Attachment 18

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PUBLIC EMPLOYEES RETIREMENT SYSTEM (PERS) VOLATILITY INDEX AND IMPACT ON THE CITY'S FUTURE PERS RATES

INTRODUCTION

Employer CalPERS rates are based on an actuarial valuation performed every year by CalPERS. The valuation includes assumptions on investment returns, pay rates, employee turnover and retirement trends. The valuations are performed based on information two years in arrears (i.e., the rates for Fiscal Year 2009-10 were based on information for the year ending June 30, 2007). A few years back, due to the impact on rates from the swings in market conditions, CalPERS implemented a rate-smoothing technique whereby investment gains and losses were amortized over a 15-year period. Along with the rate smoothing, a market value corridor was established whereby the market value of assets are required to be within a corridor of 80.0 percent to 120.0 percent of the actuarial value of assets regardless of the rate smoothing.

BACKGROUND AND ANALYSIS

On October 6, 2008, CalPERS issued a circular letter to employers with the topic being CalPERS investments during the recent market downturn. This circular provided only information regarding CalPERS' investment history, diversification and strategy. On October 21, 2008, an agenda item to the members of the CalPERS Benefits and Program Administration Committee was the Impact of Recent Investment Market Downturn on Employer Rates. This agenda item and subsequent teleconference provided more specific information to employers on the potential impact of the losses of the CalPERS fund and as of October 10, 2008, the fund had lost more than 20.0 percent of its value since July 1, 2008. It also provided some hypothetical investment returns and what range of rate changes would be expected based on those investment returns.

In late February 2009, CalPERS began to communicate to employers how they could more accurately determine their specific rate impacts with the use of the PERS Volatility Index (VI). The VI is the ratio of the accrued liability to Annual Covered Payroll (Payroll). The higher the ratio, the higher the rate impact would be based on the investment losses of the portfolio. The annual actuarial valuation received from CalPERS provides each agency with their VI. The VIs for the City and the average VIs for all plans with the same retirement formula are as follows:

	City of Mountain View	Average
Public Safety	9.7	9.3
Miscellaneous	5.9	5.1

The City's VI appears to be higher than the average, but in the midrange of VI.

As of June 30, 2009, CalPERS experienced losses to the portfolio of 24.0 percent and the impact to the City's rates for Fiscal Year 2011-12 if the impact was reflected in a single year is as follows:

	Current Rate	Estimated Increase	Projected Rate Based on 25.0 Percent Market Value Losses
Public Safety	24.343	8.3	32.643
Miscellaneous	14.509	5.0	19.509

With the CalPERS portfolio loss of 24.0 percent for the fiscal year ending June 30, 2009, the employer rates beginning in Fiscal Year 2011-12 were estimated to rise approximately 8.3 percent to 32.5 percent and 5.0 percent to 19.5 percent for Public Safety and Miscellaneous, respectively. The employees cost-share a portion of the employer rates up to 4.0 percent for Public Safety and between 1.5 percent and 3.25 percent for Miscellaneous. However, the estimated rate increases noted above will be the responsibility of the City. It is important to understand that due to the significant investment losses, a substantial amount of the rate increase is to bring the MVA back within the established corridor of 80.0 percent to 120.0 percent regardless of the smoothing techniques employed.

However, on June 17, 2009, the PERS board adopted a policy to phase in the impact of the investment losses over a three-year period by expanding the current rate smoothing corridor from 80.0 percent to 120.0 percent of MVA to 60.0 percent to 140.0 percent of MVA in the first year, to 70.0 percent to 130.0 percent in the second year, then back to 80.0 percent to 120.0 percent of MVA in the third year. In addition, PERS is isolating and amortizing investment gains and losses in the next three years using a fixed and declining 30-year period as opposed to the current rolling 30-year amortization period. Staff is estimating the increase to the General Operating Fund to be $1.4 million in Fiscal Year 2011-12 and $2.0 million in each year for Fiscal Years 2012-13 and 2013-14.

The other issue is that if agencies are reducing payroll (due to hiring freezes or reductions in staff), this will affect rates as well. Since the index is calculated as a ratio of accrued liability to Payroll, if the Payroll is reduced, this increases the VI. The employer rates are determined as a set dollar amount, not as a percentage, but then are translated into a percentage of Payroll. The amount translated into a percentage also factors in new hires, so if there are no new hires or payroll is flat or declining, the employer

pension costs, when factored as a percentage of Payroll, becomes even bigger and rates will increase even more.

SUMMARY

The PERS Volatility Index is a ratio of the accrued liability to Annual Covered Payroll. The higher the index, the higher you can expect your employer rates to rise based on market losses. The CalPERS portfolio experienced market losses of 24.0 percent as of June 30, 2009. The rates are rising significantly primarily due to the Market Value of Assets falling outside the 80.0 percent to 120.0 percent corridor of actuarial value. In other words, rates will need to be increased to bring the actuarial value back within 120.0 percent of the plan's assets. The PERS board adopted a plan to phase in the impact of these investment losses over a three-year period. It is estimated the increase in the rates over the three fiscal years beginning in Fiscal Year 2011-12 will be $1.4 million, $2.0 million and $2.0 million. If payroll remains flat or declines, this will also cause rates to rise as the employer's rates are determined as a set dollar amount that is translated into a percentage of payroll that assumes new hires.

It is anticipated the Fiscal Years 2011-12 to 2013-14, budgets will be dramatically impacted by the investment losses for Fiscal Year 2008-09. This presents a very serious challenge to all funds but, particularly, the General Operating Fund.

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GENERAL FUND "CARRYOVER BALANCE"

The General Operating Fund "carryover balance" is comprised of the revenues over expenditures at the end of the fiscal year (operating balance), plus one-time revenues or expenditure savings. This balance can result from a variety of circumstances. Most commonly it is a result of the budget not being fully expended during the fiscal year due to vacant positions or contract and supply savings. Additionally, it can result from actual revenues exceeding budgeted revenues during the fiscal year. Another reason a carryover balance might result is through the receipt of "one-time" revenues. The exact amount of this balance is not known to a certainty until the completion of each fiscal year-end's close and annual audit.

The amount of carryover balance each fiscal year can vary substantially from fiscal year to fiscal year based on a number of factors. The most notable factor is whether actual revenue performance varies significantly from budget. Since revenue forecasting is inherently difficult based on the volatile nature of many General Fund revenues, the carryover balance varies fairly significantly. A more consistent factor is the underexpenditure of the budget. This is a result of combinations of all components (personnel and nonpersonnel) of the budget being underexpended each fiscal year. The portion of the carryover balance based on underexpenditures has ranged from $1.6 million to $4.7 million per fiscal year.

The existence of a carryover balance is relied upon to meet a variety of needs. These include:

- Funding annual obligations not covered in the operating budget, including those for Retirees' Health Insurance, equipment replacement and compensated absences.
- Replenishing the General Fund Reserve (or supplementing it to meet policy level) or the Capital Improvement Reserve.
- Funding "limited-period expenditures."
- Supplemental funding for capital equipment purchases.

For the Fiscal Year 2009-10 budget, an alternative to "budget" (take credit for) an average estimate of annual expenditure savings (estimated at $2.6 million) was adopted for the first time. However, since these funds (which would otherwise end up being "carryover" at the end of the year) are relied upon to cover annual costs for Retirees' Health Insurance and equipment replacement, these costs were also incorporated as ongoing expenditures in the operating budget. This would result in fully accounting for these expenditures in the operating budget. The "budget savings" amount is $2.6 million and is offset by costs of $1.6 million for Retirees' Health Insurance and $685,000 for

equipment replacement. This may, however, result in many years when there will be little or no carryover balance.

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Attachment 20

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STRUCTURAL DEFICITS

The definition of a "deficit" can vary from one government agency to another. Oftentimes the distinction between a "structurally balanced" budget versus a "technically balanced" budget is blurred. However, the distinction is significant, particularly as it relates to the long-term fiscal health of an organization.

A structural deficit occurs when there is an imbalance between ongoing revenues and ongoing expenditures. That is, ongoing (permanent) revenues are not sufficient to fund ongoing (permanent) expenditures. Structural deficits can be resolved by bringing revenues and expenditures into balance through revenue enhancements and/or expenditure reductions. The implications of a structurally imbalanced budget are that it will absorb other temporary resources until those are exhausted.

It is possible to have a "technically" balanced budget while still having a structural deficit. The way you can technically balance a budget is to use temporary measures to bridge the budgetary gap, including reserves, grants, temporary expenditure decreases, etc. In these cases, the obligations for that fiscal year can be met, but the underlying problem is not resolved.

Examples of strategies that can resolve a structural deficit include:

- Increase permanent revenues.
- Decrease permanent expenditures.
- Decrease the growth of permanent expenditures to a level below permanent revenue growth.
- Decrease the current expenditure level by:
    - Decreased staffing.
    - Alternative service delivery models.
    - Decreased service levels.

Examples of strategies that do not resolve structural deficits, but can temporarily address a budget shortfall include:

- Use of temporary revenues.
- Backfilling with reserves.

- Grants.
- Staff furloughs.
- Temporary compensation reductions.
- Hiring freezes.

It is reasonable to use temporary measures in some circumstances for a variety of reasons, including:

- "Buying time" to develop permanent strategies.
- To provide time for the transition into permanent solutions.
- To deal with conditions that are not permanent in nature (will "self correct" over time).

Some public agencies have placed themselves into an increasingly difficult financial condition by the use of temporary measures to cover increasing structural ("ongoing") deficits while depleting reserves and other resources without implementing permanent solutions. This can eventually result in a significant structural deficit with limited or no available resources to resolve the deficit even on a temporary basis.

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Attachment 21

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LIMITED-PERIOD EXPENDITURES

An important budgeting principle is to match ongoing revenues to ongoing expenditures in order to create a balanced operating budget. Often there are requests/needs which are of a one-time or limited duration in nature that are not appropriate to be made part of the permanent operating budget. These requests are considered "limited-period" expenditures.

Limited-period requests/needs that are General Fund-related are funded from the prior fiscal year carryover balance or reserves. Limited-period requests related to other City funds are funded from the balance available of those funds. Unlike most other funds of the City, the General Operating Fund does not maintain a balance. At the end of each fiscal year, any operating balance is used to replenish reserves, supplement expenditure funding, fund limited-period expenditures or fund capital improvement projects.

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Attachment 22

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BUDGETING FOR SALARIES AND BENEFITS

The purpose of this memo is to explain the methodology used by the City to budget for salaries and benefits. Employees are classified into three categories, Management, Professional and Front-Line. The City pays for all or portions of certain City-wide benefits, including PERS retirement, Medicare and life, medical and dental insurances. There are also other benefits that are employee group-related as stated in each Memorandum of Understanding (MOU), such as career incentive and holiday in-lieu pay.

The salary range for management positions is from 80.0 percent to 120.0 percent of control point and 85.0 percent to 115.0 percent of control point for professional positions. Front-line positions are on a step plan, going from first step to fifth step in 5.0 percent increments. Some benefits are a percentage of salary and others, such as health benefits, range between plans and can be single, two-party or family coverage.

<u>Salary Savings</u>

Filled positions are budgeted at the employee's actual salary and benefits plus assumptions for increases in salary (for step or merit increases based on employee eligibility) and benefits (PERS rates, medical/dental increases, etc.). Historically, vacant positions were budgeted at 100.0 percent of control point for management and professional positions and fifth step for front-line positions. Medical benefits for vacant positions are budgeted at two-party HMO and dental benefits are budgeted at two-party.

Because filled positions are budgeted at actual cost, there is little salary savings derived unless the position becomes vacant during the fiscal year. Most salary savings is derived from vacant positions and most occurs in larger departments having more staff and, therefore, more turnover.

Staff has not previously applied a salary savings factor for modeling of salaries and benefits. Reasons for this include: (1) the salary and benefits budget is more consistent from fiscal year to fiscal year; (2) salary savings adds to the carryover which is used to fund limited-period expenditures and replenish reserves; and (3) applying an across-the-board salary savings factor can be difficult for smaller departments to absorb. Based on a survey of Santa Clara County cities, more than half of the cities do not apply a salary savings factor to their budget.

Another way to apply a salary savings factor is to change the way vacant positions are budgeted. Staff incorporated changing the practice of budgeting vacant positions from a full fiscal year to 80.0 percent of the fiscal year for the 2009-10 fiscal year budget. This is a 20.0 percent reduction and will require some positions remain vacant for part of the

fiscal year. This reduced the budget by approximately $300,000 (excluding vacant public safety position) after taking into consideration unfunded positions.

Frozen Positions

During Fiscal Year 2008-09, a partial hiring freeze was implemented. All vacant positions that do not result in a significant negative impact on City services or result in additional costs (such as overtime) are frozen and not being filled, subject to review by the Assistant City Manager and Employee Services Director. The purpose of this hiring freeze was both to save as much money as possible during the fiscal year while creating flexibility for unfunding positions in the context of the next fiscal year's budget.

As we work through the current fiscal year and into next fiscal year, as positions become vacant, they will continue to be reviewed to determine if they should be frozen. Doing so will allow the City to continue to generate salary savings and provide more flexibility for future positions that may need to be unfunded or to provide a position for an employee who may be moved due to their position being unfunded or eliminated.

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Attachment 23

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Attachment 23

OVERVIEW OF CITY'S INVESTMENT PORTFOLIO

The purpose of this memo is to provide some background and information regarding the City's investment portfolio.

BACKGROUND AND ANALYSIS

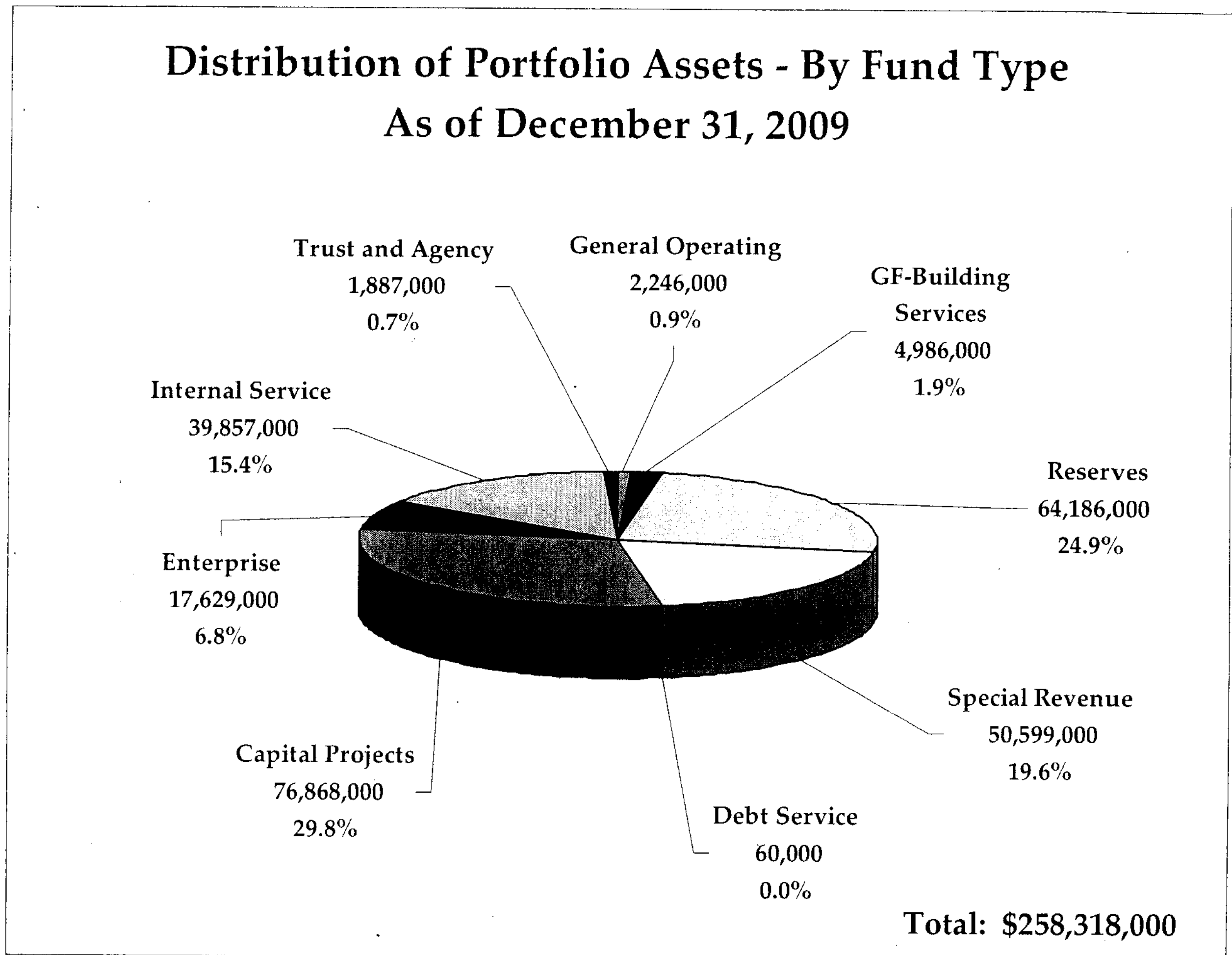
All cash and investments of the City are pooled, regardless of source, designated use or ownership by fund, to more effectively manage the City's resources. The City's investment portfolio is governed by the Government Code of California, Section 53600, and the City's own Investment Policy, B-2. The objective of the City's Investment Policy is to provide safety of principal, meet the cash flow needs of the City and to earn a market-rate return for the City.

The portfolio varies based on the cash flow of the City. The portfolio, as of December 31, 2009, is allocated to the various funds of the City as follows (dollars in thousands):

Fund	Amount	Percent
General Operating Fund	$ 2,246	0.9%
General Fund Building Services	4,986	1.9
Reserves	64,186	24.9
Special Revenue Funds	50,599	19.6
Debt Service Funds	60	0.0
Capital Projects Funds	76,868	29.8
Enterprise Funds	17,629	6.8
Internal Service Funds	39,857	15.4
Trust and Agency Funds	1,887	0.7
Total	$258,318	100.0%

For a definition of the variety of funds and fund types, please see memo regarding the overview of the City's accounting and fund types (Attachment 10).

The amounts above represent each fund type's share of the pooled investment portfolio. Below is a chart based on the above distribution as of December 31, 2009.



The chart above represents each fund type's ownership share of the City's pooled investment portfolio. This does not represent each fund's budget. The budget may use the fund's share of assets in the portfolio, but may also take into consideration the revenues flowing into the fund during the fiscal year. The portfolio is measured at a point in time, whereby the budget is for a duration of time being the fiscal year.

PERMITTED INVESTMENTS

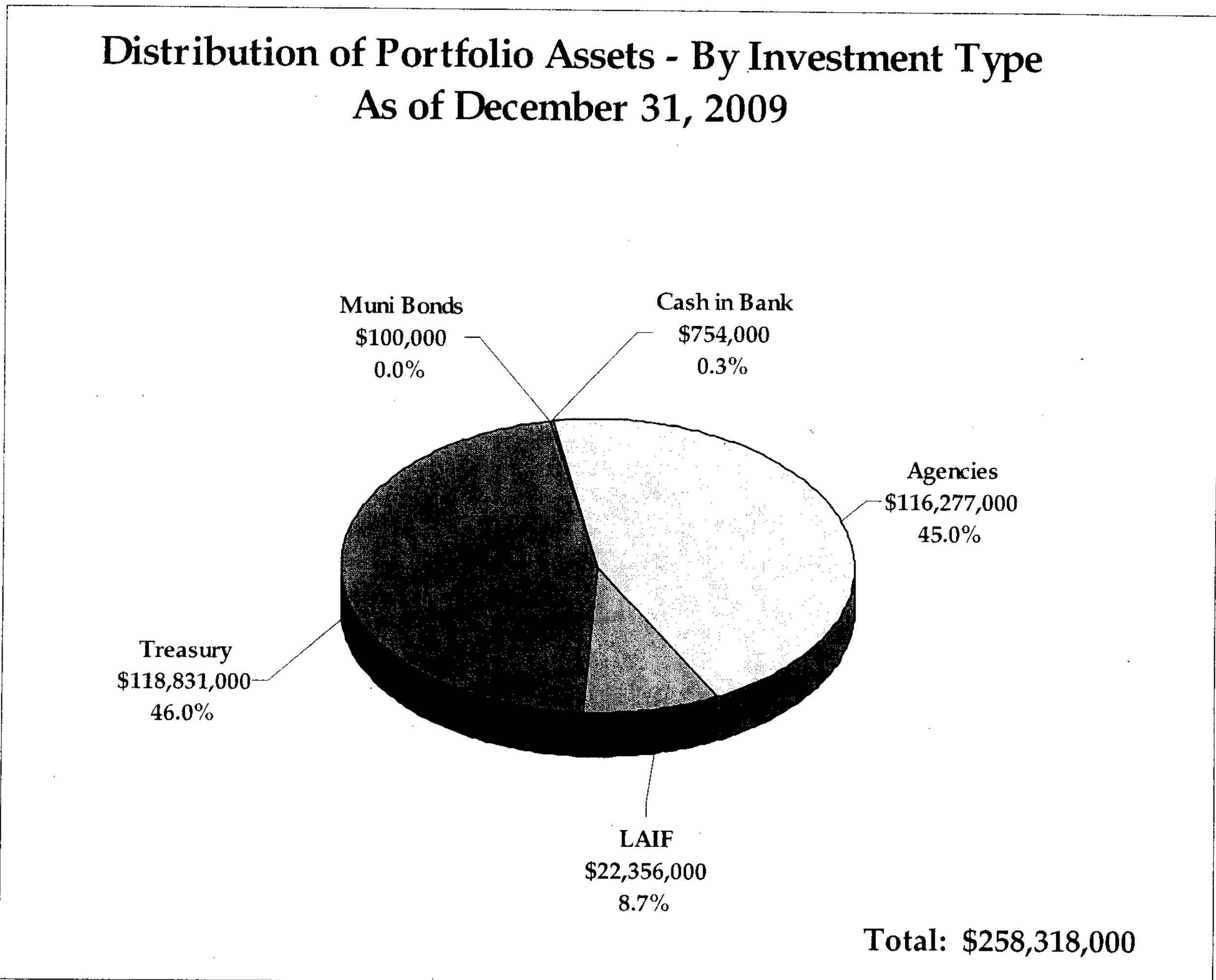
The Government Code and City's Investment Policy provides restrictions on the length and type of investments the City can purchase. The City's investment portfolio is a fixed-income portfolio primarily consisting of securities of the U.S. Government Treasuries and agencies of the U.S. Government or Government-Sponsored Enterprises (GSE). There is a five-year maximum maturity for any investment, unless explicitly approved by the Council. The safest investment is viewed to be U.S. Treasuries, as they are backed by the full faith and credit of the U.S. Government. The typical agencies the City has securities in are Fannie Mae (previously known as Federal National Mortgage

Association or FNMA), the Federal Home Loan Bank (FHLB) and Federal Home Loan Mortgage Corporation (FHLMC).

Additionally, a minimum of 5.0 percent of the portfolio is required to mature within seven days or less to provide for the liquidity needs to meet the obligations of the City. The City deposits money with the State of California Local Agency Investment Fund (LAIF) to meet this requirement, as funds with LAIF can be withdrawn on a daily basis with some restrictions as to the number of transactions in a month.

A summary of the types and limitations allowed by the City's Investment Policy is included as Exhibit A. Although there are a variety of investments permitted by policy, staff has focused placing investments in U.S. Treasuries, agencies and LAIF.

A breakdown of the City's investment by type is as follows:



CONCLUSION

The City's investment portfolio represents all the available resources of the City collectively, regardless of fund ownership. The portfolio is pooled to more effectively manage the City's resources with the objective of safety of principal, liquidity to meet cash flow demands and to earn a market rate of return. Based on the investment objectives, the City did not and has not experienced any investment losses due to the declines in the stock market or the current economic downturn.

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Exhibit A

ELIGIBLE INVESTMENTS AND LIMITS CRITERIA

With the exception of securities issued by the U.S. Government and its agencies, no more than 5 percent of the portfolio may be invested in securities of any one issuer.

No individual holding shall constitute more than 5 percent of the total debt outstanding of any issuer.

Type	Conditions	Rating	Limits	Maturity
U.S. Treasury Bills, Notes and Bonds	Fixed coupons, fixed maturity dates, no call provisions, no CMOs.	N/A	25% Minimum	5 Years
U.S. Government Agency Issues (e.g., F.N.M.A., G.N.M.A., etc.)	Fixed coupons, fixed maturity dates, no call provisions, no CMOs.	N/A	Total 50% of Portfolio in U.S. government agencies. 25% per Agency	5 Years
Mortgage-Backed Securities	Issued by an agency of the U.S. government.	N/A	Total 20% of Portfolio in U.S. government agencies. 25% per Agency	5 Years
Commercial Paper	Organized and operated in the U.S. with assets in excess of $500 million.	A1/P1	15% of Portfolio	180 Days
Banker's Acceptances	Eligible for purchase by the Federal Reserve System.	A1/P1	20% of Portfolio	180 Days
Medium-Term Corporate Notes	Fixed coupons, fixed maturity, no call provisions.	AA/Aa	10% of Portfolio	2 Years
Local Agency Investment Fund (LAIF)	N/A	N/A	20% of Portfolio	On Demand
Certificates of Deposit	Fixed coupons and fixed maturity date.	FDIC insured not exceeding $100,000; secured—see 9.1.7.2; unsecured—see 9.1.7.2	10% of Portfolio for each type	2 Years
Mutual Funds	Invested in U.S. government securities; strive for $1 per share price. Minimum $500 million in total portfolio value.	AAA/Aaa	10% of Portfolio	N/A
Municipal Bonds	City of Mountain View or a component unit of the City of Mountain View.	N/A	As approved by Council.	As approved by Council.

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