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Memorandum

To: Michael Bilbrey, Board of Administration and Chair of the Performance, Compensation and Talent Management Committee ("PCTMC") of CalPERS

Date: February 6, 2017

From: Eric Gonzaga / Grant Thornton LLP

Re: Enterprise Operational Effectiveness Metric 2016/2017

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Dear Mr. Bilbrey,

Background

The Performance, Compensation and Talent Management Committee ("PCTMC") engaged Grant Thornton ("us", we", or "Firm") to review proposed modifications to the annual incentive plan metrics for the 2016/2017 fiscal year.

In August, 2016, the Performance, Compensation and Talent Management Committee (PCTMC) approved various performance metrics for inclusion in the 2016/2017 incentive plans for the CalPERS executive team and the investment office. One of the performance metrics selected was Enterprise Operational Effectiveness, measured as a percentage ratio of Overhead Operating Costs as a Percentage of Total Operating Costs. After the August approval, the Finance and Administration Committee of CalPERS worked with management to conduct further analysis, and adopted the above metric as part of its 2017 through 2022 Strategic Plan. As part of this analysis, the Finance and Administration Committee adopted a goal of reducing overhead costs by 1.5 to 2 percentage points per year through the five year Strategic Plan.

In order to be consistent with the approved strategic goals from December, CalPERS is proposing three modifications to the Enterprise Operational Effectiveness metric for 2016/2017 incentive plan purposes:

- Change the baseline against which the performance improvement will be measured. In August, the baseline included three fiscal years against which performance improvement would be measured against (2013/2014; 2014/2015; 2015/2016). The proposal would exclude 2013/2014, and would measure performance improvement against 2014/2015 and 2015/2016 fiscal years only. 2013/2014 is considered a transitional year, and inclusion as a benchmark is considered an anomaly given that it includes significantly lower costs in the Health Program as it was the first year of the flex-funded plan options. Going forward, performance improvement will be measured against average three-year performance improvement
- Change the incentive payment hurdles to be consistent with the targeted performance improvement approved in December 2016, as opposed to the current ratios that were built off of performance improvement based on 2016/2017 budget. The rationale is to target performance improvement consistent with the December 2016 strategic plan approval, and to allow for ease of administration by establishing targets linked directly to long-term strategic improvement, as opposed to the annual complexities of the budgeting process.

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- Modify the interpolation used to establish payouts under the incentive plans. As approved in August 2016, the plan allows for linear interpolation, thereby increasing or decreasing award with each incremental change in performance relative to the target. The current proposal would modify this use of interpolation, by allowing increase or decrease in award with .5% to .6% increases or decreases in performance. Thus, the proposal creates ranges of performance that must be met before any award is increased or decreased.

Analysis and Conclusions

Grant Thornton has reviewed the proposed changes and the supporting detail, and believes that these proposed modifications are reasonable. Our conclusions are based on the following:

- The use of discretion in modifying performance outcomes during a specific period is a common tool exercised by all Compensation Committees charged with administering executive compensation programs. Actual exercise of discretion in modifying performance outcomes during the performance period are rare, but are used in instances when doing so would enhance the strategic alignment of executives with the strategies of the organization. Such discretion is typically used in instances where there are unexpected circumstances that could not reasonably be anticipated, or when organizations are implementing a new plan (like in this instance).
- Exclusion of the 2013/2014 year for performance measurement purposes appears reasonable, particularly given that the 2013/2014 is not representative of current state CalPERS Health Programs, and hence potentially skews measurement of performance improvement.
- Changing the performance improvement targets to percentage improvements over the historical averages consistent with the strategic planning targets is reasonable, particularly given that the performance challenge is consistent with the strategic plan approved after the August 2016 date at which the metric was approved, in addition to the fact that CalPERS has a strong history of beating the budget. Hence, the proposed metric potentially increases the challenge of meeting goal.
- Modifying the use of interpolation to the proposed ranges is reasonable. Although straight-line interpolation is common, some organizations use interpolation via banding and ranges of performance as well. The argument is that it reduces the risk of decision-making based on small incremental performance improvement as increase/decrease of reward will only occur if performance is “meaningful” (i.e., improving the ratio by .5% to .6%).

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We hope this information is helpful to you, and please feel free to reach out to us with any questions.

CAVEATS

This memorandum address certain U.S. Federal income tax issues only and does not address state, local or other foreign tax issues. Our discussion is based on the Internal Revenue Code of 1986, as amended, the Treasury Regulations promulgated thereunder, and other relevant authorities. These authorities are all subject to change, and such change could have retroactive effect. Any such changes could thus have effect on the validity of our conclusions. Unless specifically requested, we will not update this Memorandum for subsequent changes or modifications to these authorities. Further, this memorandum is based on interpretation of these authorities; another knowledgeable party (such as the IRS or court hearing the same facts) might reach different conclusions.

The advice expressed in the Memorandum is not an opinion as to the tax consequences of the transaction. We would need to perform a more thorough review and analysis before we could render an opinion. Our conclusions are limited to the issues addressed in this Memorandum, and are based on facts, assumptions, documents and representations we have received from you, and on any assumptions stated herein. We have neither independently investigated nor verified these facts, representations or assumptions, although we have considered their reasonableness. If any of the facts, representations or assumptions reflected in the Memorandum are not accurate, our conclusions are not applicable.

DISCLOSURE PURSUANT TO IRS CIRCULAR 230

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