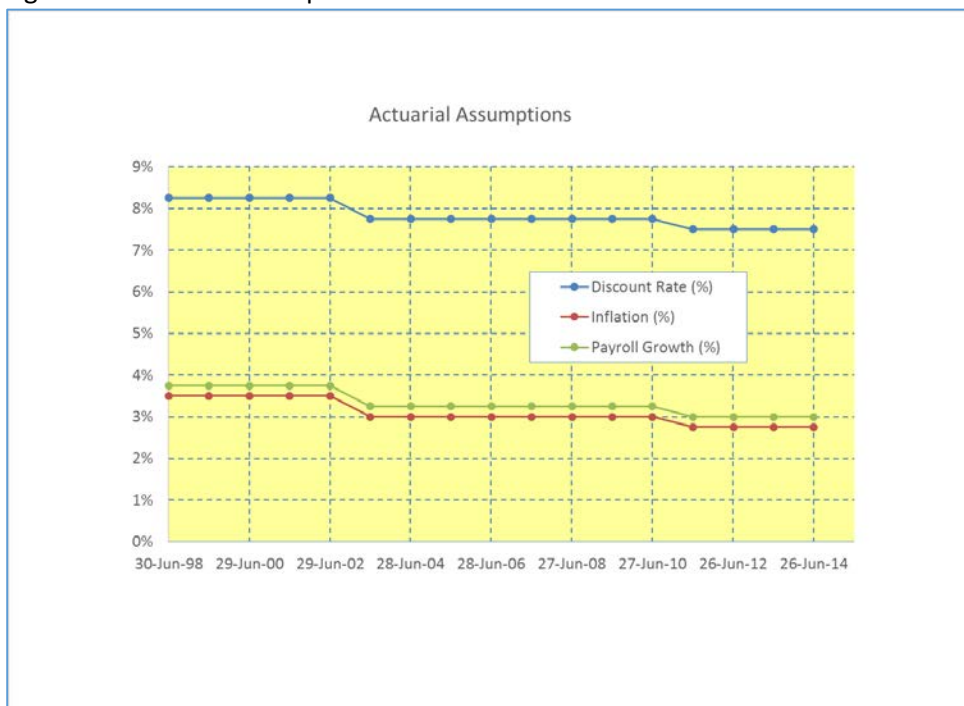


Figure 6. Actuarial Assumptions



References

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2. CalPERS Annual Review of Funding Levels and Risks, November 18, 2014
3. CalPERS Section 2 Actuarial Valuation as of June 30, 2013 Safety Risk Pool
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6. City of Pacific Grove California, Comprehensive Annual Financial Report, June 30, 2013

Appendix – Comparison to Other Cities

Because the character of California cities varies widely, it was felt that it would be best to compare Pacific Grove pension finances to cities of similar characteristics such as population, area, location, city services, and revenue per capita. The comparison cities are listed in the table below. In the following map and charts Pacific Grove appears to be average for this group of 10 cities. Although there is no comparison to each city economy, it is assumed that a large component for each is tourism.

Table 1. City, county, major city services

	City	County	Major City Services
1	Arroyo Grande	San Luis Obispo	police, water, sewer
2	Capitola	Santa Cruz	police
3	Carmel by the Sea	Monterey	police, sewer
4	Grover Beach	San Luis Obispo	police, water, sewer, waste water treatment
5	Marina	Monterey	police, fire
6	Monterey	Monterey	police, fire, sewer, marina, Presidio
7	Morro Bay	San Luis Obispo	police, fire, water, sewer, waste water treatment, harbor
8	Pacific Grove	Monterey	police, sewer
9	Pismo Beach	San Luis Obispo	police, water, sewer, waste water treatment
10	Seaside	Monterey	police, fire, water (partial), sewer

Figure 1. Location



Figure 2. 2015 Population

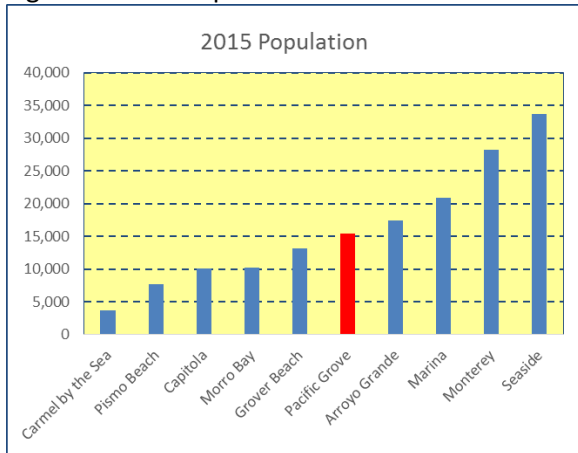
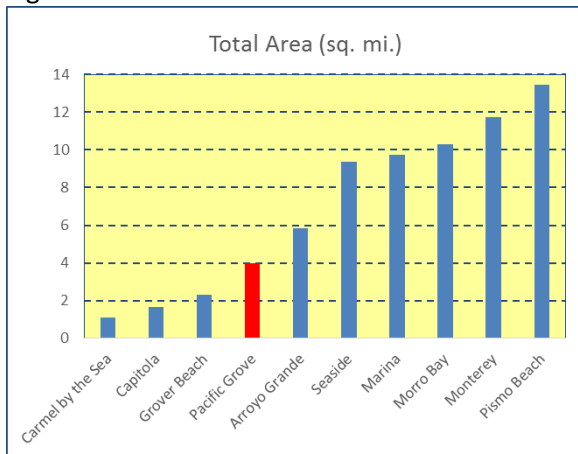


Figure 3. Total Area



Pension costs are paid through General Fund and non-General (enterprise) Funds revenue, the proportion of which varies from city-to-city. Because of this variation, comparisons below are made on the basis of both all-city and General Fund revenues. Results are also shown normalized by population (per capita). [Note: all pension costs are from June 30, 2013 valuation reports.]

Figure 4. City Wide Revenue (\$)

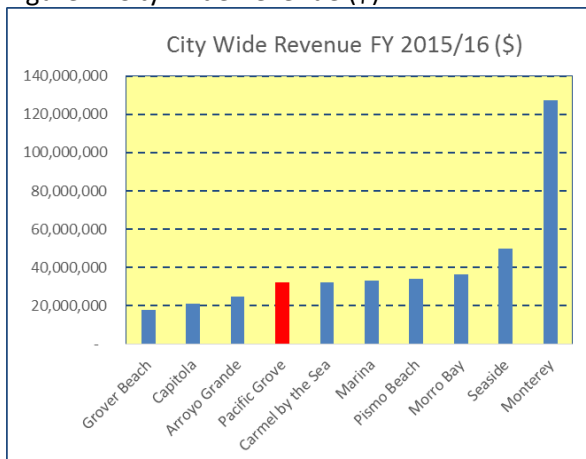


Figure 5. General Fund Revenue (\$)

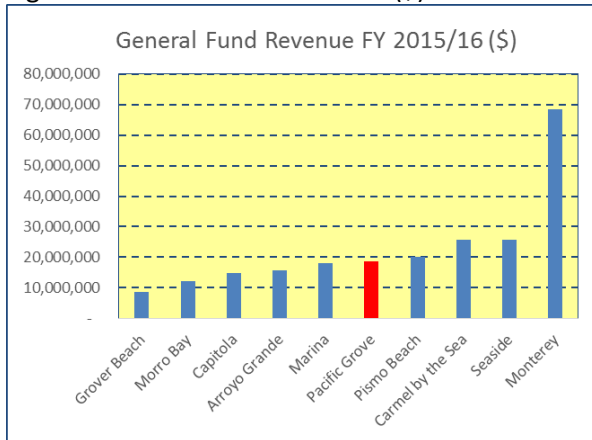


Figure 6. City Wide Revenue Per Capita (\$/person)

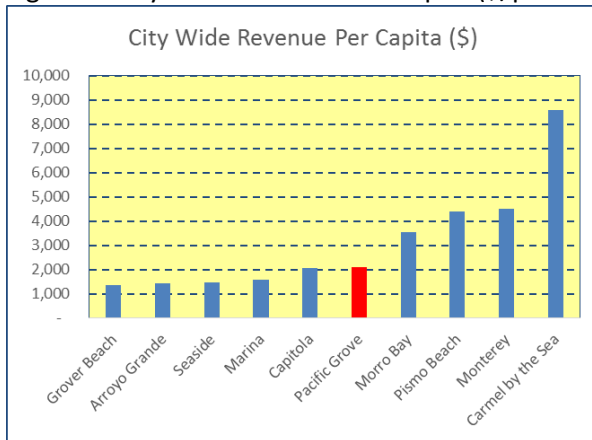
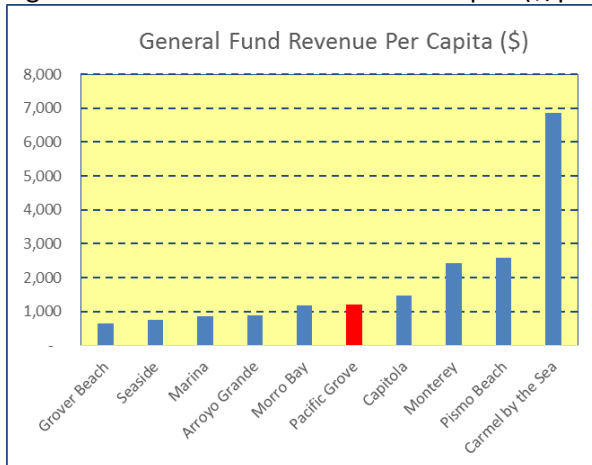


Figure 7. General Fund Revenue Per Capita (\$/person)



The number of people enrolled in CalPERS pension plans (i.e. plan members) from Pacific Grove is slightly above the average as shown in Figure 8. However, after accounting for population size, Pacific Grove is average as shown in Figure 9.

Figure 8. Plan Members

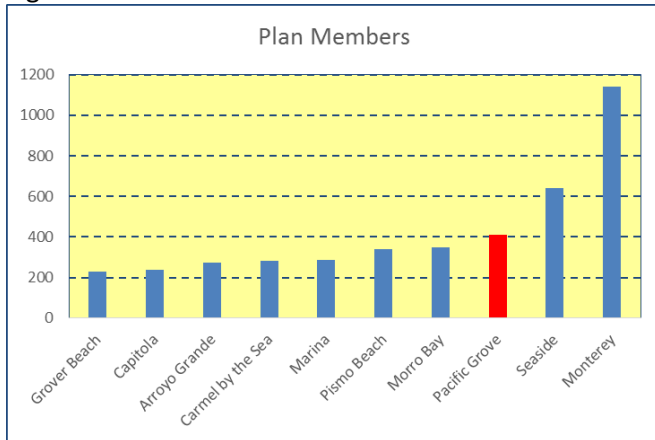
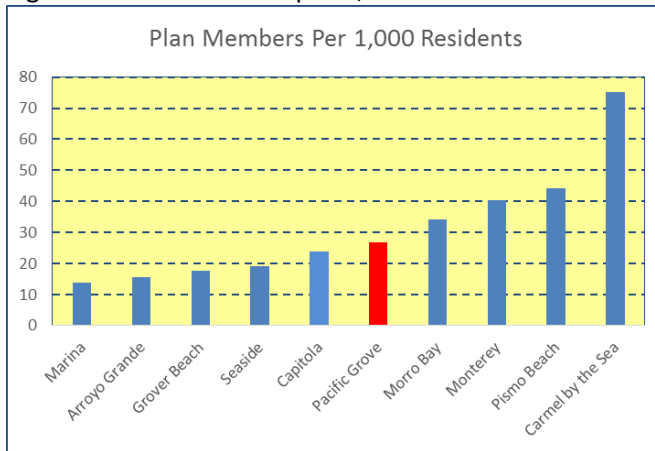


Figure 9. Plan Members per 1,000 Residents



In Figure 10 the status of members are shown as a percentage of the total number from that city. The chart is ordered from the smallest percentage of active (employed) members which is Pacific Grove, to the highest which is Monterey. The number of retirees to employees is shown in Figure 11. Pacific Grove is the highest.

Figure 10. Member Status

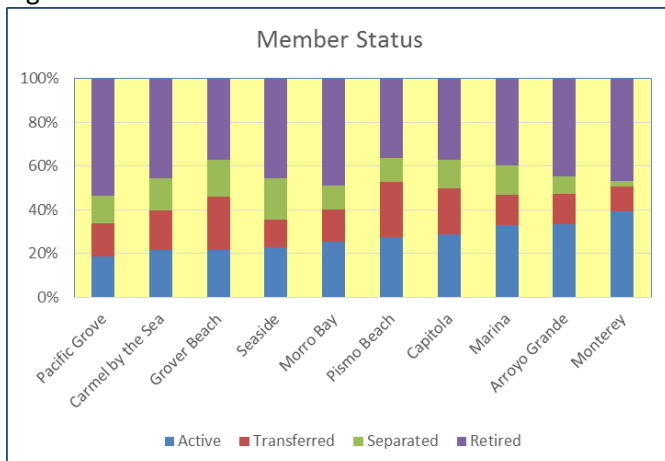
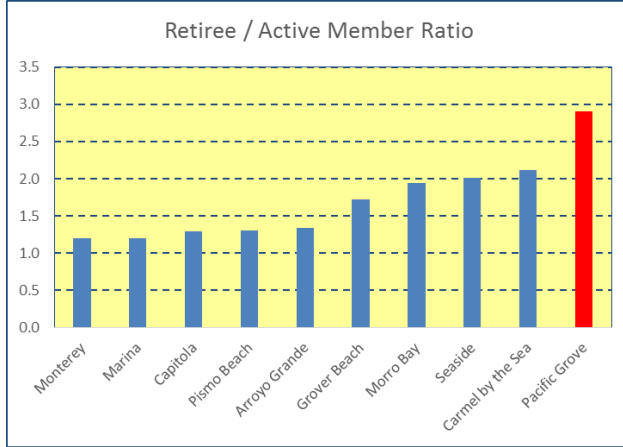
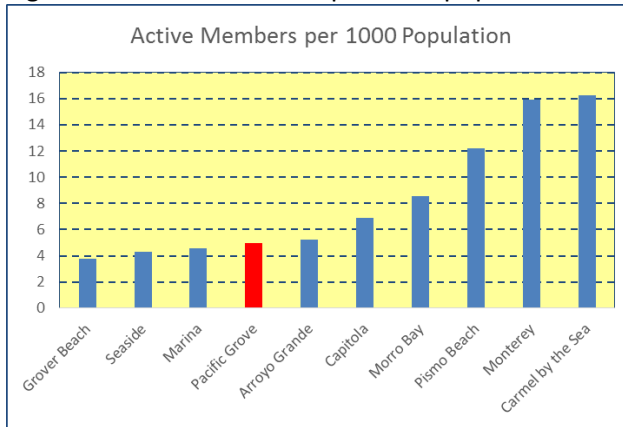


Figure 11. Number of Retirees to Employees



However, the ratio of employees per 1,000 residents, shown in Figure 12, indicates Pacific Grove is average. This means that eventually Pacific Grove will have lower pension costs as the number of retirees decline.

Figure 12. Active members per 1000 population



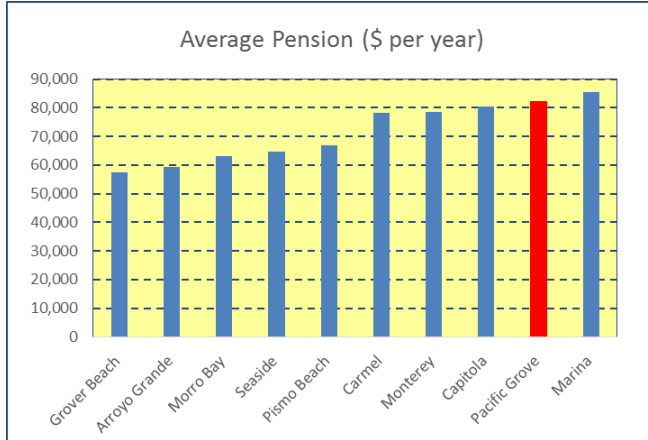
Pacific Grove pension benefit formulas are similar to other cities as shown below.

Table 2. Pension plan benefit formulas

	Miscellaneous	Police	Fire
Arroyo Grande	Tier I - 2.5%@55	Tier I - 3%@50	3%@55
	Tier II - 2%@55	Tier II - 3%@55	
	PEPRA - 2%@62	PEPRA - 2.7%@57	
Capitola	2.5%@55	3%@50	
	2%@55		
	PEPRA - 2%@62		
Carmel by the Sea	2%@55	3%@50	3%@50
	Tier 2 - 2%@60	Tier 2 - 2%@50	Tier 2 - 2%@50
Grover Beach	2.5%@55	3%@55	2%@55
	2%@55	PEPRA - 2.7%@57	1/2%@55
Marina	2%@55	3%@50	3%@50
	PEPRA - 2%@62	PEPRA - 2.7%@57	
Monterey	2%@55	3%@50	3%@50
	2.7%@55		PEPRA - 2.7%@57
	2%@62		
Morro Bay	2%@55	3%@50	Tier I - 3%@50
	2.7%@55	Tier II - 3%@55	Tier II - 3%@55
	2%@60		
	PEPRA - 2%@62		
Pacific Grove	2%@55	3%@50	3%@50
	PEPRA - 2%@62	PEPRA - 2.7%@57	
Pismo Beach	2%@55	3%@50	2%@50
	2.5%@55	Tier 2 - 3%@55	
	2%@60	PEPRA - 2.7%@57	
	T2 - 2%@60		
	PEPRA - 2%@62		
Seaside	2%@55	Tier 1 - 3%@50	Tier 1 - 3%@50
	PEPRA - 2%@62		Tier 2 - 2%@50

The average pension for full-career retirees (30+ years of service) is shown in Figure 13. Pacific Grove is on the high end of the comparison group, however many factors including seniority and job classifications, account for this outcome.

Figure 13. Average Pension for Full-Career (30+ years' service) Retirees



City pension payments consist of payments to CalPERS, i.e. employer contributions, and pension obligation bond payments, if any. Six of the ten cities have pension obligation bonds. Pacific Grove has the largest bond payment. The Pacific Grove pension obligation bond remaining principal as of June 30, 2016, is \$24,914,000.

Table 3. Pension Obligation Bonds

	City	Pension Obligation Bond Payment FY 2015-16 (\$)	Maturity
1	Arroyo Grande	502,860 (est.)	2018-2031
2	Capitola	667,704	2017
3	Carmel by the Sea	697,443	2023
4	Grover Beach	N/A	
5	Marina	648,540	2019
6	Monterey	N/A	
7	Morro Bay	N/A	
8	Pismo Beach	N/A	
9	Seaside	628,943	2025
10	Pacific Grove	1,875,000	2029

Figures 14 and 15 demonstrate that high Pacific Grove annual pension costs are high compared to revenue. These charts include pension obligation bond payments.

Figure 14. Pension Costs as Percent City Wide Revenue

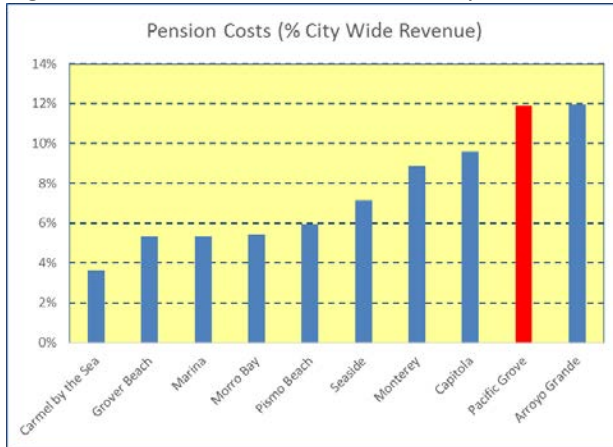
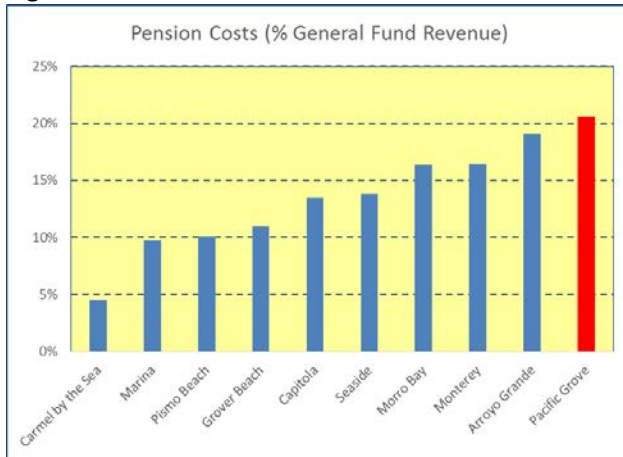


Figure 15. Pension Costs as Percent General Fund Revenue



Pacific Grove has higher than average actuarial accrued liability, as shown in Figure 16. A mature workforce would have higher than average actuarial accrued liability per plan member (Figure 17).

Figure 16. Actuarial Accrued Liability

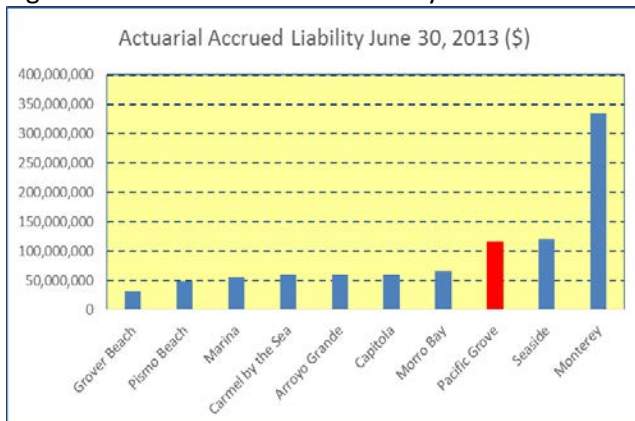
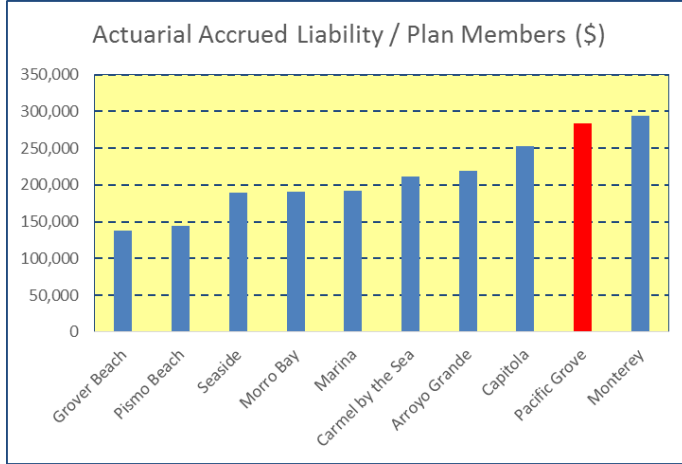


Figure 17. Actuarial Accrued Liability Per Plan Member (\$)



In terms of pension fund assets, Pacific Grove is above average as shown in Figures 18 and 19.

Figure 18. Market Value of Assets

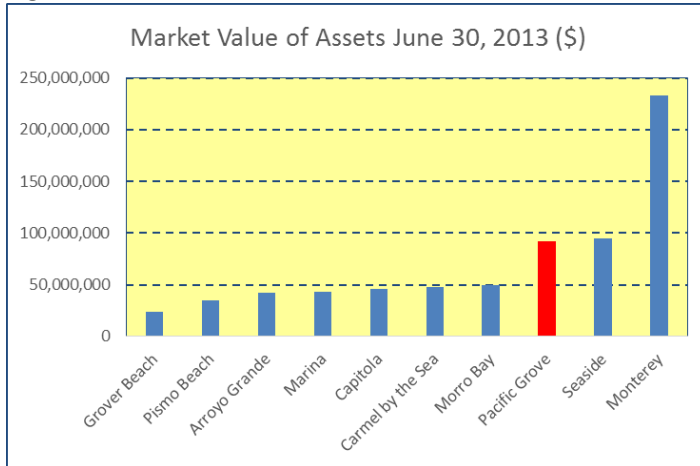
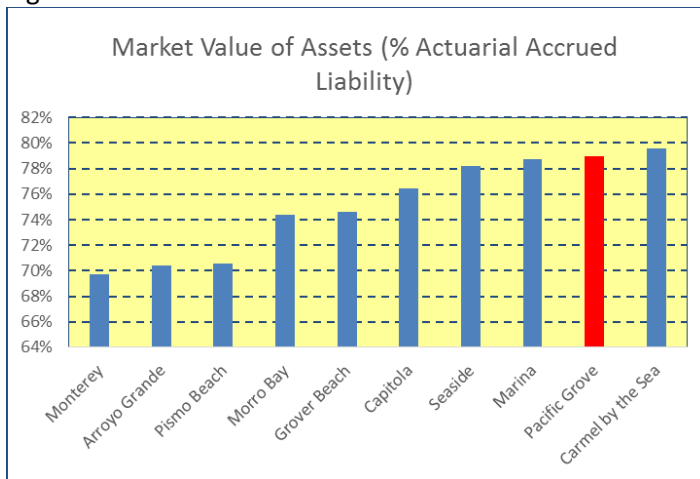


Figure 19. Market Value of Assets as Percent Actuarial Accrued Liability



However, comparing unfunded liability as a percent of revenue, Pacific Grove is above average, as seen in the figures below. Figures 20, 21 and 22 do not include outstanding bond principal. Cities with pension obligation bonds are shown with **.

Figure 20. Unfunded Actuarial Accrued Liability

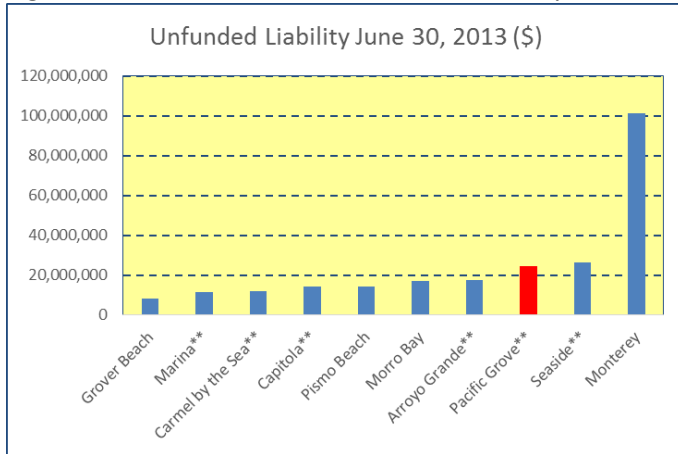


Figure 21. Unfunded Actuarial Accrued Liability as Percent City Wide Revenue

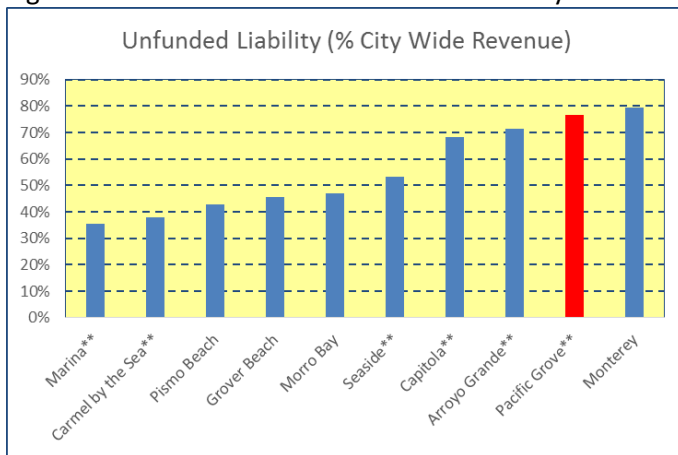
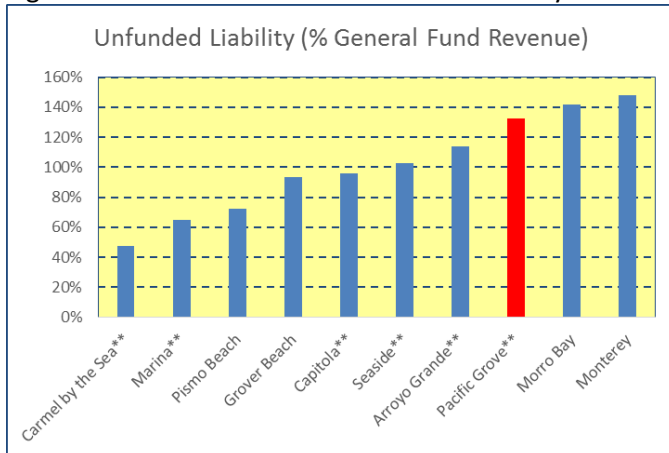


Figure 22. Unfunded Actuarial Accrued Liability as Percent General Fund Revenue



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