City of Piedmont
Budget Advisory & Financial Planning Committee

June 4, 2012

Mayor Chiang and Piedmont City Council:

We are pleased to present our analysis of the 5 year projections in the draft 2012-2013 Budget presented to City Council on May 7, 2012, as well as some thoughts and suggestions on steps to improve the financial risk profile of the City. Specifically, in this memorandum, we briefly compare the projections to the 2011 Municipal Tax Review Committee (MTRC) projections, provide some general and specific commentary about the risks we see to achieving them (with background information attached in addenda as needed), and suggest some courses of action to reduce the financial risks facing the City. Our objective is not to opine on the accuracy of the projections, but rather to (1) understand and provide comment to the process of preparing the projections, (2) evaluate the reasonableness of assumptions, (3) determine which areas present more risk (in the opinion of the Committee), and (4) provide more analysis for those areas. Overall, we feel the projections are reasonable (subject to a series of risks we discuss further below), based on the information available today, with two significant caveats; the sewer fund and its likely negative impact on the General Fund, and the uncertainty relating to future CalPERS retirement and healthcare payments. Additionally, we were not asked at this time to evaluate contingencies in the event the Municipal Services Tax ("parcel tax") was not passed at the ballot, and we made no attempt to create a viable set of expense assumptions matching the reduced revenues without the parcel tax.

In preparing this memorandum, the Committee met several hours each week with Mayor Chiang and Mark Bichsel and other City staff. We received presentations about various budget line items and their history, and we asked for additional information about certain budget categories, bringing in third party experts as needed. The assumptions for the projections were derived with significant input and influence of the Committee in cooperation with staff. Although the Committee spent considerable time in the areas discussed further below, given the short timeframe, we did not focus on certain items that did not appear to present substantial risks based on the experience of the City. Those areas of lesser focus include non-property revenues, workers comp and liability insurance, litigation costs, and non-employee related costs. Nor did we investigate staffing and service levels, but instead assumed the full staffing model presented. In general, we undertook to understand the risks to city finances from the existing programs and services rather than attempting to identify service cuts or efficiencies.

One item to note concerning the modeling of the projections: as a modeling convention only, the projections were initially prepared assuming flat salaries for five years, with all projected increases to benefit costs being paid for by the City out of the General Fund. The Committee would have liked to change that convention, given that salaries are unlikely to be flat for 5 years (see below on Salaries), and the City is completing negotiations on staff contracts in which benefit cost increases are being divided between the City and staff. The Committee would have preferred to be able to model salary and benefit projections on a more granular basis, with various assumptions regarding employer and employee

contributions to benefit costs, but there wasn't time to create such a detailed model for this year's report. Overall we felt the results shown in the projections are reasonable despite the modeling convention used, assuming benefit cost increases picked up by the City do not rise faster than forecast.

Municipal Tax Review Committee Projections

Addendum 1 provides a summary comparison of the MTRC "base case" projections versus the recently provided 5-year projections. The projections differ primarily in the initial year in that actual 2010-2011revenues were $386k higher and expenses were $805k lower than the MTRC projections; combined with $323k higher net transfers compared to MTRC, these differences led to an actual ending fund balance in June 2011that was $868k higher than MTRC projected. The current projections and the MTRC model use slightly different growth rates in revenues and expenses over the term - our projections use slightly higher revenue growth and slightly lower expense growth assumptions than the MTRC model. In both projections, revenue growth was projected to outpace expense growth, but the fact that the City actually started with a positive net of $868k versus the MTRC projection of only $37k results in a total revenues less expenses over the term of the projections that is $6.8 million higher ($3.8 million higher revenue and $1.8 million lower expense and $1.2 million less in net transfers). The result is an overall increase in projected General Fund balance over the period of about $6.8 million, leaving a *positive* ending fund balance of over $4.5 million (not including the projected sewer fund deficit) versus the MTRC projected ending fund balance of a *negative* $2.2 million.

One brief note on capital transfers: The MTRC proposed $1.3 million of total capital annually for facilities maintenance, roads and parks, and equipment and showed it all coming from the General Fund. The current projections show $1.25 million annually - $900,000 from the General Fund and $350,000 from Measure B directly for resurfacing, curbs, etc. Also note that a small error exists in the last page (12) of the 5 Year Projection tab in the recently presented projections. The schedule shows $950,000 of transfers from the General Fund, but the actual projections only show $900,000.

Findings

After reviewing the history of the General Fund and the various assumptions included in the projections, we have highlighted several areas of risk to achieving the projections and discuss them below. Although most of these areas represent risks of higher expenses or lower revenues, the Committee did feel that there were some areas of potential upside in terms of higher revenues or lower costs, but decided to focus at this time on the items that posed more negative financial risks.

Impact on General Fund from the Sewer Fund – Addendum2 provides background and information about the financial requirements and issues surrounding the Sewer Fund. Of primary importance is the financial shortfall expected in the fund and the likely adverse impact it will have on the General Fund. Current projections, assuming no new sewer revenues, result in a Sewer Fund ending balance of *negative* $118k. Clearly this is not a reasonable projection as the Committee felt that a minimum Sewer Fund balance of $1million is the minimum required for prudent operations of this critical system. Without increased sewer revenues, it is unlikely the City can fully fund the proposed capital items for

equipment and facilities replacement currently projected, as money will certainly have to be diverted to the Sewer Fund.

Property Revenue Assumptions – A significant part of the City's revenues comes from the Alameda County Property Tax and the Real Property Transfer Tax, which together are estimated to provide $11.85 million in revenue in FY12, representing 57% of revenues. In the projections, the Property Tax revenues are projected to grow at a 4.5% rate, which is somewhat below the 30-year average of over 6% but slightly above the more recent 5 year average of 3.7%, hopefully resulting in a conservative revenue projection.

The Transfer Tax is levied at $13 per thousand of the value of the real property at the time of the transfer, and collections have been very volatile over the last 30 years, ranging as high as $3.3 million and as low as $1.7 million in the last 10 years. The projections assume the amount collected will remain steady at an average amount of $2.6 million. The amount collected is very dependent on the number and average price of properties transferred in a given year and the Committee agreed with the MTRC that a level average amount collected, with surpluses assumed to be set aside to offset "lean" years, was a more prudent assumption going forward.

Parcel Tax Impact – As the MTRC noted, particularly given the rising cost of employee benefits, in recent years the parcel tax has become an essential part of the City's budget, accounting for approximately $1.6 million annually, about 7.5% of total revenues. The 5-year projections include a scenario without the parcel tax, resulting in a reduction of about $8.5 million in City revenue over the 5-year period. This would wipe out the General Fund reserve in FY 14/15 and result in a combined $4 million shortfall through FY 16/17. By contrast, if voters renew the parcel tax and the Council levies the full amount with a 3% annual inflator, the projections show a positive and growing General Fund balance that reaches 21% of annual expenditures by the end of the 5-year period. (Note: no transfers out to the Sewer Fund are assumed in these General Fund projections).

The Committee concludes that if the parcel tax renewal measure on the November 2012 ballot fails to achieve a 2/3 majority, the Council will need to continue to place parcel tax measures before the voters or face the unpleasant prospect of having to make unprecedented cuts in programs, staffing levels, employee benefits, and capital expenditures.

Salaries – As noted above, the projections used a modeling convention that initially had salaries remaining flat over the period but had all benefit cost increases paid for by the City. The Committee felt that holding salaries flat over 5 years was not realistic. The projections were changed to reflect flat salaries for 2 years and growth at 2% annually thereafter. It is worth noting that the salaries line item assumes full staffing at current pay levels 100% of the time over the five year period. It does not account for routine turnover vacancy and retirements, which could lead to actual salary costs coming in below projections.

Retirement Contributions –The City provides a defined benefit plan for its employees, and, although the actual retirement benefits to employees have not changed for some time, the cost of providing those benefits to employees has risen significantly, in the case of Safety employees from 32% of salary to 44% in the coming year. The reasons for the increase are primarily driven by CalPERS investment history and other demographic issues within the funds. As addressed by the MTRC, the issues are two-fold; one, the benefit provided is very generous, and two, the cost is completely out of control of the City and subject to both investment returns and pool demographics. Although the City has taken steps to reduce the risk of further cost increases by negotiating a cap on the amount the City contributes, the fact that the labor contracts only last a short while and the absolutely uncontrollable nature of the costs from CalPERS subject the City to considerable risks.

The City engaged an actuary to provide assumptions of the impact on CalPERS retirement contributions with hypothetical investment rates of return at and below those assumed by CalPERS (7.5%). Even assuming CalPERS hits the 7.5% return over the next 5 years, the required cost for safety personnel rises from 42.2% of salaries this year to 47.2% in FY17. The projections conservatively show these costs as being paid by the City per the modeling note above, but current contract negotiations provide that these increases would be passed on to the employees, thus providing some upside to the projections. It is important to note that the actuary also calculated estimated contribution rates using historically conservative investment returns ranging from 0.2% in FY13 increasing to 3.4% in FY16; these hypothetical returns would result in contribution rates for safety employees increasing to 54.0% of salaries in FY17 from 42.2% today and costing the General Fund $650k over the projection period. The impact from the lower investment returns on the Miscellaneous employee retirement benefits would be an additional $200k over the projection period if the City paid the costs.

Addendum 3 provides a more complete discussion of the factors affecting contribution rates and the current funding of the CalPERS plans. One positive note is the current impact from the "Side Fund" amortization (see Addendum 4 and further comments below), which represents almost 40% of the safety retirement fund contribution and 32% of the Miscellaneous employee retirement contribution, will be complete in10 years. At the completion of the amortization, contribution rates will, all other things being equal, decline substantially and save the City approximately $1 million at current rates.

It is important to note that the factors affecting retirement plan contribution rates are varied and complicated. The actuarial analysis assumed only changes in investment returns, but is also dependent on salary increases, pool demographic composition and experience, as well as political decisions made in the future. The Committee feels it is important to continue to study the various impacts on retirement contributions, particularly as it relates to pool demographics.

Healthcare Contributions –The City pays for healthcare for retirees, the cost of which has been growing steadily over the last few years. Although the City has provided this benefit for several years, Assembly Bill 2544 made effective in 2008 – combined with the issuance in 2009 of Governmental Accounting Standards Board Statement Number 45, Fund Balance Reporting and Governmental Fund Type Definitions – led to a substantial increase in healthcare liabilities for the City. The new law required the

City to increase the amount it contributed to retiree healthcare to provide "parity" between active employee and retired employee contribution rates – i.e., the City was required to pay more of the healthcare costs of retirees. The projections show funding costs as incurred for retiree healthcare of $186k per year, growing at 7%, plus an additional $300k per year to fund a healthcare trust to help pay for future obligations. However, even with these funding levels, the retiree healthcare costs are not being covered on an actuarial basis, representing further risk to the City. In 2009, the City engaged an actuary to estimate the cost of the future healthcare liability as it stood in 2009 and the actuarial cost going forward. According to the actuarial report, the City would have to pay approximately $1 million dollars annually to have enough money set aside just to cover current liabilities that are accruing for current service. In addition, the City has a liability for past service (somewhat similar to the side fund for retirement) of approximately $12 million and funded assets in a trust of only $2.5 million, resulting in an unfunded liability of $9.5 million which is growing by over $500k per year.

As a result, the total costs assumed in the projections are inadequate to satisfy "actuarially" the full costs of providing retiree healthcare, which poses substantial economic risks to the City long term. As somewhat of an offset, the City has a separate Police and Fire Pension Fund for employees who retired prior to Piedmont joining CalPERS in the early 1980's. This fund is substantially over funded by several million dollars and could be used to help reduce the unfunded retiree healthcare liability over time.

Employee Demographics and Turnover Impacts – As the City Administrator pointed out in his budget message, the City faces the likelihood of substantial turnover in the next 5-10 years, as over 40 of the City employees are likely to retire. The City has historically recruited more experienced employees mid-career who transfer over and maintain their prior high level retirement benefits. Given that the City is on a path to lower its retirement benefit with the new two-tiered structure, it is reasonable to assume that mid-career transfers who have the higher pension benefit would be less likely to switch jobs to Piedmont and take a lower retirement benefit. Thus the two-tier system could reduce the likely pool of candidates available and put pressure on Piedmont's ability to hire experienced employees. Council should develop contingency plans for what could be a significant demographic shift.

The demographic shift not only in Piedmont, but statewide, could also have unforeseen impacts on CalPERS and retirement contributions. As discussed in Addendum 3, CalPERS amortizes any shortfall in investment performance over a rolling 30 year period. This amortization implies that people will be leaving and joining the retirement system on a continuing basis. If in fact more people retire than enter the pools (which is likely to happen to higher-benefit pools given the increase in the use of two-tier systems), the amortization of investment shortfall will likely never catch up, creating a bigger and bigger problem down the road for employers that have employees in the shrinking higher benefit pool.

Potential Refinancing of the Retirement Side Fund – When the City enhanced the retirement plan for employees on a retro-active basis, the City incurred an immediate unfunded liability for the benefits attributable to prior years' service. The balance today of this liability is $8.5 million in aggregate for safety and miscellaneous employees. Under the terms of converting to the higher benefit plan, the unfunded liability must be paid down over a 20 year term which has 8 years remaining for the Safety

employees and 10 years for the Miscellaneous employees. CalPERS is currently charging an interest rate of 7.75%, which results in over $11.6 million in future payments by the City (of which over $3.1 million is interest).

The City has the option of discharging the liability by making a one -time payment to CalPERS equal to the principal amount of the unfunded liability. The City is considering funding this payment by selling a bond, which could allow for a lower interest rate, potentially saving the City $1 million in interest over the 8-10 year term. The Committee is in favor of pursuing the bond refinancing from a financial standpoint, but the issue has complications that would need to be investigated further. The current projections do not assume refinancing this liability.

Overall Capital Transfers – The 5-year projections include transfers out from the General Fund to the Facilities Maintenance Fund and Equipment Replacement Fund totaling $900,000 annually. Together with the Measure B funds that the City expects to receive, the projections anticipate capital investment of $1.25 million per year. Although not an exact match, this funding is in line with the amounts suggested by the MTRC as fiscally prudent. The amounts fund all expected equipment replacement needs based upon projected useful lives of the City's equipment stock while still maintaining an adequate ending fund balance. In addition to equipment, $450,000 annually would go into the new Facilities Maintenance Fund for major projects as recommended by the MTRC. The City should undertake to develop a long-range replacement/maintenance plan for City facilities to "prove up" the right level of funding long term.

It should be noted that any unexpected increase in expenditures or fall in revenues, failure to renew the Parcel Tax, and /or failure to increase the Sewer Tax will likely lead to the City not funding capital needs at the projected levels. However, on a positive note, if taxpayers approve the transportation sales tax measure on the November 2012 ballot, the City could get approximately $340,000 annually beginning in FY 13/14 in additional Measure B money for roads and other transportation improvements.

Aquatics Issues – City operation of the swimming pool, beginning in FY 11/12, has led to past and anticipated ongoing costs to the City, despite the admirable goal, supported by this Committee and the MTRC, of making pool operation revenue-neutral. Expenses and revenues associated with the transition, potential staffing changes, and incomplete data from less than a full year of City operation, make forecasting a challenge. The 5-year projections, based on the draft FY 12/13 aquatics budget, assume ongoing program expenditures for staffing, management, operations and facility maintenance that are offset only partially by aquatics revenues from gate fees, lessons and pass sales, resulting in an estimated annual General Fund subsidy of $200,000. This figure includes a $50,000 annual allowance for capital expenditures for likely facility maintenance needs, which the Committee has not reviewed.

Potential budgetary liabilities associated with pool operation include lower than anticipated pass sales, higher than anticipated capital and maintenance costs, and potential future capital expenditures for a new or expanded swim facility. Future policy changes in pass structure and pricing could have either a positive or negative effect on pool revenues, depending on pass sales and pool usage. There is also a

potential fiscal upside from new or revised cost-sharing agreements with pool user groups such as the Piedmont Unified School District, which currently does not pay for pool use, and the Piedmont Swim Team.

Suggested Courses of Action

Given the analysis to date and the risks identified above, the Committee had several suggested courses of action for the City Council to consider that may help to reduce financial risks in the future.

Sewer Fund

1. Additional analysis of sewer needs/projects should be completed in preparation for a new sewer tax surcharge, including exploring alternative structures for the sewer tax that provide more transparency, such as a tax dedicated to sewer replacement projects and their debt service rather than just increasing the existing tax.
2. Given the availability of low cost state loans for sewer replacement, the City should continue with the long term sewer replacement plan, initially with an alternative "5a" phase focusing on known problem spots as opposed to entire sub-basins. One hundred percent of the cost (including soft costs) can be financed; however, because of a timing delay in the receipt of the loan proceeds from the State, the City will need to pay for soft costs such as engineering and planning, and be reimbursed when the loan closes.

Pay, Pensions, and Benefits

3. The City's pay and benefit structure is unsustainable. The average total annual cost to the City per full time safety employee exceeds $180k, including salary, current benefits and retirement benefits. The "defined benefit" retirement and health care benefit system provided through CalPERS continues to be an uncontrollable risk to the City's financial well-being. Historically, benefits and pay have increased in good times and have not been rolled back in bad times. The result is the City has pay practices which are high, uncontrolled, and structurally set up only to increase. The very nature of CalPERS' pension and retirement benefit accounting results in costs being hidden and deferred. Further, the City is at the whim of not only CalPERS policy and investment practices, but also demographic issues with other pool participants, as well as legislative actions taken by the State that are completely outside of our control. Between the funding status of the current CalPERS retirement plans, the side fund, and the unfunded healthcare retiree benefits (as enhanced by State law), the City has unfunded liabilities relating to benefits of almost $40 million – or over $400k per full time equivalent employee – which continue to grow. The Committee notes for the first time the City Council has taken action to address the growing uncertainty stemming from employee compensation. A recent agreement on a two-tier retirement plan and a "cap" on City contribution percentages at very high levels does not address the long term nature of the structural issue of promising benefits that can't be adequately priced and paid for today.

   The Committee strongly suggests the City undertake a longer-term study of pay practices with the goal of removing defined benefit practices in favor of defined contribution pay practices.

The Committee recognizes the significant political and legal considerations involved. The Committee strongly recommends evaluating thoroughly the long-term future consequences of any changes to pay practices, in order to avoid both incurring unknown, unfunded liabilities and making commitments to employees that the City may not be able to meet.

4. Given any change in benefit plans going forward for new safety employees, and the high proportion of Piedmont safety employees nearing retirement age, it may be more challenging for the City to hire new mid- to high-level safety employees to replace retirements in the near term, as potential employees may not transfer mid-career to Piedmont with the lower benefit programs. As a result, Piedmont should prepare for potential hiring delays and investigate other steps or other sources of new employees.
5. Given today's low interest rates, the City should further investigate refinancing the side fund by issuing a bond, potentially saving $1 million over the next 10 years and fixing the annual cost of removing the liability.

Capital Transfers

6. The City should develop a long-term facilities maintenance plan to identify and prioritize facilities replacement needs and help determine long-term capital funding requirements, as it does currently with its equipment maintenance plan.
7. Given the uncertainty around the Sewer Fund tax surcharge and the capital needs, the City should attempt to transfer any increases in the transfer tax above the projected average into capital funds to prepare for years with lesser transfer tax revenues.

Other Items

8. Staff should include an annual ending balance projection for each of the major funds over the five-year period to better understand the resources the City has available over the projection time frame.
9. In the future, the projection model should have additional flexibility to model salaries and benefits on a more granular basis to account for potential step rate increases, retirements, turnover, etc.

The Committee would like to especially thanks Mark Bichsel, City Finance Director, for all of the education and effort he and his team have provided to the Committee.

With this report, the Committee has concluded its work for now, but stands ready to reassemble as required by the City Council to further study and advise on these or other issues.

Respectfully Submitted,

Piedmont Budget Advisory and Financial Planning Committee
Mary Geong, Steve Hollis, Bill Hosler, Tom Lehrkind, and Tim Rood

Addendum 1 - Comparison of Current Projections With MTRC "Base Case"

	FY 10/11	FY 11/12	FY 12/13	FY 13/14	FY 14/15	FY 15/16	FY 16/17	Total FY11-FY17
1. MTRC Projections								
Beginning Fund Balance	2,194,122	2,232,083	1,869,791	864,911	(52,855)	(876,186)	(1,597,413)	2,194,122
Revenues	19,952,131	20,103,281	20,579,189	21,258,083	21,964,138	22,698,499	23,462,363	150,017,684
Expenses	19,259,295	19,809,934	20,062,317	20,623,662	21,204,238	21,804,831	22,426,262	145,190,539
Net Operating Transfers	45,125	(305,639)	(415,752)	(424,067)	(432,549)	(441,199)	(450,023)	(2,424,104)
Capital Transfers	700,000	350,000	1,106,000	1,128,120	1,150,682	1,173,696	1,197,170	6,805,668
Net	37,961	(362,292)	(1,004,880)	(917,766)	(823,331)	(721,227)	(611,092)	(4,402,627)
Ending Fund Balance	2,232,083	1,869,791	864,911	(52,855)	(876,186)	(1,597,413)	(2,208,505)	(2,208,505)
Revenue Growth		0.76%	2.37%	3.30%	3.32%	3.34%	3.37%	
Expense Growth		2.86%	1.27%	2.80%	2.82%	2.83%	2.85%	
2. Current Projections								
Beginning Fund Balance	2,194,122	3,101,066	3,009,915	2,778,990	2,796,530	3,088,094	3,670,286	2,194,122
Revenues	20,338,464	20,508,858	21,060,108	21,791,879	22,555,650	23,351,740	24,181,564	153,788,263
Expenses	18,454,031	19,733,438	20,139,247	20,514,339	21,004,9086	21,509,548	22,026,912	143,381,601
Net Operating Transfers	(277,489)	(430,610)	(251,786)	(360,000)	(360,000)	(360,000)	(360,000)	(2,399,885)
Capital Transfers	700,000	435,961	900,000	900,000	900,000	900,000	900,000	5,635,961
Net	906,944	(91,151)	(230,925)	17,540	291,564	582,192	894,652	2,370,816
Ending Fund Balance	3,101,066	3,009,915	2,778,990	2,796,530	3,088,094	3,670,286	4,564,938	4,564,938
Revenue Growth		0.84%	2.69%	3.47%	3.50%	3.53%	3.55%	
Expense Growth		6.93%	2.06%	1.86%	2.39%	2.41%	2.41%	
Difference (2-1)								
Beginning Fund Balance	-	868,983	1,140,124	1,914,079	2,849,385	3,964,280	5,267,699	-
Revenues	386,333	405,577	480,919	533,796	591,512	653,241	719,201	3,770,579
Expenses	(805,264)	(76,496)	76,930	(109,323)	(200,152)	(295,283)	(399,350)	(1,808,938)
Net Operating Transfers	(322,614)	(124,971)	163,966	64,067	72,549)	81,199	90,023)	24,219
Capital Transfers	-	85,961	(206,000)	(228,120)	(250,682)	(273,696)	(297,170)	(1,169,707)
Net	868,983	271,141	773,955	935,306	1,114,895	1,303,419	1,505,744	6,773,443
Ending Fund Balance	868,983	1,140,124	1,914,079	2,849,385	3,964,280	5,267,699	6,773,443	6,773,443

Addendum 2 - SEWER FUND

The Sewer Fund accounts for all operational and capital expenses of maintaining the City's sewer and storm drain system. The Sewer Fund is separately funded by a permanent voter-approved sewer tax. However, in the event that sewer tax receipts are insufficient to fund expenditures, the General Fund will likely have to cover any shortfall (and has so in the past). The Sewer fund expenditures are primarily made up of (1) operating/maintenance expenses, (2) ongoing general sewer projects including emergency repairs, and (3) debt service on borrowings used for capital replacement of sewer lines. New in the last year are costs spent on EPA compliance, which primarily consist of monitoring and professional services. Table 1 shows a history and projection of the Sewer Fund revenues and expenditures.

Sewer fund revenues from the sewer tax are approximately $2.1 million and increase at approximately 2% per year. The MTRC recommended a 50% increase in the sewer tax as a surcharge for 10 years, which failed to pass in February 2012. The current Sewer Fund balance is just over $1 million, which is considered a minimum level to protect the City (and the General Fund) against emergency situations. The Sewer Fund balance stood at over $2.5 million in 2008.

The Sewer fund covers many costs including annual operations and maintenance, which are predictable, and general sewer projects including emergency repair work, which are volatile and harder to predict or control. Approximately $900,000 annually is transferred from the Sewer Fund to the General Fund to cover estimated staffing costs for sewer related work. This amount has been steady over the last five years, but has increased from under $700,000 in FY06. The Sewer Fund has also been covering the full replacement of the City's aging sewer lines over time in phases (4 phases have been completed equating to about 60% of the entire system). The initial planning and engineering of these phases is funded by the Sewer Fund, but ultimately the Sewer Fund is reimbursed for these costs, as well as the actual cost of completing the replacement work through State loan pools for water quality. The debt service on these first 4 phases is now over $550k annually and is paid from the Sewer Fund. In recent years, the City has also incurred costs for EPA monitoring, and, although these costs are substantially less than originally feared, they still pose costs to the Sewer Fund.

The chart below shows the average annual revenues and expenditures of the Sewer Fund, including ongoing general sewer projects and capital repairs over the prior five years and the projections for the next 5 years.

Sewer Fund Historic and Projected Annual Averages

	Annual Average FY07-FY11	Annual Average FY12-FY16
Revenues	1,935,059	2,201,600
Operations/Maintenance	928,392	985,600
General Projects/Emergency Repairs	618,014	656,000
EPA Monitoring	0	261,340
Debt Service	447,635	532,487
Net Total	(58,981)	(233,827)
Average Fund Balance	1,630,296	389,598

As shown above, revenues are increasing (by 2% per year), while operating expenses and general projects/repairs are projected to be essentially flat. Note that the emergency repair costs are projected to average the same as in the past, but the year-to-year volatility of those costs is very high and subjects the Sewer Fund to significant annual funding risks. If the sewer fund had only to pay for operations and general and emergency repairs, over the projection period, the sewer fund balance would be growing by over $500k a year. However, two items lead instead to a declining fund balance: almost 25% of revenues are used to pay debt service on prior sewer replacement projects, which has increased by about $106k due to the recent completion of Phase IV of the sewer replacement project; and EPA monitoring costs are projected to consume over $250k per year. The effect of these two items, without increased revenues in to the fund, results in a Sewer Fund balance that declines quickly to an imprudent level of under $1 million and further to a negative balance. Notice from Table 1 at the end of this Addendum that the Sewer Fund balance has already suffered a significant decline from over $2.5 million to just over $1 million today.

So what has happened? The City has undertaken to replace the sewer system over a period of years and has been able to finance those replacement projects with low rate (2.0% interest or less), 20 year amortizing, loans from a revolving State pool. As a result, the City has been able to replace 60% of the entire system without having to save up large fund balances. However, the debt service on those loans has added up and the original sewer tax was not necessarily sized to handle the increasing debt service load.

Additionally, many years ago, a series of legal actions were initiated by Bay Area environmental groups against the jurisdictions that discharge effluent into the Bay. The ensuing negotiations were led by the EPA and culminated in a Stipulated Order committing the agencies, including the City of Piedmont, to monitor the efficiency of their sewer systems, report findings to the EPA, and develop and implement a sewer line repair and replacement plan that meets the EPA standards, all designed to limit sewer system overflow polluting the Bay. The EPA has not yet approved the proposed plan, which will be submitted in July 2012. If the EPA were to reject the plan, it could result in penalties to the City and/or amendments to the plan. As a

result, the City has taken steps (and incurred costs) to gather data and create a plan to monitor sewer flows in an effort to locate and reduce storm water entering the sewer system. The result is higher ongoing costs in the near term for monitoring and fulfilling a compliance plan, which were never anticipated in the original structuring of the size of the sewer tax.

Piedmont's compliance proposal to the EPA is based in part upon continuing the timely completion of its existing long-term replacement project. With the rejection of the increase in the sewer tax in February 2012, the City has temporarily halted the planned Phase 5 of the replacement project. The City needs time to evaluate the potential costs of "fronting" the engineering and design money as balanced against the risk of incurring a significant emergency repair given the currently low (and projected lower) fund balance. However, it is the ultimate replacement program over time, funded by low cost State loans, that has the best chance of reducing the City's risk of incurring both large emergency repair costs and the costs of EPA monitoring.

The Committee feels it is in the best long-term interest of the City to continue with the replacement project, but the Sewer Fund is not currently structured to handle the economic burden without taking significant risks to an already reduced Sewer Fund balance (and General Fund balance). However, it appears the Sewer Fund does not need a ***permanent*** increase in the sewer tax at this time as ongoing operations and repairs (which should moderate as more of the system gets replaced) seems sufficiently covered by the existing sewer tax, excluding the debt service obligations. For better transparency, the voters should be asked for a new ***temporary*** sewer tax surcharge that is tied to the debt service already being incurred and perhaps the next 1-2 phases, which is probably what should have occurred once the burden of increased debt service became apparent. In some ways taking on additional sewer loans (which the Committee supports) without properly providing for the revenues needed is similar to increasing employee benefits and taking on an unfunded liability without giving thought to the long term financial implications.

Without a surcharge to generate increased Sewer Fund revenues, it is reasonable to assume that the General Fund will be called upon to transfer funds into the Sewer Fund. In effect, the General Fund balance is supporting both the General Fund and the Sewer Fund. Without a sewer surcharge, there is a real risk that unexpected sewer replacement/repair costs will materially erode the City's General Fund reserves.

The Committee does believe, however, that the City should explore the viability of reinstating a modified Phase 5a, focusing on the most problematic areas of the system, with a view to funding the costs with a State loan, as in all previous phases. We recognize that there is typically a lag between project implementation and receipt of funds from the State. In Phase 4, the City expended approximately $178,000 over three years before drawing down the loan in 2009. Debt service on the Phase 4 loan comes to about $106k per annum. If Phase 5a were to cost the same as Phase 4 and the timing of expenditure and loan availability were broadly similar, that would mean reallocating approximately $100,000 a year from the projected General Sewer Project line item and thus would not, in our view, result in a significant increase in risk to the General Fund compared to the projections without Phase 5a.

Addendum 2 Table 1 - Historical and Projected Sewer Fund Activity

	Actual					Projected				
	2006-07	**2007-08**	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2015-16**
Beginning Fund Balance	**2,192,836**	**2,506,507**	**2,221,890**	**1,062,652**	**1,185,723**	**1,174,710**	**1,098,937**	**792,723**	**171,260**	**3,812**
Operating Revenues										
Interest	115,186	111,676	46,378	9,061	1,929	4,080	4,162	4,245	4,330	4,417
Sewer Tax	1,742,853	1,746,076	1,808,081	2,021,332	2,072,726	2,111,200	2,153,424	2,196,492	2,240,422	2,285,230
Total	**1,858,038**	**1,857,752**	**1,854,459**	**2,030,393**	**2,074,655**	**2,115,280**	**2,157,586**	**2,200,737**	**2,244,752**	**2,289,647**
Operating Expenses										
General Fund	795,000	805,000	1,000,000	950,000	900,000	900,000	900,000	900,000	900,000	900,000
Equipment Maintenance	7,407	33,553	60,686	70,821	19,490	66,000	66,000	66,000	66,000	66,000
County of Alameda Clean Water Program						18,000	20,000	20,000	20,000	20,000
Total	**802,407**	**838,553**	**1,060,686**	**1,020,821**	**919,490**	**984,000**	**986,000**	**986,000**	**986,000**	**986,000**
New Mentoring and Related Costs for EPA										
Professional Service (including legal)					99,809	110,000	175,000	130,000	120,000	120,000
Flow Monitoring, Modeling, and Inflow ID					50,617	92,000	22,000	25,000	25,000	25,000
Root Cleanings, Repairs					96,471	64,000	85,000	85,000	85,000	85,000
Miscellaneous					172,054	49,100	2,100	2,500	2,500	2,500
Total	**0**	**0**	**0**	**0**	**418,951**	**315,100**	**284,100**	**242,500**	**232,500**	**232,500**
Transfer In From General Fund	**100,000**					**275,682**				
Ongoing Capital Expenses										
Major Equipment Purchases			178,491					400,000		
General Sewer Projects/Emergency Repairs	349,735	758,569	1,291,491	472,017	218,259	720,000	640,000	640,000	640,000	640,000
Total	**349,735**	**758,569**	**1,469,982**	**472,017**	**218,259**	**720,000**	**640,000**	**1,040,000**	**640,000**	**640,000**
Major Sewer Replacement/Debt Service										
Phase IV Sewer Rehabilitation	44,590	97,612	35,395	590,321	1,358,048					
State of California Loan - Phase IV				(623,473)	(1,276,715)					
Phase I Sewer Loan Payment	96,448	98,763	101,133	103,561	106,046	108,591	111,197	113,866	116,599	119,397
Phase I Sewer Loan Interest Expense	47,894	45,579	43,209	40,782	38,296	35,751	33,145	30,476	27,744	24,945
Phase II Sewer Loan Payment	90,904	93,177	95,506	97,894	100,341	102,850	105,421	108,057	110,758	113,527
Phase II Sewer Loan Interest Expense	50,875	48,603	46,273	43,886	41,438	38,930	36,359	33,723	31,022	28,253
Phase III Sewer Loan Payment	101,031	103,557	106,146	108,799	111,519	114,307	117,165	120,094	123,096	126,174
Phase III Sewer Loan Interest Expense	60,482	57,956	55,367	52,714	49,994	47,206	44,348	41,419	38,417	35,339
Phase IV Sewer Loan Payment							86,925	87,794	88,672	89,559
Phase IV Sewer Loan Interest Expense							19,140	18,271	17,393	16,506
Total	**492,225**	**545,247**	**483,030**	**414,483**	**528,968**	**447,635**	**553,700**	**553,700**	**553,700**	**553,700**
Ending Fund Balance	**2,506,507**	**2,221,890**	**1,062,652**	**1,185,723**	**1,174,710**	**1,098,937**	**792,723**	**171,260**	**3,812**	**(118,741)**

Addendum 3 - PENSION PLAN

The following information came from research, discussions with City staff, and discussions with Bartel Associates, the actuary retained by the City, as well as CalPERS' Risk Pool Annual Valuation Report.

Pensions 101

CalPERS provides defined benefit pension plans for state employees, state agencies, and municipalities, offering several types of plans. Most large cities have their own segregated plans. Piedmont had its own segregated plan, but beginning in 2003, CalPERS terminated Piedmont's plan, and Piedmont went into a "pool" with other smaller cities (under 100 employees). The City currently belongs to two CalPERS pools, one for safety employees (called 3% at 50) and one for the "miscellaneous" or non-safety employees (called 3% at 60). The plan names describe the basic terms in that a 3% at 50 plan means an employee vested in retirement benefits (typically 5 years of service) is entitled to receive an annual retirement benefit, once they reach 50 years old, equal to their highest year's salary times 3% times the number of years worked. For safety employees, this amount is capped at 30 years of service, or 90% of their highest salary. This benefit then increases at CPI up to 2% per year. As discussed below, the fact that we are in a pool with other cities likely serves to reduce administrative costs for CalPERS and smooth annual variability, but it exposes the City to some interesting and hard to quantify demographic risks. To be able to pay for these future benefits, the City contributes an amount each year for each category of employee as a percentage of salary – the same percentage that other participants in the same pool contribute. CalPERS calculates those numbers each year and provides those to the City. The basic idea behind the plan is that money is set aside while an employee is working, and it is invested such that the growing balance is enough to pay for the retirement benefit. However, as illustrated below, the contributions percentages have increased substantially over the last several years and are expected to increase further in the future.

How Does the Math Work?

Pension plans are quite complicated and are dependent on a number of "actuarial" assumptions including length of service, life expectancy, earnings on assets in the plan, salary levels, etc. The calculations are dependent on so many assumptions and are so complicated that it would be virtually impossible for someone to replicate them exactly. After every fiscal year end (June), for each pool, CalPERS determines how much it earned on assets, examines how the employee and statewide retiree pool changed, decides on what changes to make to the plans and plan assumptions, and estimates what annual salaries will be going forward for active workers. The method used is referred to as the "Entry Age Normal Cost Method," which takes all this data and these assumptions and calculates what constant percentage of salary of current workers it would take every year until assumed retirement to provide for the retirement benefits until death. It actually takes quite a while to assemble and calculate this information, so that the fiscal year information ending 6/30/09 is used to determine the fiscal year ending 6/30/12 contribution rates. However, a city typically has to contribute at a level above the

Normal Cost. These additional amounts are explained below and include "Risk Pool's Amortization of Bases," Class Benefits, and Side Fund Amortization.

Risk Pool's Amortization of Bases - In addition to Normal Costs, CalPERS also calculates the variance each year in the performance of the investment return versus what was assumed and the variances in the actuarial assumptions of salary, number of employees, retirement, etc., versus what was assumed. CalPERS determines the magnitude of the variances, and depending on the type of variance (investment return versus changes in plan features versus actuarial performance), it "amortizes" the variance over different periods of time ranging from 15-30 years. This amortization amount is then applied to each employee in the pool on a constant percentage of salary as additional contributions required by the City. This percentage is referred to as the Risk Pool's Amortization of Bases in the actuarial report.

To calculate the amortization of bases, CalPERS determines the actuarial liability and compares it to the "actuarial" value of the investment pool assets. The actuarial liability is the present value of all projected retirement benefits for every active and retired employee discounted back to today less the present value of the projected future contributions for every active employee. In theory, this liability represents the money needed today, growing at the assumed investment rate of return, to satisfy all future needs. The actuarial value of the assets is determined by CalPERS as described below:

> *"In order to dampen the effect of short term market value fluctuations on employer contribution rates, the following asset smoothing technique is used. First an Expected Value of Assets is computed by bringing forward the prior year's Actuarial Value of Assets and the contributions received and benefits paid during the year at the assumed actuarial rate of return. The Actuarial Value of Assets is then computed as the Expected Value of Assets plus one fifteenth of the difference between the actual Market Value of Assets and the Expected Value of Assets as of the valuation date."* (Taken from the CalPERS Risk Pool Annual Valuation Report, Page A-2)

What this means is that the actuarial value of the assets is a hypothetical number and does not reflect the actual market value of the assets. If this actuarial value of the assets in the plan exactly matched the actuarial value of liabilities, the plan would be considered fully funded and there would be no need for amortization of bases as an additional contribution beyond the normal cost. If the actuarial value of assets is less than the actuarial liability (a shortfall), the difference is amortized over a rolling 30 year period, meaning each year it is re-calculated and re-amortized over 30 year again. If long-term investment returns fall below the assumed return, then the shortfall will continue to be pushed forward and the plan will not achieve fully funded status.

Class Benefits – In addition to the base plan CalPERS offers several features that add to the Normal Cost. These features could include using the final year to calculate the retirement benefit instead of the average of the final three years (Piedmont chooses the final year option). Class benefits choices and contribution amounts are specific to each City.

Side Fund –In the late 1990s, CalPERS was experiencing above expected investment returns, and several cities (including Piedmont) experienced very low pension plan contributions (Piedmont actually paid nothing for several years). Many cities increased their benefit plans (from 2% at 50 to 3% at 50) without much increase in plan contributions. This period coincided with the dot.com bubble when it became more difficult for cities to compete in the economy to hire employees for safety and miscellaneous positions. Piedmont suffered through hiring difficulties and had to operate with less staff compared to historical levels. This situation led the City Council to increase the pension benefit plan to compete more effectively with other cities from the 2% at 50 for safety to 3% at 50 and from 2% at 60 for non-safety to 3% at 60. These changes were made *retroactively,* meaning that any employees with prior service time would get credit for that time on the 3% plans as though the 3% plans had been in place since they were hired. Whether it was known at the time or not, this created an immediate unfunded liability for the City, as it now had to fund the accrued cost of increasing the benefit for the prior service period. This unfunded liability was approximately $8.5 million.
CalPERS had a program to fund this liability called a "Side Fund". Essentially a liability was set up with CalPERS whereby the City had to amortize the unfunded liability over a 20-year period at CalPERS assumed investment return rate which was 7.75%. Although other cities do have side funds, each side fund is unique to each city. Piedmont's side fund represents over $90k per active employee.

A Simple Example

As stated, the math involved for calculating the annual contribution is quite complicated since it deals with large numbers of people and large numbers of actuarial assumptions. This complication makes understanding the impacts of various potential outcomes quite difficult – especially since the calculations involve large pools of participants outside of the City. However, the Committee created a simple model that calculates the Normal Cost for only one employee and allows for such variables as salary growth, years of service, years of retirement, and investment return. The objective is to try and understand just how sensitive the Normal Cost is to changes in these assumptions. Note that this model is greatly over-simplified.

The table below shows the resulting Normal Costs for 20% changes in a base case set of assumptions.

Potential Impact on Normal Costs of Various Assumptions

	Base Case	Better Case		Worse Case	
Parameter	**Assumption**	**Assumption**	**Normal Cost**	**Assumption**	**Normal Cost**
Length of Service	25 years	30 years	17.3%	20 Years	22.1%
Length of Retirement	20 Years	16 Years	17.2%	24 Years	21.5%
Annual Salary Growth	3.0%	2.4%	18.0%	3.6%	21.2%
Investment Return	7.5%	9.0%	14.1%	6.0%	27.1%
Base Case Normal Cost	19.5%				

The table shows a base case Normal Cost for our hypothetical employee of 19.5% assuming 25 years of service, 20 years of retirement, 3% annual salary growth, and 7.5% investment return. The table also shows the new Normal Cost for 20% stand-alone changes in the base case assumptions. Based on the model, a change in service or retirement of 20% (which is a significant change) increases or decreases Normal Cost by 2-3%. A 20% change in the long-term growth in annual salary changes Normal Cost by less than 2%. However, a comparable percentage change in investment return – which does not seem like a significant change - increases the Normal Cost contribution by almost 8% which is very significant.

The takeaway from the modeling exercise is that the Normal Costs are sensitive to several variables, but most (other than salary increase) are outside the control of the City, and the contribution rate seems especially sensitive to investment returns. The other takeaway is that the myriad of assumptions that operate over a long period of time make for potentially significant divergences between what is expected and what actually occurs. It would probably not be surprising that over the last 10+ years, those divergences have worked to the City's disadvantage, as assumptions have been rosier than reality.

Investment Returns

Given the sensitivity of investment returns to retirement contributions, it is important to look at what has occurred with CalPERS. The table below shows the historical investment performance of CalPERS on a gross basis. As the table shows, investment returns since 1991 have averaged on a compound basis over 7.5%. Up until recently, CalPERS had assumed 7.75%, which is relatively close.

CalPERS Stated Returns

Year	Actual Annual Return	Running CAGR Since 1991	Running CAGR Since 2000
1991	6.5%	6.50%	
1992	12.5%	9.46%	
1993	14.5%	11.11%	
1994	2.0%	8.76%	
1995	16.3%	10.23%	
1996	15.3%	11.06%	
1997	20.1%	12.31%	
1998	19.5%	13.18%	
1999	12.5%	13.11%	
2000	10.5%	12.84%	
2001	-7.2%	10.85%	-7.20%
2002	-6.1%	9.33%	-6.65%
2003	3.7%	8.89%	-3.32%
2004	16.6%	9.42%	1.31%
2005	12.3%	9.61%	3.42%
2006	11.8%	9.75%	4.77%
2007	19.1%	10.28%	6.71%
2008	-5.1%	9.36%	5.16%
2009	-24.0%	7.29%	1.43%
2010	13.3%	7.58%	2.56%

CAGR stands for compound annual growth rate

However, due to the outstanding performance in the 1990s where contributions in some cases dropped to zero because of the negative amortization of bases, many new participants joined the CalPERS pools, especially those that offered more generous 3% at 50 benefits (as Piedmont did). Unfortunately, since 2000, CalPERS investment returns have significantly underperformed their 7.75% assumption, returning a compound return of 2.56%, which would lead to large unfunded liabilities and growing amortization of bases payments.

Further, although no one can successfully predict investment returns, it is important to note that the 10-year treasury had a yield of 8% in 1991 and is generally a good proxy for investment returns in bonds over ensuing 10-year periods. The stock market had extra-ordinary returns in the 1990s, which further boosted returns. Today's 10-year treasury yield is under 2%, and it is hard to see how it could possibly provide a return in excess of that over the next ten years.

How Do The Piedmont Retirement Pools Look Today?

In a word – sickly. The small city pools that Piedmont joined in 2003 have performed poorly in the years that followed. The table below shows recent data concerning the two Piedmont plans as well as the two plans currently contemplated for new Piedmont employees.

Most Recent Available CalPERS Plan Data (as of 6/30/10)

	Safety		Misc	
	3% @ 50 Plan	2% @ 50 Plan	3% @ 60 Plan	2% @ 60 Plan
Active Members	10,417	949	2,401	3,473
Retired Members	13,276	1,033	1,935	1,614
Retired/Active Ratio	127.4%	108.9%	80.6%	46.5%
Market Value of Assets (000)	$6,650,161	$312,647	$597,968	$467,903
Accrued Liabilities (000)	$10,165,475	$469,526	$945,221	$624,423
Unfunded Liability (000)	$3,515,314	$156,879	$347,253	$156,520
Funded Percentage	65.4%	66.6%	63.3%	74.9%
P.V. of Benefits for Retired Members Only (000)	$5,857,517	$250,704	$387,279	$209,530
Market Value of Assets Less Retiree Benefits (000)	$792,644	$61,943	$210,689	$258,373
Active Member Annual Payroll (000)	$955,981	$61,878	$159,157	$186,778
Rate Volatility Index	7.0	5.1	3.8	2.5
Unfunded Liability/Payroll	367.7%	253.5%	218.2%	83.8%
Unfunded Liability/Active Member (actual $)	**$337,459**	**$165,310**	**$144,628**	**$45,068**

Note: Data as of 6/30/10

The table above shows the number of active members (currently working) and retired members as of June 30, 2010 (latest data available). Piedmont accounts for 0.4% of "3% at 50" members and 2% of "3% at 60" members. The City's current safety plan has retired members outnumbering active members by 1.27:1. Actuarially, that wouldn't be bad as long as the pension fund was fully funded – by definition there would be enough funds on hand to cover retiree benefits. However, the next rows show the market value of assets, accrued liabilities and the unfunded liability. The unfunded liability for safety is $3.5 billion, and funding represents only 65% of liabilities (assuming CalPERS earns 7.75% on those assets). Going further, of the $10.1 billion of accrued liabilities, $5.8 billion of them are due to members already retired – 57.6%. If you apply the market value of assets just to the retirees (seems logical since they can't contribute any more) that would leave just $0.8 billion of assets for the remaining $4.3 billion of active member accrued liabilities – a funding ratio of just 19%. CalPERS uses a Rate Volatility measure that divides the market value of assets by the current payroll. This measure is an indicator of how volatile the contribution rate can be – the higher the number, the more the contribution rate can be affected by differences in asset values. Piedmont has seen the impact of the higher volatility in the contribution rates for its employees and it is likely the volatility will continue.

Active members have a current payroll (on which contributions are calculated) of $955 million, so the total unfunded liability represents 367% of payroll. Even more alarming, the unfunded liability per active employee is $337k for 3% at 50 safety members. Although the numbers for miscellaneous employees are not as dire as safety, the unfunded liability per miscellaneous member is still over $144k. Given the number of safety and miscellaneous employees, Piedmont's share of the unfunded liability is over $21.5 million, and that excludes the $8.5 million side fund unfunded liability and the $9.5 million of unfunded retiree healthcare liability, bring the total unfunded liability to almost $40 million!

It is also interesting to note that although the 3% at 50 safety plan is in dire shape, the 2nd tier plan of 2% at 50 still faces funding shortfalls and poses significant risks of increasing contributions.

An even more stark demonstration of the funding risks is shown in the table below.

Recent Plan Growth Rates
(compound annual growth rates 6/30/06-6/30/10)

	Safety 3% @ 50 Plan	Misc 3% @ 60 Plan
Annual Growth in Accrued Liabilities	8.7%	11.1%
Annual Growth in Market Value of Assets	0.7%	3.1%
Annual Growth in Actuarial Value of Assets	8.5%	10.8%
Annual Growth in Covered Payroll '06 - '09	8.9%	8.7%
Annual Growth in Covered Payroll '09 - '10	-1.8%	-1.7%

The table shows, for each of the City's retirement plans, the recent annual growth in liabilities and "actuarial" asset values compared to actual asset values. As shown, the trajectory of actual liabilities is substantially above even the "expected" investment returns – and market returns have barely kept the assets growing. Even more striking, the growth in payroll of active members (Covered Payroll), which has been increasing substantially in the past, has actually declined in the most recent years, which again portends dire consequences for future funding requirements.

Piedmont Contributions Trends

The tables below show the City's CalPERS contribution history as a percent of salary.

PERS Employer Contribution History - 3% at 50

	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13
Normal Cost	13.0%	15.5%	15.6%	15.7%	17.2%	17.3%
Amortization of Bases	0.8%	1.7%	1.7%	2.5%	5.9%	6.4%
Class 1 Benefits	2.6%	2.7%	2.7%	2.7%	2.7%	2.7%
Other	1.2%	0.8%	0.4%	0.0%	0.0%	0.0%
Amortization of Side Fund	14.7%	18.0%	17.8%	18.1%	16.4%	17.6%
Total Employer Contribution	32.4%	38.7%	38.3%	39.0%	42.2%	44.0%

PERS Employer Contribution History - 3% at 60

	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13
Normal Cost	10.4%	10.3%	10.5%	10.5%	10.3%	10.3%
Amortization of Bases	0.8%	1.1%	1.2%	1.6%	3.9%	4.3%
Class 1 Benefits	0.7%	0.7%	0.7%	0.7%	0.7%	0.7%
Other	0.2%	0.2%	0.1%	0.0%	0.0%	0.0%
Amortization of Side Fund	8.1%	8.3%	8.0%	7.6%	7.2%	7.4%
Total Employer Contribution	20.2%	20.5%	20.5%	20.3%	22.1%	22.7%

The tables both show increasing contribution rates, but the increases for safety employees are more dramatic, due in part to the demographics of the 3% at 50 plan as well as other factors. Note that in the 3% at 50 plan above the FY08 numbers reflect a 3% at 55 formula that was in place at the time.

The actuary engaged by the City provided projections for contribution rates for the next five years under three investment return scenarios (no other changes were made in the assumptions). The table below shows the results. Note that the new expected return for CalPERS is 7.5% (base case), the "Poor" returns start at 0.2% initially and grow to 3.4% over the term, and the "Good" investment returns start at 15.1% initially and decline to 11.6%.

PERS Employer Contribution Projection - 3% at 50

	FY 14	FY 15	FY 16	FY 17	FY 18
Poor Investment Returns	46.6%	47.5%	51.3%	54.0%	56.1%
Expected Investment Returns	46.6%	46.8%	47.0%	47.2%	47.3%
Good Expected Return	46.6%	46.7%	46.6%	46.3%	45.8%

PERS Employer Contribution Projection - 3% at 60

	FY 14	FY 15	FY 16	FY 17	FY 18
Poor Investment Returns	23.7%	23.6%	24.9%	25.9%	26.5%
Expected Investment Returns	23.7%	23.6%	23.5%	23.3%	23.1%
Good Expected Return	23.7%	23.5%	23.3%	22.8%	22.4%

Interestingly, the "Poor" returns are not that dissimilar on a compound basis from the experience since 2000 and the "Good" returns are similar to the returns experienced in the 1990's leading up to the dot.com bubble. In any event, the safety contributions do not return to the 44% level of FY13 under any investment return scenario, further demonstrating the uncontrollable impact the safety pool demographics have on the retirement contribution. Also note that the projections do not assume any changes in other plan variables, but rather assume payrolls continue to grow to help cover all these costs.

Demographic Concerns and the Future

Unfortunately, as shown, Piedmont has even less control over pension costs given it is part of larger risk pool and is subject to the experience and demographics of other participants. The table below shows the demographic comparisons of Piedmont compared to the CalPERS risk pools. As shown, Piedmont safety employees are generally older than the average with more years of service, while miscellaneous employees are comparably aged with slightly more experience.

Demographic Comparison

	3% @ 50 Plan		3% @ 60 Plan	
	CalPERS	**Piedmont**	**CalPERS**	**Piedmont**
Active Members	10,786	43	2,450	49
Average Age	39.4	45.0	45.5	45.8
Average Service	10.1	14.1	9.1	11.9
Average Pay	$90,285	$112,100	$66,111	$70,300
% Over 50	13.4%	20.9%	38.5%	39.6%

The next table shows a breakdown of the age distribution comparing Piedmont to the risk pools. As shown, Piedmont age distribution is comparable in the 3% at 60 pool, but with almost ¾ of employees over 40, Piedmont has a substantially older safety membership.

Age Distribution

3% @ 50 Pool % of Employees			3% @ 60 Pool % of Employees		
Over Age…	**CalPERS**	**Piedmont**	**Over Age…**	**CalPERS**	**Piedmont**
30	83.6%	100.0%	30	91.7%	91.8%
40	47.0%	74.4%	40	70.0%	67.3%
50	13.8%	20.9%	50	39.3%	38.8%
60	1.2%	2.3%	60	7.9%	10.2%

Piedmont's older workforce presents turnover risks to the City, and if we had our own pension plan as underfunded as the CalPERS pool, we would face significant challenges funding the retirement. However, being part of the pool could have benefits in that if more Piedmont employees retire in advance of other cities, our share of the active membership goes down and more of the unfunded liability is spread to other cities. It is worth spending time to further understand this phenomenon as it may lead to some interesting and counterintuitive strategies and decisions.

Where Does That Leave Piedmont?

Piedmont is budgeting $3.1 million in CalPERS retirement contributions this year – over 15% of budgeted expenditures. Despite the significance of the number, Piedmont has no near term control over the rates it is charged, and hence its retirement expense, other than to reduce staff. Presumably many other cities are in a similar position. However, due to the shared risk pool, if everyone were to reduce staff, there would be fewer employees over which to spread costs. Given that much of the cost or providing retirement under these pools is "fixed" in some way (either the side fund or the unfunded liabilities), reducing staff will further increase the contribution percentage, as the "fixed" costs will be allocated over fewer employees. The irony is that in the name of controlling costs, services in many cities will actually be cut, resulting in increases in the costs of what services remain and putting the City on a downward spiral. The only certain way to control these costs in the future and to move Piedmont forward on a sustainable basis is to get out of the defined benefit CalPERS retirement system and consider implementing a defined contribution retirement plan.

Addendum 4 – BONDING FOR SIDE FUND UNFUNDED LIABILITY

When the City enhanced the retirement scheme for employees on a back-dated basis, the City incurred an immediate unfunded liability for the benefits attributable to prior years' service. The balance today of this liability is $8.5 million. The liability will increase over time proportionate to increases in salaries. The liability is being paid down by the City over 8 years for safety employees and 10 years for Miscellaneous employees. CalPERS is currently charging an interest rate of 7.75% on this liability.

The City has the option of discharging the liability by making a one -time payment to CalPERS equal to the principal amount of the unfunded liability. The City is considering funding this payment by selling a tax-exempt bond. It is estimated that a bond issue with this amortization profile would cost an estimated 3% in today's market.

A number of issues need to be considered:

1. Initial research suggests that the borrowing would not qualify for tax-exempt status, but this needs to be determined by specialist counsel before proceeding.

2. Any such borrowing would be subject to a voter approval and judicial validation. It is unlikely that the City could close the issue before mid 2013. Interest rates will vary over the intervening months, possibly eroding savings.

3. Structuring the issue is estimated to cost approximately $200,000.

4. A traditional public offering of bonds will call for the City to obtain and maintain a rating from a rating agency. A direct sale to a sophisticated financial institution may not require a rating.

5. A traditional public offering will probably require that the City increase the issue by one year's debt service, in order to fund a so-called Debt Service Reserve Fund. The interest cost of this increased borrowing amount will erode savings. Again, a direct sale to a sophisticated financial institution may avoid the necessity for the Debt Service Reserve Fund

6. The bonds would not be supported by a special revenue source such as a tax, but would rather represent a general unsecured debt of the City's General Fund, at a time when a sewer tax proposal has been declined by voters and the parcel tax is up for renewal. This could cloud investors' view of the credit.

We suggest therefore that, as first steps, the City should explore the tax questions with bond counsel. This will determine whether the transaction should be structured on a tax exempt or taxable basis. Then we recommend that the City approach one or two banks with a set of financial information and seek a general indication of interest in acquiring the bonds on a direct basis, looking to avoid the costs of a public transaction.