Special Meeting
January 30, 2012

The City Council of the City of Palo Alto met on this date in the Council Chambers at 5:35 P.M.

Present: Burt, Espinosa, Holman, Klein, Scharff, Schmid, Shepherd, Yeh arrived @ 5:45 P.M.

Absent: Price

CLOSED SESSION

1. CONFERENCE WITH LABOR NEGOTIATOR
City Designated Representatives: City Manager and his designees pursuant to Merit System Rules and Regulations (James Keene, Pamela Antil, Dennis Burns, Lalo Perez, Joe Saccio, Sandra Blanch, Marcie Scott, Darrell Murray)
Employee Organization: Palo Alto Police Officers Association (PAPOA)
Authority: Government Code Section 54957.6(a)

2. CONFERENCE WITH LABOR NEGOTIATOR
City Designated Representatives: City Manager and his designees pursuant to Merit System Rules and Regulations (James Keene, Pamela Antil, Dennis Burns, Lalo Perez, Joe Saccio, Sandra Blanch, Marcie Scott, Darrell Murray)
Employee Organization: Palo Alto Police Manager's Association (PAPMA)
Authority: Government Code Section 54957.6(a)

3. CONFERENCE WITH LABOR NEGOTIATOR
City Designated Representatives: City Manager and his designees pursuant to Merit System Rules and Regulations (James Keene, Pamela Antil, Dennis Burns, Lalo Perez, Joe Saccio, Sandra Blanch, Marcie Scott, Roger Bloom, Darrell Murray)
Employee Organization: Palo Alto Fire Chiefs' Association
Authority: Government Code Section 54957.6(a)

The City Council reconvened from the Closed Sessions at 7:01 P.M. and Mayor Yeh advised no reportable action.

CITY MANAGER COMMENTS

City Manager, James Keene reported on: 1) recycling center closing on February 1, 2012, additional information was available on the Zero Waste webpage; 2) Oak tree removal at 816 Cowper Street to begin on February 6, 2012 a Valley Oak Tree will replace it; and 3) RBlock working with for past 2 years, kicked off this past week to several neighborhoods within the City.

ORAL COMMUNICATIONS

Herb Borock spoke regarding High Speed Rail funding sources.

CONSENT CALENDAR

MOTION: Council Member Shepherd moved, seconded by Vice Mayor Scharff to approve Agenda Item Nos. 4-6.

4. **Ordinance 5141** entitled "Ordinance of the Council of the City of Palo Alto to Close FY 2011 Budget and Authorize Re-Appropriation into FY 2012 Budget; Close Completed Capital Improvement Projects and Transfer Remaining Balances to Reserves"; Approve the City's FY 2011 Comprehensive Annual Financial Report (CAFR).

5. Approval of the Final City Council Priorities Report for Calendar Year 2011.

6. Approval to Submit Application to the State Water Resources Control Board for Grant Funding from the Proposition 84 Storm Water Grant Program for the Southgate Neighborhood Storm Drain Improvements and Green Street Project.

MOTION PASSED: 8-0 Price absent

ACTION ITEMS

7. Continued Public Hearing: Appeal of an Architectural Review Approval and A Record of Land Use Action Regarding the Director's Architectural Review Approval of A Three Story Development Consisting of 84 Rental Residential Units In 104,971 Square Feet Within the Upper Floors, 50,467 S.F. Ground Floor Research and Development Area, Subterranean and Surface Parking Facilities, And Offsite Improvements, With Two Concessions Under State Housing Density Bonus Law (GC65915) On A 2.5 Acre Parcel At 195 Page Mill Road And 2865 Park Boulevard (PLNG) ***** Quasi Judicial**-** Applicant has requested continuance.

MOTION: Mayor Yeh moved, seconded by Council Member Holman to continue Agenda Item No. 7 to a date uncertain.

MOTION PASSED: 8-0 Price absent

8. Retirement Medical Actuarial Report Discussion.

Director of Administrative Services, Lalo Perez announced the item was previously brought before Council on November 28, 2011 where they determined it should be returned with the Actuarial Consultant available to answer questions. Although the Council had accepted the Staff recommendation during the previous meeting, Staff informed them they were in a position to make changes to the assumptions as they felt necessary during the presentation by the Consultant.

President, Bartel Associates, LLC, John Bartel gave a presentation to explain the process of how the actuarial assumptions came to be. Initially there were two valuations prepared, January 2009 and 2011 which determined the end of Fiscal Year 2012 Annual Required Contribution (ARC) was not a requirement. The key number to pay attention to was the Actuarial Accrued Liability (AAL); which was the value of benefits due to service that had already been rendered. If the assumptions were met, the amount presented should be considered as the amount of assets that should be set aside. The Actuarial Accrued Liability for active employees dropped modestly from $51.3 million to $50.2 million while there was a large increase for those who were no longer rendering service went from $78.4 million to $119 million; therefore, the total liability went from $130 million to $169 million. The presentation was broken out into assumption changes, plan changes, and gains and losses. He explained the Actuarial Load item was the review of the increase to the CalPERS premiums; that had not been keeping pace from one year to the next with their claims. CalPERS had been pulling funds from their reserves to mitigate their premium increases. It was discovered that people were opting into more expensive Medical Plans at retirement, which increased the assumption numbers by $2.6 million. The two items that decreased the liability were the cost sharing and the International Association of Fire Fighters (IAFF). The Un-funded Actuarial Accrued Liability (UAAL) of $134 million represented the distance the City was from its AAL. The UAAL was rolled over on June 30, 2011 to be added to the Fiscal Years 2011 and 2012 ARC in the amount of $8,597,000 to equal a 28-year amortization of the original number which was for a 30-year amortization. He noted if the City was pre-funding an obligation there should be a period where that amount was being paid off over. He mentioned if the City was to continue the pattern of an open or rolling amortization in the current Fiscal Year, the ARC would be lower and there would be a cash flow but 30-years from now the Un-funded Liability would not be paid off and in fact the Un-funded Liability would be higher than today.

Mr. Perez clarified if the City switched to a 30-year open amortization for Fiscal Year 2012 the reduction in the ARC would be $280,000 or $196,000 for the General Fund. For Fiscal Year 2013, the number would be $470,000 citywide or $329,000 for the General Fund. The Rate of Return discussed in November for Fiscal Year 2012 and 2013 was 7.75 percent and forward there were three choices; the highest rate available was 7.61 percent, 7.06 percent, and 6.39 percent. Staff had recommended the City use 7.61 percent with an adjustment for adverse deviation which lowered the percentage to 7.25. This was the return used for Fiscal Year 2013. If the number used remained at 7.61 percent the ARC would be $570,000 citywide with the General Fund being $399,000; 70 percent of the contribution was a General Fund obligation. If there was a change to a 30-year rolling amortization with a higher rate of return assumption of 7.61 percent it would lower the General Fund annual required obligation by $728,000. The Rate of Return was 3.62 percent to the positive since its inception in March of 2008 through December of 2011. Staff intended to return to Council at Mid-Year for a discussion on options to fully fund the ARC and to locate solutions to fund the ARC on an ongoing basis beginning with Fiscal Year 2013 which meant increasing the budget by $3.7 million citywide or $2.3 million in the General Fund in Fiscal Year 2012 and an additional $800,000 citywide or $500,000 for the General Fund.

Council Member Klein made note that the non-required ARC was absorbing ten percent of the budget which appeared to be freezing out expenditures that may be better for the health of the community long-term. He asked if the goal of the Consultant was to choose the most conservative assumption.

Mr. Bartel said that was incorrect. The information his firm provided was their educated speculation. They did not feel the assumptions provided were the most conservative but were not the most aggressive either. He noted CalPERS selected the ranges and the firm had a choice from their provided percentages. CalPERS had a significant amount of equity invested in the Global Equity market which was volatile.

Council Member Klein asked if there was a standard in the Actuarial Field as to which amortization approach was approved or required.

Mr. Bartel said some Actuaries had used the Government Accounting Standards Board (GASB) accounting standard as the out of bounds marker for the minimum contribution that could be paid. If that was the approach taken, from an accrual standpoint, there should not be an amortization period longer than 30-years. He believed if a client was pre-funding and they had a goal of paying their un-funded liability off, using an open or rolling amortization period did not meet that objective. If the objective was to pay the minimum that the GASB accounting standard allowed without worry whether the unfunded liability was paid off, an open or rolling amortization was sufficient.

Council Member Klein had concerns with Bartel Associates not recognizing there may be an un-bubble as it were with the number of employees not retiring opposed to the high number of retirees over the past few years.

Mr. Bartel expressed his understanding of the un-bubble was when the City ended up with far fewer people eligible to retire.

Council Member Klein said if the information was acknowledged in the report that was sufficient.

Mr. Bartel requested the Council review the presentation where the active liability was shown from January 1, 2009 to January 1, 2011. The rate of retirement did not impact the people who had already retired; it only impacted the active liability where the un-bubble was partially reflected by the number of active liability being lower because there were a lot of people who retired in the short-run. His firms' calculations reflected CalPERS experience in terms of how people will retire.

Council Member Klein asked how the CalPERS experience was reflective of the City of Palo Alto experience.

Mr. Bartel clarified Palo Alto's non-safety employees had retired on average at age 57, while the CalPERS rate of retirement being used for the current active employees had future employees expected to retire slightly above age 58. Therefore his firm consistently believed the Experience Analysis CalPERS had completed, which was specifically related to CalPERS Public Agencies with their pension formulas.

Council Member Klein asked how the factors related since the non-safety employees were now at a two percent at age 60.

Mr. Bartel said the Palo Alto non-safety employees did not have two percent at age 60.

Council Member Klein clarified the incoming employees were brought in at two percent at age 60.

Mr. Bartel said the two percent at age 60 only applied to employees hired after a certain date. They would need to use the rate of retirement associated with the formula that people had so the formula of a retirement age of 58 would be closer to 60 or 61 with two percent at 60. He noted until the employees were hired under the calculation, they were not taken into consideration in the valuation.

Council Member Klein said if the Actuarial Report was performed every two years and the firm reviewed long-term, in ten years most of the employees would be at two percent at 60.

Mr. Bartel said how the City achieved the factors would be based on how the employees were hired. His experience with second tiers was it would take approximately ten years for the agency to make up half of the population. For now the employees who had not been hired had no impact on the un-funded liability.

Council Member Shepherd asked if Mr. Bartel felt the Milliman firm would have stayed at the 7.75 percent rate on discount.

Mr. Bartel said they would have had to drop to 7.61 percent for the period ending June 30, 2011 since it was the cap.

Council Member Shepherd asked when the five year averaging was compiled with respect to asset smoothing. She had seen the measurement between 2009 and 2010 and clearly 2009 was a low point for savings and portfolios.

Mr. Bartel said the firm settled on a five year asset smoothing period after reviewing economic cycles and the CalPERS rate of return cycles which ranged between a three to five year span. When the firm reviewed the CalPERS 15-year pension smoothing system there was a fear the length of time would mask a large systematic adjustment. The reason the firm settled on a five year asset smoothing cycle was because it was a long enough period to see an economic flux without being so long there was a masking occurring.

Council Member Shepherd asked if there was recognition of the 2009 financial crisis.

Mr. Bartel said what was occurring was the difference between what was expected and actual and bringing those amounts in 20 percent each year. Well over half of the 2009 downturn was in the June 30, 2011 valuation especially since the investment return was offset by good investment returns. The goal was to not inflate the contribution rate if there was a volatile market as well as it was not recommended to lower fears if the investment market rose.

Council Member Shepherd asked what the risk would be if Council chose to make a change to the five year asset averaging by either funding or not funding the AAL.

Mr. Bartel said Council needed to look at the difference between the market value and the actuarial value which was the compromise between the smoothing and not. On June 30, 2011 the City had a market value of $44.8 million and the actuarial value being used to set the rate was $40 million. There were approximately ten percent of the assets not included so a $4 million change in the un-funded liability might increase the ARC by $500,000. Using smoothing for actuarial value of assets understated the contribution at the expense of smoothing, similarly if the investment return was particularly good it might overstate in a good investment years.

Council Member Shepherd said there was an $8 million difference between 2008 and 2010.

Mr. Bartel acknowledged that was correct.

Council Member Shepherd asked why there was a $12 million change between 2009 and 2011.

Mr. Bartel said the investment return for the City due to the timing of when the contribution was placed was consistently good. The $4 million difference was being used as an actuarial value below the market value so they were overstating the contribution by the $250,000.

Council Member Burt said the newly hired non-public safety employees were coming in on a two tier retirement program of two percent at 60. Mr. Bartel mentioned those employees did not have an impact on the current actuarial discussion. He asked if in ten years half of the City's employees were at two percent at 60, would they be in the equation to a fairly significant degree. So if the actuarial was looking into the future at a 30-year horizon, he asked how they would not impact the equation.

Mr. Bartel said there was more than a 30-year horizon. For example, if the valuation was completed the day before the employee change was effective that valuation would determine an un-funded liability using no one in the new tier. However, if the valuation occurred the day after the benefit changed, and there were employees hired under the tier benefit program, the un-funded liability for those new employees and the actuarial liability would be zero. The un-funded liability did not change because there were new employees being hired, what would change was the normal cost component of the ARC.

Council Member Burt asked for a scenario in ten years where half of the newly hired employees were at two percent at 60 who retired at age 58 while the other half retired at age 63. He asked if it was correct to state those who retire at age 63, had attached to them less un-funded liability than those who retired at age 58.

Mr. Bartel stated no. The scenario would be the employees retiring at age 63 had a lower actuarial liability. Although the retiree medical benefits may not have changes, they would begin drawing those benefits later than the earlier retirements.

Council Member Burt said the period in which the City was paying the full amount for the employee before they were eligible for Medicare was significantly shorter.

Mr. Bartel said that was correct so the employee's liability would be lower on a per capita basis and their normal cost rate would be lower on a per capita basis.

Council Member Burt asked if that was reflected in the fixed closed amortization rate.

Mr. Bartel clarified the fixed closed amortization had no impact on the second tier employees. The fixed closed amortization had to do with the un-funded liability for employees in the first tier and that number would not change because of the second tier employees.

Council Member Burt asked if the City moved forward with an open amortization rate, presumably that dollar amount would decline as far as the contribution based upon the change in the employee retirement age.

Mr. Bartel stated no. If there was an un-funded liability and the funding policy was to pay the normal cost plus some amortization of the un-funded liability, the amortization on the un-funded liability was not being driven by the accrual for the new employees. It was not being driven by the normal cost because the policy was paying the normal cost. The topic of discussion was how the un-funded liability was being paid, none of which was due to the employees in the new tier. As time went on, the only way the new employees would impact the liability was one of two ways 1) if the City did not contribute to the normal cost for the new employees then they would contribute to a higher un-funded liability or 2) if the City thought the new employees were going to retire at age 61 but in actuality they retired at age 58 then the normal cost for the new employees would be too high or too low.

Council Member Burt asked what the assumptions of the firm were when they informed the City, if they did not move forward with the fixed close rate, at the outset they would be paying less than interest. He asked for confirmation that in ten years there was an expectation the annual payment would be reduced as a result of a rolling amortization that reflected a later retirement date.

Mr. Bartel said in actuality the normal cost would be lower although that was not the amortization component. To clarify, whether the City accepted an open or closed amortization rate, the new tier employees had little to no impact on the current amortization number; the impact would be on the Rate of Accrual not the payment on the un-funded liability.

Council Member Burt said there were two alternatives presented the fixed closed amortization and the open rolling amortization. He asked why there was not an alternative based upon the interest.

Mr. Bartel said the firm had the information for a third alternative although since the majority of their clients amortized the un-funded liability as a level percentage of pay they did not include it. An amortization that was a level percentage of pay with a 7.50 percent investment return assumption on a 30-year amortization, the first year would be approximately six percent on the balance. Interest would accrue at 7.50 and the payment was six percent of the balance leaving a negative amortization until the City was below 20 years on the 30-year amortization period.

Council Member Burt said with the fixed closed amortization the probability to payoff the liability was high within the 30-year period and an open rolling amortization was basically a reverse mortgage with the City paying less than the interest. Assuming there would always be an interest payment, Palo Alto did not want to go further into debt they; wanted to pay more interest amount without necessarily taking on the principle. He asked why that was not an option.

Mr. Bartel said the numbers would roughly be 7.75 percent of the un-funded liability of approximately $134 million. With that option the payment grew from $8.4 million to $10 million and there would be a contribution decrease as a percentage of pay.

Council Member Burt said he would be interested in reviewing that option in more detail as an alternative.

Vice Mayor Scharff asked for clarification on the process where the money was placed in a Trust account, then the money was taken to pay the Retiree Medical on a cash flow basis as it became due.

Mr. Bartel confirmed yes, that was the current process.

Vice Mayor Scharff asked how much would be owed for the current year, on a cash flow basis.

Mr. Bartel said for Fiscal Years 2011 and 2012 the amount would be approximately $8.4 million if the City was only paying the benefits due to retirees.

Vice Mayor Scharff said prior to the Actuarial Study the City was looking at paying $9.4 million and now it was $13.3 million but on a pure cash flow basis it would be at $8.4 million.

Mr. Bartel said that was correct.

Vice Mayor Scharff said on a cash basis there would have been an additional $1 million paid off.

Mr. Bartel stated yes.

Vice Mayor Scharff said the current recommendation was to pay off an additional $4 million.

Mr. Bartel said yes.

Vice Mayor Scharff said the Actuarial Study was a snapshot with changed assumptions which was compiled every two-years. He asked if the suggestion was in two-years things would remain as is with the City paying the $13.3 million with no changes.

Mr. Bartel noted reality interfered with what the Actuary expected to occur.

Vice Mayor Scharff asked if the City did not pay the amount would they still be fine on a cash flow basis.

Mr. Bartel agreed.

Vice Mayor Scharff asked if the City would still be paying down on the amount if they continued to pay the $9 million as previously recommended.

Mr. Bartel said yes.

Vice Mayor Scharff said there was no obligation to pay more than $9 million.

Mr. Bartel clarified there was no legal requirement to pay a higher amount. With that being said, the un-funded liability was due in large part because there were employees who were no longer working for the City.

Vice Mayor Scharff noted soon the City would be paying more people to not work in the City than to work.

Mr. Bartel said that was true.

Vice Mayor Scharff said for example if the $3.8 million was not paid towards the un-funded liability it could be paid towards infrastructure.

Mr. Bartel said yes.

Vice Mayor Scharff said there were a number of un-funded liabilities throughout the City that drew a limited amount of money. The goal to pay off a funded amount was because of a future lack of income, a City did not retire, posing the argument of paying interest only. He understood not adding amounts for the future employees to pay although it was the past employees portion that the present employees were being dealt with.

Mr. Bartel said that was an appropriate policy question. To the extent if it were possible to return to when Palo Alto initiated the Retiree Medical Benefit and set aside the cost of service each year, that would be generationally equitable. Unfortunately, going back was not an option; therefore, as an Actuary the recommendation was to set aside more than the cost of service for two reasons 1) there was a large number of retirees and the City was obligated to make those payments and 2) there was a large un-funded liability so setting money aside provided the advantage of future benefits being paid by interest rather than cash.

Vice Mayor Scharff said the $14 million reduction came about because of the 90/10 cost sharing change in the medical plan.

Mr. Bartel said that was correct.

Vice Mayor Scharff said if the plan change went to 80/20 there would be an additional $14 million reduction.

Mr. Bartel said he could not say the answer was yes. Hypothetically speaking he said the answer was yes.

Vice Mayor Scharff said the City Council received different requests for cash, he asked why the Retiree Medical Benefits trumped the other requests. The increase from $9 million to $14 million was not easily absorbed and the additional funds could be spent elsewhere.

Mr. Bartel stated he was not qualified to respond on why one item was of a higher importance than another.

Mr. Perez said an area of concern discussed in the Municipal Finance Groups was the eventual review by the Credit Rating Agencies in terms of the outstanding liability. Yes, it was possible to not fund the liability fully and only pay the retiree obligation although there will come a time when the rating agencies will consider this a liability.

Vice Mayor Scharff said as long as the appropriate assumptions were chosen the ARC will show fully funded. He asked the amount of money that could be saved staying within the boundaries of the assumptions.

Mr. Perez said if there were changes made to a 30-year amortization and the 7.61 percent rate of assumption there could be a savings of $860,000.

Vice Mayor Scharff asked if the funds were being taken from the Reserves since the concessions were not received.

Mr. Perez agreed that was a possibility.

Vice Mayor Scharff noted taking funds from one Reserve to add to another Reserve provided less flexibility.

Mr. Perez confirmed that would be the scenario for 2012 but Staff was not suggesting the same approach for 2013.

Council Member Schmid said the question for the Actuary was about clear and true picture of costs and obligations. There was a recommended option outlined in the Actuarial Report that the City accept a discount rate of 7.25 percent although staying under Option 1 raised the confidence level of achievement and yet it maintained the same set of asset distributions.

Mr. Bartel said that was correct.

Council Member Schmid asked how long it took for an Actuarial Assessment to catch up with structural changes. As an Actuary the position was to have the City assume a greater risk. A City was required to assume all final risk. His concern was staying with Option 1 was pushing more of the investments into a Hedge Fund scenario where risks had been exaggerated over the past few years.

Mr. Bartel stated the firm was not recommending Investment Option 1, 2, or 3.

Council Member Schmid said there was a recommendation for Option 1.

Mr. Bartel clarified if there was an incident where Option 1 was identified it was in error, he clearly noted the firm personnel were not investment advisors.

Council Member Schmid read Bartel and Associates had recommended selecting the rate of 55 percent confidence limit under Option 1.

Mr. Bartel clarified the confidence level was noted for each option but no single option was recommended.

Council Member Schmid asked how an Actuary could assist the City to understand when there was a structural change rather than a general cycle.

Mr. Bartel said the Investment Advisors were saying currently if you were to invest more aggressively, the volatility of the contribution and assets would be greater. He explained the volatility mattered when there was a large amount of assets relative to the payroll. It mattered less in the short run, particularly when the assets were smaller relative to the payroll.

Council Member Schmid said the discussion at hand was on past obligations the City needed to pay off.

Mr. Bartel answered yes.

Council Member Schmid questioned the information saying the City was paying two times the amount for previous employees and the number was growing.

Mr. Bartel acknowledged the growth and noted the expectation was the growth pattern would not be to the scope of the recent past.

Council Member Schmid said it was important to be open with the community to provide them with what the City's obligations were so there was an understanding of when items needed to be given up.

Mr. Bartel agreed and said for that reason the percentage of the confidence level was recommended for the discount rate.

Council Member Schmid asked for confirmation the firm was recommending the 55 or 60 percent confidence level but were not recommending Option 1, 2, or 3.

Mr. Bartel said that was correct.

Council Member Schmid said the report indicated many people switched medical plans to PERSCare at the age of 65. He asked if that was where the $7.7 million came from.

Mr. Bartel said according to the study performed, Palo Alto had no active employees under the PERSCare medical plan. There were 11 percent of the retirees in PERSCare that were not yet Medicare eligible.

Council Member Schmid said there was a contract that said the City would pay the second most expensive medical plan; therefore if retirees moved into PERSCare the City would not pay.

Mr. Perez confirmed that contract was effective January 2007 and forward so any employee who retired prior to that date was eligible to shift into PERSCare at the City's expense.

Mayor Yeh asked what GASB would do beyond requiring cities to disclose what their liabilities were as cities began to see the liability grow. He asked what the timeframe would be for that information and how serious that development might be. From a legal perspective what type of authority did GASB have to draft that type of requirement.

Mr. Bartel said if Mayor Yeh was referring to the Pension Disclosure Exposure Draft it required the city to place on their financial statement the pension un-funded liability. He had been told by GASB staff they would be following-up on the requirements and the Draft would be final by June 30, 2012. He said it would be effective for Palo Alto on their Fiscal Years 2012 and 2013 budget so when the June 30, 2013 financial statement was completed he believed the un-funded liability would appear on the pension side. GASB was following-up the Draft project with an Other Post Employee Benefit (OPEB) standard.

Mayor Yeh asked when the firm looked at the majority of cities' financial situations what were the implications the liability might cause besides the rating agencies downgrading cities. Would GASB acknowledge and accept cities filing for bankruptcy or would they request them to issue OPEB or Pension Obligation Bonds to meet their liability.

Mr. Bartel said all of the rating agencies were aware of cities un-funded liabilities because they read the financial statements. He did not believe there would be a dramatic effect unless there was an agency not adequately setting money aside.

Mayor Yeh said he was aware the rating agencies had gone under scrutiny to make their criteria more transparent on how they reached the rating for the different entities. He asked if there was knowledge as to what municipalities could anticipate once their transparency was affected.

Mr. Perez acknowledged there had been concern amongst the financial groups and they had met with the rating agencies themselves without clarity. Part of the issue for the rating agencies to create a fixed pattern was the different cities were inconsistent with their liabilities and offered benefits. Palo Alto was on the upper end.

Mayor Yeh said the process appeared as through there was a grading curve created and those who were closest to the 50 percent received an A.

Mr. Perez noted many of the municipalities were on different reporting cycles and it was mentioned having a majority on the same reporting cycle created a smoother comparison for the rating agencies.

Mayor Yeh suggested adding a separate line item to the budget process reflective of the health of the ARC showing where the City was in paying down the un-funded liability. Having the information readily available to Council would provide flexibility in decision making with the competing priorities requesting funds.

Mr. Bartel noted the recommendation and understood there should be a range and a projection of how the un-funded liability would react as time passed.

Mayor Yeh agreed on the understanding and noted as the valuation was completed every two years it could be a continuous update reflective of market performance.

Council Member Klein asked why the interest rate remained the same on the liabilities as it did with the investments. As time went on and a person wished to reduce their payments they would refinance the loan and reduce the interest rate.

Mr. Bartel rephrased the question for accuracy; as there was an un-funded liability of $133 million, if that amount could be borrowed at five percent, would the City not be better of borrowing the money at five percent giving it to CalPERS and have them earn their higher rate of return so the City was only paying five percent on the debt.

Council Member Klein said that was one way of looking at the situation but not what he was referring to. His thought was moving forward using a number other than what was suggested by the firm of 7.6 percent for the annual payment.

Mr. Bartel said the 7.6 percent was based on the probable lost opportunity the City would have had if they contributed.

Council Member Klein asked why they could not consider the 7.6 percent as an unrealistically high number on the liability in the same manner as a bank earned money on the arbitrage.

Mr. Bartel clarified when a discount rate was being used whether it was at 7.25 percent or 7.61 percent and the decision was to contribute $1 million less it was looked upon as a lost opportunity to earn that percentage of interest.

Council Member Klein disagreed with the mathematics because people frequently borrowed at one rate and received an investment return at a different rate.

Mr. Bartel said if money was borrowed at a lower rate of return, contributed the money to CalPERS and expected to receive a higher rate of return was considered an interest arbitrage. He understood there was a chance the City may come out ahead in that situation; however, there was no certainty.

Council Member Klein stated he was not suggesting the City borrow their full debt amount but rather borrow on a year to year basis.

Mr. Bartel asked who the lender would be.

Council Member Klein was not certain who the lender would be.

Mr. Bartel said the lender mattered because if the City was not making their contribution to the plan but borrowing from the plan it did not make financial sense.

Council Member Klein corrected borrowing the money from the recipients or the beneficiaries of the plan not the plan itself.

Mr. Bartel stated by borrowing from the plan what was happening was the amount being borrowed was not earning the highest interest rate.

Council Member Klein disagreed, he felt borrowing the money and using the arbitrage method would benefit the plan.

Mr. Bartel said any money not contributed to the plan or borrowed from the plan was not earning interest under the plan.

Council Member Klein said he would be earning interest because the money would be invested.

Mr. Bartel gave an example of the City owing $1 million each year from today. The valuation valued the $1 million discounted at 7.25 percent making its actual value $930,000. There were two choices 1) put $930,000 into CalPERS today or 2) put $1 million into CalPERS one year from today. Either of those options would earn the City the 7.25 percent interest. His understanding of the recommendation by Council Member Klein was the City was not going to contribute the $930,000 and was going to pay 4 percent interest on the $930,000 and somehow that transaction would accumulate to $1 million.

Council Member Klein presented the situation as the City owed $1 million; the question was how much would that $1 million grow to in a year at 7 percent and why was it not calculated in the same manner as when an individual borrowed money from a bank.

Mr. Bartel said the misunderstanding was the money was not being borrowed from anyone, so the analogy did not work. The reality was the City was borrowing money from the plan. The plan was saying if you want to use an expected return of four percent than the un-funded liability would be substantially higher because there was going to be less interest earned.

Council Member Klein said the bank was a potential lender.

Mr. Bartel said that was correct, or there was someone who would loan the City the money at a reasonable interest rate.

Council Member Klein was aware with the City's current credit rating an amount of money could be borrowed at a four to four and a half percent interest. The benchmark was if it was necessary to borrow money, it was possible to do so at an amount substantially less than the discount rate being used.

Mr. Bartel noted four percent was a tax advantaged interest rate so if there was money borrowed against the debt he did not believe it could be at a tax advantaged rate. The City could not receive the arbitrage unless they actually borrowed money from a lender. The caveat was if the money was borrowed and contributed to CalPERS there would be a significantly greater than zero risk that CalPERS investments would earn less than what was being paid on the debt service.

Council Member Klein agreed there would always be a risk with arbitrage.

Mr. Bartel said the issue became whether the risk was an appropriate one for the City and the taxpayers.

Council Member Holman asked as the City looked forward at increased medical costs and rates of returns that were less how municipalities would look at addressing retiree benefits.

Mr. Perez acknowledged Staff needed to continue to review ways in which to reduce the expense. The trend data from 2002 to 2008 for the City doubled the medical payment for current citywide health care without the additional cost to pension. He agreed that route was not sustainable and he noted the national average according to the Kaiser Study http://ehbs.kff.org/, in terms of employer/employee cost sharing was 70/30 whereas Palo Alto was achieving a 95/5 for miscellaneous and 90/10 for fire fighters. He added there was a significant reduction in cost when PERSCare was eliminated for the equation.

Council Member Holman felt it was important for the pubic to be informed that any changes in the cost of healthcare was not without difficulty and there were limitations the City had to abide by.

Council Member Shepherd discussed how municipalities were explaining and handling their un-funded liabilities. She was interested in a better understanding of how to roll out the liability a little longer in order for the City to be more frugal with its cash flow. She was aware there was $34,000 placed in the CalPERS Irrevocable Trust and asked if those funds would always belong to Palo Alto.

Mr. Perez said the City would carry the risk of investment but the funds would remain the property of Palo Alto. The funds could be pulled out by the City at any time as well as added to in the future.

Council Member Shepherd asked how much medical plan flexibility was available at retirement or was it scripted when employees were hired.

Mr. Perez said his understanding was there could not be changes made to current retirees. For those hired after 2004, where changes were made such as the vesting period and PERSCare, the employee could choose to pay the difference out of pocket.

Mr. Bartel corrected the firm was not saying the City could not change it for current employees. They were saying they were not expecting Palo Alto to make that change to the benefits.

City Attorney, Molly Stump noted the retiree medical issue was an area still in its infancy although the California Supreme Court issued a decision late 2011 clarifying benefits to retirees could be vested dependant upon the language in the various agreements, facts, and circumstances in which the employees received their benefits. The courts left open for discussion to some degree the question of medical benefits to be paid upon retirement to current employees.

Robert Moss expressed his initial reaction to the amount of money the City was committed to spend for healthcare which was only a portion to the total cost of retirement. The un-funded liabilities depended in large part on assumptions, which tended to be adjustable and the manner in which CalPERS invested the funds. He predicted there would be a rise in healthcare costs of approximately 6.5 percent annually except with programs such as Kaiser. He suggested capping the cost the City was willing to pay thereby reducing the overhead cost and swaying employees to accept the lower cost medical plan.

Council Member Espinosa said Mr. Bartel had mentioned if his firm was to have a conference with the Milliman Actuarial firm there would be similarities in the manner in which the assumptions were reached. He asked for clarification on the areas where Milliman would disagree with the Bartel firm.

Mr. Bartel believed Milliman would agree with his firms' assessment of the Confidence Level although he supposed in their report they would have used a 7.61 percent for the discount. He suspected they would disagree with the medical trend numbers. He expected they would have matched the new CalPERS demographics numbers, and they would have agreed with the $3.4 million actuarial load but it was unlikely they would have implemented the assumption. There was no doubt if they looked closely at the demographics of the medical plan at retirement they would agree with the change similarly to the Medical eligibility. They clearly had a different view on the amortization where they would have accepted a rolling 30-year.

Council Member Espinosa asked how the information was being presented to Staff across the City and to retirees assisting them in understanding the broader context of the challenges the City was facing.

Mr. Perez said Staff had presented the City Manager with draft presentation slides regarding a similar discussion. There had been questions on how the un-funded liability grew to the extent it had and doubled in a matter of four years. It was important to have the discussion regarding the pension and healthcare, how those rising costs affected the budget and the consequences to the services offered throughout the City.

City Manager, James Keene said over the past couple of years Staff had been shown charts reflective of the trajectory of the increases.

Mayor Yeh asked for confirmation that absent any Council action Staff would be returning at Mid-Year with a Budget Amendment Ordinance to increase funding the ARC by $2.3 million for the General Fund and potentially $1.5 million for the Enterprise Fund. However, if Council wished to take action the options were 1) accepting the minimum resulting in growth in the un-funded liability, 2) holding the un-funded liability steady, or 3) a 30-year closed amortization.

Mr. Keene mentioned there was a scheduled action at the Mid-Year although technically the adjustments did not need to be reconciled until before the end of the Fiscal Year. He explained no matter the Motion provided during this meeting or at the Mid-year, Council had some flexibility after the fact.

Mr. Bartel wanted the Council to understand a 28 year amortization was paying in the initial period less interest. The interest only option increases your contributions. Under that scenario the numbers for the ARC would increase.

Mayor Yeh said in preparation for the Mid-Year and the budget decisions it would be helpful if the Council received the data numbers indicated from the Milliman low to the Bartel high with the spread in between.

Mr. Bartel asked for clarification if the question was how much work would be required to supply those numbers.

Mayor Yeh clarified his interest was to receive a definite number and its meaning if the Council chose the interest only option.

Mr. Bartel said his firm could provide any of those calculations but he was still uncertain as to what was being requested. He noted the numbers provided to the Council and City Staff in the presentation were the firm's best estimations for the liability and contribution and they did not think in terms of minimum or maximum. He mentioned if the City paid interest on the un-funded liability, the ARC would be higher than what was being presented. In the range of order it could be considered the Milliman minimum or the Bartel best guess and the no-negative amortization as being an upper limit on the short term contribution.

Council Member Klein was troubled by Council considering Motions considering neither the agenda nor the Staff memo requested one.

Ms. Stump stated Council had a reasonable amount of flexibility in the term providing feedback.

Mayor Yeh clarified there was leeway for a Motion as long as it stayed within the confines of the discussion.

Ms. Stump agreed the parameters laid out were appropriate to be included in a Motion.

Council Member Klein felt there was not fair notice given to the public or Council itself to make a decision on the numbers involved.

Mayor Yeh noted his position was for Staff to return with more analysis and not to take a firm position.

Ms. Stump said her advice was predicated that the Motion would request for additional information and not for Council to be making a decision or adjustment to the ARC itself.

MOTION: Mayor Yeh moved, seconded by Council Member Shepherd to direct Staff to return with additional analysis conducted with the consultant for the different levels of the ARC contributions for the nine different assumption areas for the February 28, 2012 Finance Committee.

Council Member Shepherd understood there was no boiler plate to the assumptions and liabilities although it was being worked on. She hoped in time there would be a smoother manner in which to go about making these decisions. She felt it was important to have the ranges brought back prior to the Mid-Year.

Council Member Schmid asked for clarification on the Motion; it was for Staff to return to Council with variations.

Mayor Yeh stated the Motion was for Staff to work with the Consultant to achieve the costs for the additional analysis.

Council Member Schmid said the value of the report before them and the discussion during the meeting was having an independent Actuary inform the Council on what his considered opinion was on what Palo Alto may face in the future. He wanted to ensure the Motion was not requesting any modification of the independent report.

Mr. Perez agreed the report had been previously approved by the Council and the work being brought back to the Council was in addition to and not an alteration to the report from the independent consultant.

Council Member Schmid said if Council did not agree with the numbers, it was something that should be stated publicly and work with the employees and public about the consequences.

Vice Mayor Scharff asked for clarification on the proposed Motion language “working with the Consultant for costs for additional analysis.” His interpretation of the Motion was returning to Council with additional analysis not costs for additional analysis.

Mayor Yeh clarified there would be a cost associated with the additional analysis so the Motion should be corrected to read: to have Staff return with costs for additional analysis conducted with the Consultant.

Mr. Bartel said the Mayor had suggested for future valuations to include a range of contributions. He agreed and recommended that should be done in conjunction with the impact that range would have on future un-funded liability. He asked if that information was the intended information being requested or were the ranges being sought strictly for the range of ARC.

Mayor Yeh said his desire was what type and amount of information could be compiled by February 28, 2012.

Mr. Bartel explained both models with the ranges could be turned around by February 28th.

Vice Mayor Scharff felt the Motion should read as followed: to have Staff return with a band of costs setting forth the different assumptions to fund the ARC.

Mayor Yeh concurred that was the intent of the Motion.

Vice Mayor Scharff understood Council was receiving the additional information because they wanted to make a determination on how much to fund the ARC. Council's decision to fund should be based on the best information provided on the assumptions. If the Motion was for additional analysis without a final report to reflect the decision that came from the additional information, he did not see the necessity of the additional information.

Mr. Bartel said if Council requested his firm to prepare a report using the 7.61 percent discount rate, he would inform them that would not be his recommendation. His interpretation of the Motion was not a change in acceptance of the report but a request for more information so the Council could make a future decision as to whether or not to rescind the acceptance and request the report be redone.

Vice Mayor Scharff said if a decision was made to rescind the acceptance of the report based on the additional information that would lead to redoing the report. He noted his understanding of the Bond Rating was the report was reviewed to verify it matched up with the contribution.

Ms. Stump clarified rescinding the report was not on the agenda and would not be an appropriate action during this meeting.

Council Member Burt asked for clarification if the City chose the option of the full payment of the interest.

Mr. Bartel clarified the 28-year amortization had no payment on the principle amount; the payment effecting the principle began once there was less than 20-years remaining on the amortization.

Council Member Burt said the dollar amount the City would pay in the initial years would actually be higher if they switched to the interest only alternative rather than if the City was paying down the principle on a 28-year amortization.

Mr. Bartel stated yes but there was no payment going towards the principle for a minimum of eight years on a 28-year amortization.

Council Member Klein said there were more than three options since there was no required payment amount. The Actuary recommended three options for the Council but those were not the only options available. He thought the information requested in the Motion was included in the report and Staff merely needed to extract it and enter it into a separate sheet.

Mr. Bartel noted the impact on the ARC was not included in the report. The report covered the impact on the un-funded liability.

Council Member Klein believed he heard several numbers discussed throughout the meeting regarding what would lower the ARC.

Mr. Perez said that was correct. Staff had derived numbers outside of the report such as the 30-year open amortization.

Council Member Klein argued the numbers were readily available if they had been discussed in the meeting so his confusion was why the report needed to be re-written. He requested a small report showing the five or so differences in the dollar amounts with the ARC.

Mr. Bartel said the clarification he needed was whether Council wanted to know in addition to the difference in the ARC what the impact in the un-funded liability would be as time went by.

Mayor Yeh clarified the value of having the additional information was the Council would have a greater certainty of the impact on the un-funded liability within the two-year timeframe before the next Actuary Report was produced. There was a budget being prepared for the upcoming Fiscal Year. Ultimately he was confident in the decision made met GASB requirements. The reason the interest only options was provided was because it was a policy goal of keeping the un-funded liability at a constant. The question was did the interest only payments achieve that goal or were there other payment streams that would not surpass it.

Mr. Bartel agreed the interest only payment method did achieve that goal. If the policy goal was to not have un-funded liability grow, the answer would be over the next eight years using the 28-year amortization method would be contrary to the policy.

Mayor Yeh agreed, with the explanation it did not make sense to include the interest only method. The two numbers in question were 1) the low at $9.8 million which was what had been formerly budgeted for the contribution for the Fiscal Year 2012 as recommended by the Milliman Group versus 2) the $9.8 million plus the $2.3 million under the new actuarial analysis, that was the band and both were GASB compliant. As Council Member Klein noted as long as there was a range of numbers the Council could make their decision.

Mr. Perez was aware the $9.8 million needed to be higher to fund the ARC but the question was to what degree.

Mayor Yeh said if Staff knew the $9.8 million was not sufficiently high was Council comfortable to choose a number that Staff was now planning to bring back.

Mr. Perez noted Mr. Bartel had said he had presented his level of recommendation and did not recommend a change.

Vice Mayor Scharff felt the current Motion provided the framework for an intellectual decision. He agreed with a brief report with the additional numbers would be sufficient unless Staff believed more was needed to meet with the Bond Counsel.

Mr. Perez said the steps being outlined did not reflect concern with respect to the rating agencies. If the Council were to make substantive changes then there may be cause to revisit.

Council Member Shepherd stated it appeared to her that each one of the differentials from the Milliman Report had a value for the ARC that could be easily distributed to review the out of pocket expense.

Council Member Schmid asked Staff to provide the most straightforward response to what the City's liability was on future medical benefits.

Mr. Perez said in order to reach the truest number he would take the actuarial load, which could be lowered a couple of percentages. Mr. Bartel may not be comfortable lowering it more than two percent.

MOTION PASSED: 8-0 Price absent

COUNCIL MEMBER QUESTIONS, COMMENTS, AND ANNOUNCEMENTS

Mayor Yeh reported on attending the Northern California Power Agency meeting. The NCPA advised they refunded hydro bonds and the City achieved a savings rate of 10.6 percent.

ADJOURNMENT: The meeting was adjourned at 10:12 P.M.