Unfunded Pension Liability and General Fund Finances

Eric Filseth
Vice Mayor, City of Palo Alto
Nov 2018
Summary

1. Recalculate pension finances independently of CalPERS, using realistic investment-return rates
2. Focus on the Income Statement (Normal Cost)
   - Root problem is systematically underestimated operating expenses, compounded over years or decades
3. Cut operating expenses accordingly, and save the difference in a Section 115 Trust
4. Future: develop a plan to amortize the existing debt

Agenda
- Where are we, and how did we get here
- What does the future look like
- What to do about it
Palo Alto = Sixth-Highest Pension Liability in State

- Palo Alto has the sixth-highest unfunded Pension liability per-household in California

(pensiontracker.org, 2015)

City of Palo Alto

June 2016 unfunded Pension Liability $509M*  
Add: 2yrs growth @7% (est) $75M  
Add: unfunded Medical Liability $153M  

---------------------------------------------------------  
Total “UAL” – Unfunded Actuarial Liability $735M  

Palo Alto now pays 8% of our General Fund towards the existing $509M unfunded pension liability alone = $17M/yr, growing at 17% /yr.

- Already crowds out $17M/yr of services: Fire, Police, Community Svcs ... 
- By far the city’s fastest-growing expense – will double in < 5 years 
- Not including Normal Cost, OPEB ...

* Source: City of Palo Alto Finance Dept, Q1 2018, based on a 6.2% investment ROI

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If We Balance our Budget Every Year …

General Fund Revenue  General Fund Expense

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If We Balance our Budget Every Year …

... then where did all this **Debt** come from?
If We Balance our Budget Every Year ...

... then where did all this *Debt* come from?

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Impact of Asset-ROI Overestimates on OpEx

- Did independent actuarial analysis using **6.2% ROI** *(est fm Wilshire Assoc. 2016)*
  - CalPERS = 7.375% going to 7% in 2020
- Focused on **annual payroll cost**, not just UAL

**Relative to ROI 6.2% ---**

- **ROI 7.0%**
  - Understates Normal/UAL Cost by 15%
  - Understates Payroll Cost by 3-4.4%
  - Understates GF Expense by **2-3%**
- **ROI 7.375%**
  - Understates Normal/UAL Cost by 30%
  - Understates Payroll Cost by 6-8.5%
  - Understates GF Expense by **4-6%**
- **ROI 8.0%** *(Proj. by CalPERS for many years)*
  - Understates Normal/UAL Cost by ... 40% ?
  - Understates GF Expense by ... 8% ?

*Source: City of Palo Alto Actuarial Study for Finance Committee 2H 2017
ROI assumption 6.2%/yr; Pension only -- OPEB difference not included
E Filseth, City of Palo Alto 2018*
### Example: GF growth 4.5% --- discount rate 8% --- expense underestimate 8%:

- UAL = **100%** of General Fund after **11 years**
- UAL = **150%** of General Fund after **15 years**

<table>
<thead>
<tr>
<th>Year</th>
<th>Factor</th>
<th>UAL</th>
<th>GF Rev</th>
<th>GF Expense</th>
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**Large UAL deficits can be produced by recurring small OpEx gaps, compounded over years**
Pension Costs and City Expenses

Two pension-related OpEx components:

- Normal Cost
- UAL Amortization Payment

UAL Payment Determined by

- “Estimated” size of UAL - Estimated Asset ROI
- Amortization schedule

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Effects of Growth in UAL Amortization Pmt

### Assume General Fund growth = 4.5%/yr

<table>
<thead>
<tr>
<th>Year</th>
<th>UAL Payment Growth %</th>
<th>UAL Payment % of GF</th>
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<tr>
<td>2013</td>
<td>4.4% 4.4% $7M</td>
<td>4.4% 4.4% $7M</td>
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<td>2019</td>
<td>7.9% 7.9% $17M</td>
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<td>14% 14% $37M</td>
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<td>2028</td>
<td>23% 23% $71M</td>
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### UAL Payment Drivers

- Future drops in CalPERS ROI until reach 6.2% → increases Estimated unfunded liability
- Understated wage-growth estimates also understate estimated liability
- Recurring OpEx gaps continue to increase Actual Liability
Impacts on City Operations

**Fire**
- **Budget**: +68% since 2005
- **Staffing**: -24% since 2005

**Police**
- **Budget**: +88% since 2005
- **Staffing**: -9% since 2005
The “Easy” Stuff

• Outsourcing
  – Aquatics management
  – Parking enforcement
  – Refuse collection, tree trimming ...
  – Animal shelter

• People → technology: cameras ...

• Staffing and work-rules mix: Fires → Medical services

• Capital impacts
  – Dropped bid for Post Office building
  – Scaled back Adobe Creek bike bridge

• Revenue increases
  – Full cost-recovery on most city fees, indexed to cost increases
  – Utility rates (only relevant to Utility Funds UAL)
  – Direct tax increases – not so far
• You cannot get out of debt while you are still adding on new debt
Plan

1. First stop adding *new* debt
   i. Recalculate actuarial pension finances independently of CalPERS, using realistic investment-return rates – *done*
   ii. Focus on the **Income Statement**, not just the Balance Sheet – *done*
      i. The root problem is systematically underestimated operating expenses, compounded over years or decades
   iii. Close OpEx gap – cut operating expenses accordingly, and save the difference – *partial*
      i. Presumably in our Section 115 Trust

2. Develop a plan to amortize the *existing* debt

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**City of Palo Alto**

- Used 6.2% ROI
- FY2019 Gen. Fund OpEx gap $8M
- Actuarial analysis by Bartel Associates
- Also deploying **GovInvest** actuarial software in COPA Finance Dept
- Directed City Manager to find structural cuts for half the gap ($4M) in FY2019
  - Expect seek the other half next year
- Expectation is to use our Sec 115 Trust for the savings
  - Allows investment at market rates
- Future initiative
- Also need expand to “OPEB” (retiree medical) and beyond General Fund (Utilities ...)
Thank You
CalPERS Projections and Riskless-Asset Returns

Jeremy Bulow, Stanford GSB – Sept 2017

Lower Interest Rates = More Risk and Lower Returns for All Investors

CalPERS Projected returns followed riskless asset return rates up ...

... but not back down (their Actual returns did fall, but not Projected returns)