A REPORT BY
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Report 1503

Time for a New Look at Pension Costs

The County Could Save Nearly $100 Million a Year through a Sensible and Fair Approach to Pension Reform.

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Contra Costa County Grand Jury Report 1503

Time for a New Look at Pension Costs

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TO: Contra Costa County Board of Supervisors
Contra Costa County Fire Protection District Board of Directors

SUMMARY

The biggest financial challenge facing the County is managing the cost of its pension and retiree health benefit obligations. The cost of pension benefits alone has doubled as a percentage of the budget since 2000. Pension and retiree health benefits combined now cost the County over $375 Million per year. This compares to a total of $183 Million as recently as ten years ago. These costs are legal debts. They take priority over funds otherwise available for other County services. As a result the County has over the past ten years cut back a wide variety of County services and reduced staffing levels in the Sheriff's Department and County Fire Department. Despite these huge costs, the County has not challenged the prevailing assumption that California law prohibits it from negotiating reductions in pension benefits for its employees who entered service before 2013. We believe that assumption is in error. A sensible and fair change or clarification in California law governing pension benefits not yet earned by current public employees would enable the County to save nearly $100 Million a year. The Board of Supervisors should without delay seek such a change or clarification in California law.

BACKGROUND

In the past several years the staggering load of pension costs on city, county, and state governments has been headline news. Indeed, the cities of Detroit, Stockton, and Vallejo filed for bankruptcy protection, in large part due to retirement obligations they could no longer afford. Why have city, county, and state officials around the country apparently failed to manage their pension and other retirement obligations responsibly? In the words of Warren Buffett, a big reason was a simple failure to "…fully grasp the magnitude of liabilities they are incurring by relatively painless current promises." He was pointing out that unlike writing a check for $100,000 today to cover a current bill, promising to pay a $100,000 pension far into the future hardly feels like a burden at all—even though in the case of a “pension promise,” the final payment will be far higher due to future salary increases, cost of living adjustments, and longer life expectancies. Another important reason, as one of our witnesses put it, is because public officials face constant pressure to “overpromise and underfund” when grappling with pension issues. That is, they increase such benefits as a relatively painless way to resolve labor negotiations while seeking ways to minimize contributions to the pension funds that are necessary to assure the benefits will be paid when due. The “pain” in such cases falls on future officials and their constituents who will have to pay the pension bills then coming due.

In California and Contra Costa County (“County”) these pressures led to a “perfect storm” in 1999 and 2002 that dramatically increased pension liabilities around the state. First, based on the very strong stock market gains of the late 1990’s, the state passed legislation in 1999 that authorized large retroactive pension benefit increases for state employees. These increases were major financial windfalls for state employees. The employees had not been required to contribute to the cost of these increased benefits during their previous career years. Yet they received full service credit for pension benefits in many cases pegged at 50% higher levels for each year of service and offering lower retirement ages for the enhanced benefits. The law was sponsored by the state’s largest pension fund, the California Public Employees Retirement System (“CALPERS”). CALPERS assured lawmakers that continued stock market gains in the pension fund would fully cover the cost of the new benefits without the need for higher contributions to the fund. This view proved to be mere wishful thinking after the “dot.com” crash of 2001 ushered in an era of sharply reduced stock market returns.

California counties followed the 1999 CALPERS-sponsored legislation with a bill of their own to authorize similar retroactive pension benefits and financial windfalls for their employees. The County, in common with other counties and cities throughout the state, then felt obliged for competitive reasons in 2002 to match the state’s retroactive pension benefit increases. The result was a large increase in its unfunded pension liabilities. The new benefits had not been funded through past contributions, and the long period of stock market gains of the late 1990’s did not return. The County was then woefully ill prepared to withstand the huge losses in its pension fund that arose during the Great Recession of 2008 – 2009. The consequence has been a major financial challenge for the County, with its obligations for pension and other retirement expenses forcing cuts in County services, layoffs, and a pay scale for its employees that is below that of many neighboring cities, counties and other public agencies.

The story of how city, county, and state pension and other retirement obligations became so large and burdensome has important lessons for all of us. Many of the pressures that have made the problem so large continue to this day. To its credit, the County has begun to address the issue and has achieved some success in reducing its level of retirement obligations with the cooperation of its employees. However, the County should take further decisive steps to bring pension and retirement liabilities under control. These costs endanger the County's ability to deliver essential public services and to assure its employees that their retirement benefits are financially secure.

The focus of this report is what additional actions the Grand Jury believes the County should take to reduce the cost of its pension obligations in a fair and responsible manner.

DISCUSSION

1. How big are the County's pension and other retirement debts?

To assure it will have sufficient funds available when needed to cover its pension and retirement obligations when they come due, the County makes payments into pension and retirement funds each year to be kept in reserve for paying those obligations. To determine what these funding levels should be, the County works with actuaries who calculate the required funding levels. These levels are based on expected employee retirement dates, expected life spans, and the level of benefits that an employee will be entitled to receive. However, the County has not contributed enough to its pension and retirement funds to cover the full cost of its projected obligations. The following figures provide a financial snapshot of the immense gaps that remain before the County will have fully funded its pension and other retirement obligations.

- **$1.26 Billion**. This is the County's current shortfall in its pension funding. The County currently covers the shortfall by increased annual payments to its pension fund in an amount set by the fund's actuaries. These payments come at the cost of cutting other items in the County budget. The only other options the County has for reducing this shortfall are hoping for increased investment returns from its pension funds, or seeking tax increases. If this amount came due today as a property tax assessment applied equally to all taxable parcels in the County, each homeowner in Contra Costa County would need to pay $3,494.

In addition to its pension liabilities, the County and its largest fire district, the Contra Costa County Fire Protection District ("CCCFPD") carry a major obligation to their employees for other retirement benefits, principally health benefits. These benefits are called "other post-employment benefits" ("OPEB"). The County and CCCFPD have the following gaps in funding for these benefits:

- **$923.8 Million**. The amount actuaries retained by the County have calculated the County should have already set aside in its OPEB funds to cover its OPEB liability to current and retired employees.
- **$129.4 Million**. The amount the County has currently available in its OPEB funds to cover the OPEB liability, as computed by the actuaries.
- **$794.4 Million**. The County's current deficit in its OPEB funding. Although the County's actuaries calculate that the County should be contributing $88.5 Million

a year to the OPEB fund in order to retire this shortfall over the next 24 years, the County only contributes $20 Million a year, due to budget constraints. The County also continues to pay directly a significant portion of the current health costs incurred by its retirees. In its fiscal year ending June 30, 2014 this direct payment amounted to $57.3 Million. The $794 Million shortfall is a debt that corresponds to an additional $2,205 for each taxpaying homeowner in the County.

Besides its accrued unfunded pension liabilities, the County has outstanding a total of $276,830,000 in "Pension Obligation Bonds" or "POBs." These are bonds the County issued in 2001 and 2003 for the purpose of making additional contributions to its pension fund in order to reduce the County's unfunded pension liabilities. Accordingly, these bonds should be viewed as additional pension obligations of the County. The $276.8 Million of pension bond obligations outstanding reflects a further debt of $769 for each homeowner if allocated equally to each parcel in the County. See the Appendix, item 1, for further information on Pension Obligation Bonds, including the potential risks to the County in relying too heavily on such bonds to finance its pension obligations.

The County has oversight responsibilities for the CCCFPD, which has a separate set of pension obligations to its employees and retirees. The County supervisors serve as the governing board of the CCCFPD in addition to their duties on the Board of Supervisors. The CCCFPD performs an essential public safety service, including the operation of 23 fire stations. As a special district it is, however, primarily dependent on property tax revenues. This has led to the CCCFPD running a serious deficit ($6 - $10 Million a year) for a number of years and dipping deeply into its reserve funds. As a consequence the CCCFPD has not been able to afford necessary equipment modernization and other capital improvements for a number of years. Pension costs are a major factor contributing to the deficit. CCCFPD pension liabilities are as follows:
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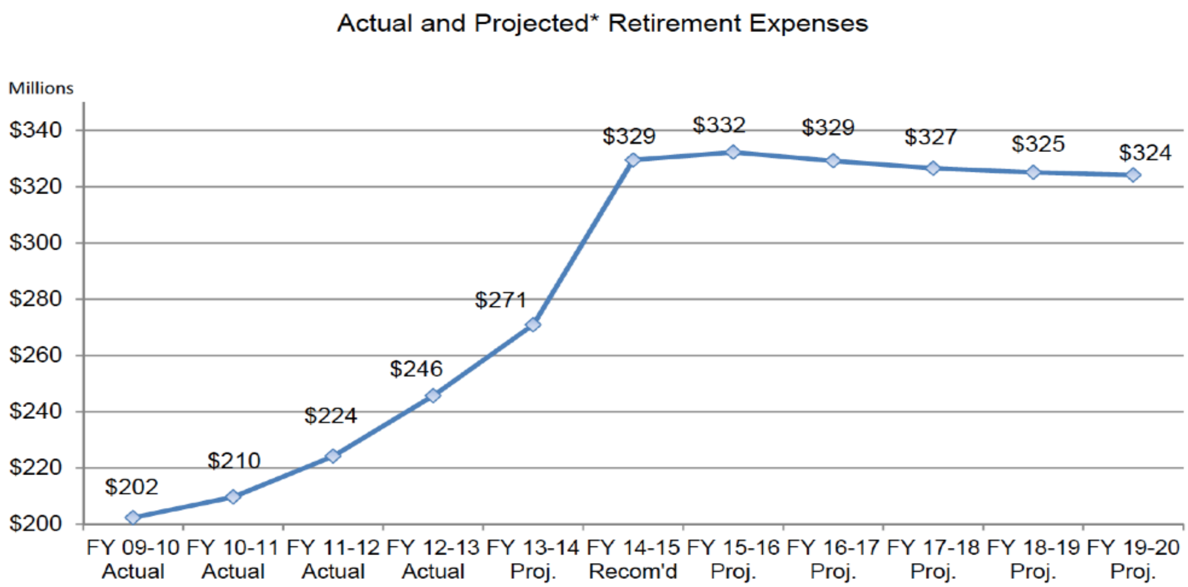
- **$180.2 Million**. CCCFPD's current deficit in its pension funding.
- **$107.4 Million**. CCCFPD's outstanding balance owed on pension obligation bonds.

As shown above, the County and CCCFPD carry an enormous financial load in the form of funding shortfalls arising from their pension and OPEB liabilities. The County and CCCFPD's combined shortfalls in funding total $2.6 Billion. If that combined load came due today in the form of an equal property tax assessment on all Contra Costa County taxable parcels, the charge would be $7,273 for each homeowner in the County.

2. **How much does it cost the County each year for pension and OPEB expenses?**

The County (including CCCFPD) now budgets over $375 Million annually to cover its pension and OPEB costs. The following chart, which includes only pension costs, shows how this annual payment has grown dramatically in recent years. In 1999-2000, the pension costs amounted to $67 Million, about five percent (5%) of all County revenues. Today, the recommended budget for pension costs is $329 Million, over 11% of all revenues. The leveling off of projected expenses shown in the chart starting in fiscal year ("FY") 2015 -2016 assumes that the County retirement fund will be successful in achieving its projected 7.25% return on invested funds.



These large increases in the County budget for retirement costs have been a major factor in County decisions to cut spending for health services, public safety (both sheriff and fire), and public works. The County has also had to defer important building maintenance and upgrade projects, including the construction and staffing of an emergency operations center. All of these projects and services have been "crowded out" in large part because of the County's obligation to keep its pension and other retirement obligations properly funded.

3. What sort of a pension plan does the County offer its employees and how is it paid for?

The County offers its employees a "defined benefit" pension plan. Unlike most plans in private industry, this means that the employee will be entitled to receive on retirement an annual pension based on his or her final or three-year average salary. The amount of the pension is calculated based on the employee's years of service multiplied by a percentage for each year of service. For example, a 3% at 55 pension benefit means that an employee with 25 years of service at age 55 could retire at that age with a pension equal to 75% of his or her salary (25 x 3%). In contrast to the "defined contribution" plans now prevalent in private industry (where only the amount of the employer's contribution is guaranteed), the amount of the pension benefit is guaranteed by the County. It does not change based on the investment results of the pension fund.

The pension payments gain added value from certain cost of living escalators (also known as "COLAs"), generally capped at 2% or 3% per year, that provide important inflation protection for the retiree.

The County's guarantee of each retiree's yearly pension benefit is the key to understanding why pension costs are now such a large and growing cost for the County. To fund these pension obligations, the County and its employees each contribute an amount each year to a pension fund managed by the Contra Costa County Employee Retirement Association ("CCCERA"). The contribution has two components. The first is the "normal cost," as determined by CCCERA's actuaries, to fund the amount of the pension benefit earned by the employee each year. The second is an amount paid to reduce the "unfunded accrued liability," the sum required to fund the employee's already accrued benefits that are not fully funded. The County and the employee share the expense of the "normal cost," although for employees hired before January 1, 2013 the County pays a larger percentage of the normal cost. However, the County bears 100% of the cost of the unfunded pension liability (actuaries refer to this as the "unfunded actuarial accrued liability" or "UAAL"). Because it is solely responsible for the UAAL liabilities in its pension plans, the County on average contributes about three times as much as its employees each year to fund the cost of their pension benefits.

4. Why have the County's retirement obligations grown so large?

The County's UAAL pension obligations are the "shortfalls in pension funding" referred to in the financial snapshot in section 1 above. They are the root cause why the County's pension costs have risen dramatically in recent years, creating immense financial challenges for the County. The UAAL obligations have grown so large for three principal reasons:

1. Granting retroactive pension benefit enhancements in 2002. Granting retroactive pension benefit increases virtually assures that an unfunded liability will arise, because no regular contributions have been made in the past to fund such higher benefits. This took place in Contra Costa County in 2002, when the County agreed to fund new benefits from so-called "excess earnings" in the CCCERA retirement funds. The "excess earnings" reflected higher than expected investment returns during the "dot.com" era of the late 1990s. The 2002 retroactive benefit grant was an unexpected windfall for employees. It offered pensions at earlier retirement ages and with increased benefits. These new benefits encouraged early retirements and led to sharply increased unfunded liabilities. The "excess earnings" proved insufficient to cover the cost of these new benefits when market gains turned sharply lower after 2000. CCCERA then called on the County to increase its pension contributions to cover the deficits arising from the retroactive pension benefits that had not been properly funded.

2. The impact of the Great Recession of 2008-2009. Six years after it had begun to bear the cost of the retroactive pension benefit increases, the County was hit very hard by investment losses in its pension fund in 2008. At least half of the money projected to fund the County's retirement benefits arises from capital gains and dividends on its pension funds. Whenever the CCCERA pension fund fails to meet the projected investment return (currently 7.25%), a shortfall develops in the pension fund. The County is then obligated to fill the gap by means of increased contributions. In 2008, the CCCERA pension fund losses were very large (over 28% or $1.47 Billion) resulting in very large additional bills to the County for increased contributions to cover the difference. See the Appendix, item 2 for additional information on how CCCERA calculates the unfunded liabilities for the County pension fund and the cost to the County when CCCERA does not earn its expected rate of return.

3. California Law Apparently Preventing the County from Negotiating Reductions in Future Pension Benefit Rates for Existing Employees. One sensible way to reduce retirement obligations arising from past increases in pension benefit rates would be for the County and its employees to negotiate through collective bargaining reductions in pension benefits to be earned in future time periods. However, in contrast to wage and other benefit negotiations, the County has not negotiated reductions in future pension benefits for current employees through collective bargaining because of obstacles arising from highly inflexible court decisions unique to California and a minority of other states.

5. Why is it so difficult for the County to manage its pension liabilities?

As noted above, the County and CCCFPD face a huge debt totaling over $2.6 Billion for combined pension and OPEB obligations. The sheer size of these liabilities makes them a major financial challenge. To its credit, the County has taken important steps to address its retirement cost problems. However, it faces external circumstances in facing this challenge that are outside its control.

The County's pension funds with CCCERA are now so large (over $5 Billion) that it faces a risk each year of incurring substantial additional obligations for pension contributions in the event CCCERA does not achieve its expected 7.25% return on those funds. For example, a slip of only one percent (1%) in the expected return (i.e., a gain of only 6.25% instead of 7.25%) would create an additional County UAAL debt of over $52 Million. A slip of 10% (i.e., a loss of 2.75%, instead of a gain of 7.25%) would create an additional UAAL debt ten times larger, of over $520 Million. Actuarial rules allow CCCERA to spread out these investment losses over five years, so the loss is not all realized in one year. The new UAAL debt in such a case would also not be payable immediately by the County. The County would be required to pay the new debt over a period of 18 years. Nevertheless, such investment losses are risks the County cannot control and that require the County to establish additional cash reserves in order to manage them prudently. See the Appendix, item 2 for further discussion of the UAAL risks carried by the County.

With respect to its OPEB obligations, the County has taken steps to limit the growth of these costs. Through negotiations with its employees, it has "frozen" the dollar amount it contributes to the health benefits that comprise most of the OPEB costs. It is also developing lower cost health plan options for its employees. That has led to a significant drop in the OPEB UAAL liability from $2.6 Billion in 2006 to $794 Million as of January 1, 2014. However, $794 Million is still a very large debt, and the County has only funded approximately 16.3% of this much-reduced OPEB liability. Because of the huge size of the OPEB debt, the County has adopted a plan to retire the debt over a period of 30 years, ending in 2038. The County's annual $20 Million contribution to the OPEB trust fund is well below the $88.5 Million determined by its actuaries as necessary to fully fund its OPEB benefit obligations accruing each year. However, the County also continues to pay OPEB benefits for retirees on a "pay as you go" basis, which cost an additional $57.3 Million in fiscal 2014. Accordingly, the $20 Million set aside for future OPEB benefits each year (plus retiree benefits still paid on the "pay as you go" basis) will continue to draw significant County resources for many years. The County therefore has no current prospect of reducing either pension or OPEB costs by means of surpluses generated in its OPEB accounts.

The County has taken responsible actions in cooperation with its employees and CCCERA to reduce a portion of its pension costs. It has secured agreements from its employees for greater contributions from them toward the cost of their pension benefits. It has supported CCCERA's efforts to counter so-called pension "spiking," although further work remains to change a pension benefit culture that tolerated and at times encouraged such practices. In "spiking" cases certain retiring employees artificially increased their pension by adding to their final salary calculation unusual pay enhancements, such as a much larger than normal number of "on call" days or other additions not contemplated by the pension plan. Since the plan's actuaries did not contemplate such enhancements, the costs associated with them were not properly funded. These "spiked" pension benefits represent windfalls for the employees and additional costs to the County because of its guarantee of the amount of each employee's pension benefit.

The County has also supported CCCERA's move to a more conservative 7.25% rate of return assumption (from an earlier 7.75%) in its pension fund investments, and has ceased offering "subventions" (i.e., subsidies paid by the County) for its employees' designated share of their annual pension contributions. The move to the lower 7.25% rate of return has required increased contributions to the pension fund by both employer and employee to cover the cost of pension benefits. That is because the fund was no longer permitted to assume that a higher percentage of the pension benefits would be financed by investment returns. While the lower return assumption imposes higher costs on both the County and its employees, it is the more financially prudent course since future investment returns are never guaranteed.

Finally, the County has supported CCCERA's action to limit pensionable compensation for members joining the pension plan after January 1, 2013 to base pay only. This action has the effect of reducing the cost for the County and its employees of pension contributions that would otherwise be calculated against a higher salary base. It also reduces the size of the compensation base on which the County will be required to bear the risk of any shortfalls in the investment results of the CCCERA pension fund to finance the cost of the pension benefit. It is a more conservative financial position than that adopted by CALPERS, which has agreed to broaden the definition of pensionable compensation for its plans.

Another difficulty the County has in attempting to reduce pension costs responsibly is that other counties, cities and public agencies are not required to do the same. A less fiscally responsible jurisdiction may, for example, establish higher investment return assumptions for its pension fund or take other steps that lower the level of contributions required of employees to fund their pensions. This creates an enticement for County employees or candidates to seek job offerings in other cities and counties. An employee may find he or she would receive higher take-home pay by working at a comparable job with a comparable pension benefit in that jurisdiction. CALPERS, for example, serves as the pension fund for a large number of California cities and counties that compete with the County for key employees. CALPERS charges its employee members a lower pension contribution from their paycheck than does CCCERA for a comparable pension benefit. The CALPERS employer must make up the difference.

Accordingly, whatever steps the County takes to manage and reduce its pension liabilities must be done in a way that balances a vital competing interest. The County and its citizens have a fundamental interest in attracting and retaining a skilled and professional workforce. That means any remedies the County pursues to reduce the size of its pension obligations must account for competitive realities in the marketplace and be viewed as fair and reasonable by its employees.

6. What is the California legal problem peculiar to pensions?

A peculiar feature of California law governing pension benefits has seriously hampered the County in its efforts to reduce pension costs fairly and responsibly. It also restrained the state legislature in its most recent attempt at major pension reform in 2012.

In response to a broad public consensus that growing pension liabilities of cities and counties in California had become unsustainable, the state legislature in 2012 passed a major pension reform law, the "Public Employee Pension Reform Act," also known as "PEPRA." When Governor Brown signed PEPRA into law in September 2012, he described it as "sweeping bipartisan pension reform legislation that saves billions of taxpayer dollars by capping benefits, increasing the retirement age, stopping abusive practices and requiring state employees to pay at least half of their pension costs." While all true, this statement left out an important point. The major cost-saving reforms in PEPRA only apply to public employees hired on or after January 1, 2013. The pension benefits for public employees hired before that date were largely unaffected. Most of the savings in pension costs offered by the PEPRA reforms will only occur gradually over the next 30 years as the new generation of public employees work through their careers and retire. In the meantime the County, like other public entities in California with large UAALs, faces the prospect of only very modest pension cost relief for the foreseeable future if no other pension reform steps are taken.

What is the legal problem? Unlike the rules governing private company pensions and the rules governing public employee pensions in most states, the California Supreme Court has issued rulings that severely restrict the ability of the County to make changes to benefits not yet earned under its pension plans. In a 1947 case, Kern vs. Long Beach, the Court ruled that public employers offering pension benefits to their employees have no right to eliminate the pension benefit to be earned in future work periods for any employees who started work when the pension system was in place. That contrasts with the general rule applicable to private employers. The private employer rule protects only pension benefits already earned on a year-to-year basis, and does not prevent an employer from making changes or even eliminating pension benefits for current employees in future time periods. The Kern court did, however, provide that the public employer "may make modifications and changes in the system. The employee does not have a right to any fixed or definite benefits, but only to a substantial or reasonable pension. There is no inconsistency therefore in holding that he has a vested right to a pension but that the amount, terms, and conditions of the benefits may be altered."

Had the California case law remained as set forth in the Kern case, the County would have retained important tools to manage and adjust its future pension obligations. However, a later Long Beach case, Allen vs. City of Long Beach, decided by the California Supreme Court in 1955, removed these tools. That case held that not only was a public employer prohibited from terminating a pension plan for current employees; it must also assure that any alterations in the pension plan "which result in disadvantage to employees should be accompanied by comparable new advantages." This meant that after the Allen case public employers in California were on a one-way legal elevator that only went up. In contrast to wages and other employee benefits, any pension benefit granted to a current employee could not be reduced in future periods even though such benefits had not yet been earned.

The opinion in the Allen case was very brief and did not provide a clear rationale for its finding that a fully vested contract right to an unalterable pension benefit arises on the very first day on the job by a public employee. Three points distinguish that case from circumstances today. First, the changes to the pension plan at issue in the Allen case were imposed by city ordinance and not by means of collective bargaining. The right of city and county employees to engage in collective bargaining was not enacted until 1968. Second, the changes the city sought to impose in the Allen case made no allowance for protecting pension benefits already earned by employees based on years they had previously worked. Third, in sharp contrast to today's circumstances, there was no suggestion in the Allen case that the city would have any difficulty in paying for the higher pension benefits the court left in place. The ratio of active employees to retirees was much higher in 1955; pension benefit rates were lower; Proposition 13 restrictions on California public revenues were far in the future; lifespans were shorter and retirements occurred later in life. All of these economic factors made pension costs much more manageable than they are today.

The consequence of the Allen case and subsequent decisions that followed it has been severe from the standpoint of a city or county seeking to reduce its pension costs. Most public agencies in California have taken the view that the vested pension contract right the Court found in the Allen case could not be changed by collective bargaining. That is a questionable assumption since collective bargaining did not exist for public employees at the time the Allen case was decided. The Meyers-Milias-Brown Act was passed in 1968 and since that time has set the legal framework for collective bargaining between public employees and their employers. The Act provides that collective bargaining is to govern "all matters relating to employment conditions and employer-employee relations, including, but not limited to, wages, hours, and other terms and conditions of employment." Certainly, pension benefits are an element of compensation and a term of employment for public employees. It is therefore time to question seriously whether public employers and their labor organizations have been correct to exclude possible reductions in future, unearned pension benefits for current employees from collective bargaining negotiations.

The California Supreme Court based its decision in the Allen case on the protection extended to contract rights under the Contracts Clause of both the California and the U.S. Constitutions. Both Constitutions prohibit California from passing laws that impair contract obligations. Nothing in that prohibition prevents the party to whom the contract obligation is owed from agreeing voluntarily to amend or waive that obligation. Since a pension benefit to be earned in future time periods is clearly a term and condition of employment, the size and terms of that benefit obligation would appear to be a proper subject of collective bargaining under the Meyers-Milias-Brown Act. In such cases, the public employees' bargaining representatives would be authorized to modify and adjust future pension benefits to be earned, as is common and accepted practice in labor-management collective bargaining. A California appellate court in the 1998 case of Public Employees Association vs. City of Fontana emphasized the importance of the collective bargaining system created by the Meyers-Milias-Brown Act. Otherwise, noted the court, the "employer [would be required] to negotiate over working conditions with any number of employees, thereby defeating the Act's goals of ensuring stability in labor management relations and the right of employees to join and be represented by an employee organization."

The Constitutional protection for contract rights does not define how broad a contract right should be implied or found in a particular case. Federal courts would have the final say on whether the U.S. Constitution extends the same protection to future, unearned pension rights that the California Supreme Court found in its Allen decision. It is unlikely a federal court would have reached the same result that the Allen Court did. A recent opinion by the Chief Bankruptcy Judge in the Eastern District of California, a federal court, had this to say about the California case law on pensions:

"The California Supreme Court has construed the Contracts Clause of the California Constitution to recognize an unusually inflexible 'vested right' in public employee pension benefits. In contrast, the United States Supreme Court takes a less rigid view of the extent of a 'vested right' in retiree benefits." Opinion by Chief Judge Klein in the Stockton Bankruptcy Case, February 4, 2015. (Emphasis added.)

The failure to bring pension benefits to the bargaining table has also run counter to the wishes of many employees. In the County's own experience, at least one bargaining unit was ready to negotiate reductions to future pension benefits not yet earned in exchange for reduced pension contributions and other benefits. However, the County took the legal position that such changes needed to be unanimously approved by all of the unit's members because of the Allen line of cases. The County has also pursued a proposal with the support of certain of its employee groups that would have allowed individual employees on an optional basis to select a pension plan that had a lower benefit level in exchange for lower pension contributions and higher take-home pay. This proposal did not go forward, however, because of legal issues that arose for such an "optional" program under federal tax law.

7. **How much could the County save through a sensible and fair change in California pension law?**

A change or clarification to California law confirming that reductions in future, unearned pension benefits are subject to collective bargaining could greatly reduce the County's enormous pension liabilities. At present, the County's main tools for reducing pension costs are to hold down salary costs, negotiate greater contributions from employees toward the cost of their pensions, outsource services to the extent permitted under California law, and in extreme situations, lay off or furlough employees. These limited options force hardships on County employees and make it harder for the County to recruit and retain key employees. The peculiar features of the California public pension law have also led to an unusual and unfair situation in which unequal pension benefit scales exist for employees hired before or after January 1, 2013, even though they may be performing the very same jobs.

The savings the County could achieve by negotiating changes to future, not yet earned pension benefits for its employees hired before 2013 could be huge. Yet the reductions in future pension benefits could still preserve for all employees hired before 2013 a "substantial or reasonable pension," in the words of the Kern case, and protect each employee's pension benefits already earned. The "substantial or reasonable pension" guarantee for future periods could be based on the benefit rates incorporated into the PEPRA legislation passed with large bipartisan majorities in the State legislature in 2012. Such a limited change in future benefit rates could still result in very large financial savings for the County. After consulting with a qualified actuary, here are the savings we understand the County and CCCFPD could achieve each year in their pension costs if they were able through collective bargaining to set pension benefits to be earned by their pre-2013 employees in future time periods at the same rates that apply to their PEPRA employees (including 2% post-retirement COLA increases):

1. For each employee in a “Safety” category (i.e., fire or sheriff) a savings of 29% of pensionable compensation; a total of $29,169,000 in savings annually based on 2014 payroll figures.
2. For each employee in other categories, a savings of 17% of pensionable compensation; a total of $69,920,000 in savings annually based on 2014 payroll figures.

Thus, a change or clarification in California law governing future pension benefits for current employees followed by successful negotiations with its employee groups could result in over $99 Million in annual pension cost savings. The annual potential savings would continue for a period of 18 years, for a theoretical aggregate savings to the County of well over $1.5 Billion. The actual savings would depend on the rate of retirements and job changes among employees hired before 2013, changes in life expectancy tables, and future salary increases. The actual savings would also depend on the details of the altered pension benefits agreed with employees at the bargaining table. For example, the savings would be lower if the reduced future pension benefits were limited to employees with less than 20 years of service credit. The net savings would also depend, of course, on the amount of wage increases or other benefits negotiated with the employee bargaining units in exchange for the future pension benefit reductions.

Another proposal the County could put forward in such negotiations would be a suspension or elimination of COLA benefits to be earned in future employment periods for both pre-2013 and PEPRA employees. Again, COLA benefits already earned and paid for on a year-to-year basis would be fully preserved. Based on advice from a qualified actuary, a suspension of future COLA benefits would result in annual savings to members and the County of 7.4% a year for Safety employees and 3.6% each year for all other employees. That would mean annual dollar savings for the County based on 2014 salary figures of $7.4 Million and $14.8 Million, respectively, for pre-2013 employees alone.

Such pension benefit changes (if implemented through collective bargaining) may be of interest to sizable numbers of the County’s employees hired before 2013, particularly younger employees. Many of these employees appear to prefer higher take-home pay rather than a larger, and less certain, pension benefit.

Limiting pension reform for pre-2013 employees to future, not yet earned benefits and assuring them through collective bargaining an opportunity to negotiate minimum future pension benefits linked to PEPRA benefit rates appears to be a sensible and fair path forward to pension reform. These changes would protect pre-2013 employees' benefits that have already been earned. They would also assure them benefits for future periods (assuming they remain employed by the County) on a par with the benefit schedules approved by the state of California for all employees hired after January 1, 2013. Linking all future pension benefits earned to PEPRA rates would also be an important step in eliminating the benefit differentials that now exist between County employees in the same job classifications. PEPRA employees hired after January 1, 2013 earn smaller pension benefits than do their counterparts hired before that date who may be performing the same work.

8. How can the California legal problem be solved?

There are four avenues open to the County to seek pension reform tied to the collective bargaining rights and protections now guaranteed to public employees.

Legal Reform Through the Initiative Process. One such avenue is for the County to join groups seeking to change the public pension law by means of a state ballot initiative. The initiative would seek to overturn the inflexible rule against reductions in future pension benefits established by the Allen case.

Legal Reform Through "Friend of the Court" Briefs. Another avenue is for the County to file "friend of the court" (also known as "amicus curiae") legal briefs in pending court cases related to California public pension law. Such briefs could urge reconsideration of the Allen case and the line of cases that followed it. These cases have created major difficulties for cities, counties and their employees to deal with the vast pension costs that now confront most public agencies in California.

Amendment to the Meyers-Milias-Brown Act. The County could sponsor clarifying legislation to the Meyers-Milias-Brown Act, stating explicitly that the terms and conditions of employment subject to collective bargaining governed by the Act include pension benefits. The specific clarifying language could be quite simple, such as the following addition to section 3504 of the Act setting forth the authority of a labor organization: "The scope of representation shall include all matters relating to employment conditions and employer-employee relations, including, but not limited to, wages, hours, [pension benefits] and other terms and conditions of employment." (New language in brackets).

Commence Collective Bargaining of Future Pension Benefits. The County could simply place changes to future pension benefits for current employees on the collective bargaining table as a proper subject of negotiation. This action could prompt a legal challenge, but the County would be in a position to argue forcefully that the action is consistent with case law emphasizing the importance of the collective bargaining process for public employees in California.

The avenues open to the County for pension legal reform should be explored at the earliest opportunity, given the enormous costs represented by pension obligations. By taking part at an early stage in a ballot initiative, for example, the County could have some influence in assuring the language of any such initiative is both effective from a financial standpoint and fair to its employees. Otherwise, such a ballot measure could be unfairly focused simply on reducing future pension benefits without fully preserving the collective bargaining rights of its employees. Timely action on pension reform is important in order to avoid more drastic remedies. Addressing the issue now forestalls the risk of a potentially more draconian and less fair remedy being sought in the future once the pension issue reaches an unavoidable and undeniable crisis level. See Appendix, item 4 for a note on possible risks to the County arising from federal Congressional action should reforms in California pension law be unduly delayed.

It would be wise to keep the County's employee groups informed as part of this process, so that they clearly understand the County's intentions in supporting any ballot initiative, amicus brief, or statutory reform action. Any ballot initiative should be drafted so as to require future pension benefit changes to be negotiated with a public entity's labor groups pursuant to existing collective bargaining procedures and duties to negotiate in good faith. To reassure its pre-2013 employees, the County could also seek to include language in any such initiative or otherwise adopt as a County policy a "minimum guarantee"—a guarantee that prospective pension benefit reductions would not fall below a specified minimum. A fair minimum could, as discussed above, be the pension benefits now provided by the County under the PEPRA law to employees joining the pension system after January 1, 2013.

The objective of the ballot initiative coupled with a "minimum guarantee" policy would be to gain for the County the needed legal flexibility to address its huge pension liabilities effectively and fairly. The financial savings could be great while still assuring pre-2013 employees that they would receive future benefit accruals that are no less than those in place for PEPRA employees, and fully protect all benefits already earned at the current rates. The same objectives and minimum guarantee policy could be pursued in any "friend of the court" legal brief filed by the County to persuade the California Supreme Court to revisit its Allen decision and allow cities and counties the flexibility contemplated by the earlier Kern case. The County could also emphasize its minimum guarantee policy as part of any action to seek an amendment to the Meyers-Milias-Brown Act clarifying that changes to future pension benefits for current employees are an authorized issue for collective bargaining.

While there are uncertainties and risks in the legal area in any of the four avenues to reform, there are greater risks and financial costs to the County in doing nothing to address the currently inflexible "vested rights" doctrine of California public pension law. The County could potentially free up nearly $100 Million a year in resources that could be applied to improved human services, infrastructure repair and replacement, health care and public safety needs, as well as needed wage increases for its employees. The Board of Supervisors should act and move forward now in support of a reform or clarification in public pension law for the benefit of all the County's stakeholders: its employees; its citizens with particular needs for County services; and of course, its taxpayers.

Conclusion.

The County and CCCFPD face major problems arising from pension and other post-retirement obligations to their employees:

1. Their combined pension and retiree health benefits cost over $375 Million each year.
2. The percentage of their combined budget taken up by pension costs alone now exceeds 11%; double what it was in 1999.
3. Their outstanding debts for pension and OPEB benefits have reached $2.6 Billion.
4. Part of this debt is in the form of pension obligation bonds, which must be repaid according to their terms. The remaining debt must be paid through increased contributions to the pension and OPEB funds or from increased investment earnings on those funds.
5. Increased contributions to the pension and OPEB funds must come either from budget cuts, increased revenues, tax increases or some combination of the three. Budget cuts mean service or salary cutbacks, deferred maintenance and postponed capital improvements, and in extreme cases, hiring freezes or job layoffs.

The County has taken important steps to reduce its pension and other retirement expenses, but has not taken an active role in seeking to change the California legal rule that blocks reductions in future, unearned public pension benefits for existing employees. Such a change tied to collective bargaining rights for its employees would be both fair and effective. The change could free up as much as $100 Million a year for the County and CCCFPD through successful negotiations with their employees. A more flexible California law on future pension benefits offers a way forward for the County to bring its pension and other retirement obligations down to manageable size.

Without added flexibility under California pension law the County will remain shackled to an enormous cost burden but with only limited tools to relieve the pension stress on its financial resources. The remaining tools available to it, wage freezes or reductions, layoffs or higher taxes, lead to what are heavy burdens on the County, its citizens, and its employees. The County has already seen service and staffing cuts, deferred maintenance and delayed system upgrades that have hurt its citizens, imposed hardships on its employees and impacted the quality of life in the County. While we have seen improved economic conditions since 2009, the challenge of pension costs is simply too large a financial problem to expect a solution through improved economic conditions and higher tax revenues. Delaying a direct attack on the California pension law problem risks further years of service cuts, postponements of needed improvement projects for disaster preparedness and other County needs, burdens on employees arising from understaffing and less than competitive wage rates, and uncertainties for employee retirement security arising from funding gaps in the pension and OPEB funds.

FINDINGS

F1. The County and CCCFPD currently have unfunded accrued pension and OPEB liabilities that exceed $2.6 Billion. The cost to the County and CCCFPD to cover these and additional annual pension and OPEB liabilities require payments in excess of $375 Million each year.

F2. Pension costs alone now consume over 11% of the combined budgets of the County and CCFPD. These costs have risen from a percentage slightly under 5% in 2000 and now constitute the largest financial challenge facing the County.

F3. The cost of pension and OPEB obligations are debts that must be paid before the County can allocate available resources to other needs and services. This has contributed to the "crowding out" of other County services, the deferral of needed building maintenance projects, and the postponement of needed system improvements for the County.

F4. Pension costs are difficult to manage because they vary directly with the investment results obtained by CCCERA on its pension funds. The County and CCCFPD are at risk each year of having to increase pension payments in the event CCCERA does not achieve its 7.25% assumed rate of investment return on the pension fund.

F5. The County faces competitive pressures in retaining and recruiting a skilled and professional workforce. This limits its ability to seek greater contributions from its employees to the costs of the pension and OPEB obligations because other counties and cities may not seek the same contributions from their employees.

F6. The County and CCCFPD have a severe handicap in reducing their pension obligations because of a highly inflexible rule under a long-standing California court precedent that the County believes severely limits their ability to negotiate reductions in future, unearned pension benefit rates with their current employees.

F7. The County has not taken steps to challenge or change the California legal rule on changes to future pension benefits for existing employees, whether through the initiative process, clarifying legislation, or friend of the court legal briefs.

RECOMMENDATIONS

R1. The County Board of Supervisors and the Board of Directors of CCCFPD should establish a task force to review all options available to reduce the burden of the

County and CCCFPD's pension obligations, including efforts to bring about a reform in California public pension law. The task force should:

- Confirm with the County's or CCCERA's actuaries what level of potential savings in pension costs could be achieved through negotiations with employees hired before 2013 for reductions in pension benefits for future employment periods.

- Review with qualified legal counsel what strategies are available to seek a change or clarification in California law to assure changes to future pension benefits for current employees are proper subjects of collective bargaining. Such strategies might include participation in a state ballot initiative, the filing of "friend of court" legal briefs, sponsoring clarifying language for the Meyers-Milias-Brown Act, or including changes to future pension benefits for current employees as a subject for collective bargaining negotiations.

- Recommend what limits the Boards should establish as a matter of policy on any such reductions in future pension benefits for current employees, such as a minimum benefit tied to PEPRA rates as set forth in this report.

- Recommend a policy for keeping the County's and CCCFPD's employee groups informed of the Boards' intentions on any strategies for change so as to assure employees that any changes would be subject to collective bargaining and minimums set forth in the Boards' minimum benefit policy.

- Recommend a policy for keeping County citizens fully informed of th3 potential costs of any changes in pension benefits negotiated with the County's and CCCFPD's employee groups.

R2. The task force should be formed within 90 days and be required to report back to the Boards with its recommendations within 90 – 120 days.

R3. Establish a special web page on the County web site where citizens can easily track by means of a pension "dashboard" the costs and size of the County's and CCCFPD's pension obligations and the progress on its plans to reduce their costs.

APPENDIX

1. Pension Obligation Bonds.

The proceeds of pension obligation bonds (POBs) are invested in the County's pension fund, thereby reducing the amount of the shortfall (the UAAL) in its current pension funding. Depending on market conditions the County may be able to postpone current payments otherwise due on its UAAL obligations if the POB payments do not fall due for some years in the future. That may of course create an incentive simply to postpone a day of reckoning on the UAALs, because the total amount of the debt (UAAL plus POB) has not changed. However, when such bonds can be sold at interest rates less than the rate the county pension board charges the County for its UAAL obligation, the County is able to save on annual interest charges. It runs the risk, however, of losing money on the investment in the event the pension fund suffers an investment loss after the bond proceeds are transferred to the pension fund. The POBs are debts with a fixed principal amount and must be paid according to a fixed schedule. The UAAL debt, by contrast, is subject to some flexibility under rules set by the actuaries to “smooth out” the UAAL obligation over time. In some respects, then, the use of pension obligation bonds to fund the County’s UAAL obligations resembles “margin” investing; i.e., investing with borrowed funds, which can increase gains if successful but also magnify losses if not successful. The County should use them only after careful consideration.

2. Unfunded Pension Fund Liabilities.

Currently, the County’s unfunded actuarially accrued pension liability (its UAAL) is $1.26 Billion. The UAAL would be higher had the County not issued the pension obligation bonds referred to above, which served to reduce the unfunded liability, at the cost of additional debt on the County’s balance sheet. The UAAL obligation means the County is currently required to pay into the pension fund an additional 17.5% of each non-safety employee’s compensation and 51.3% of each safety employee’s compensation each year ($125.6 Million in total) to make up the pension fund deficit. Further, the County faces the risk, particularly after five years of rising stock markets since the financial meltdown of 2009, of seeing the UAAL contribution increase should the pension fund fail to achieve a 7.25% return in 2015 or 2016. Specifically, a slip of only 1% in the assumed return (i.e., a gain of only 6.25 % instead of 7.25%) would create an additional County debt of 9.5% of payroll ($52 Million) to CCCERA. A slip of 10% (i.e., a loss of 2.75% instead of the assumed 7.25% gain) would create an additional debt to CCCERA of 95% of payroll ($520 Million).

In each of these cases the County would not be required to pay or recognize the debt in one year. Under CCCERA actuarial rules, the loss would be spread over five years, thereby reducing the amount of the loss that would be recognized in the first year. The adjusted or “smoothed” debt would be paid in installments over 18 years. Any loss remaining after the smoothing adjustment would raise annual pension contributions by 0.7% of payroll for each 1% slip in return below 7.25%. That is, an annual increase of $3,847,000 if the smoothed debt remained at $52 Million and an annual increase of $38,470,000 if the smoothed debt remained at $520 Million.

While in theory such losses should be balanced over time by returns in excess of the assumed 7.25% per annum, we question whether the 7.25% assumed rate of return is in fact realistic. The County’s actual rate of return on its pension assets over the past ten years has been 6.89%, rather than 7.25%. The 6.89% figure included returns starting from a lower base after the massive losses incurred in 2008. It therefore is not an accurate measure of the compounded annual return on a dollar invested in 2005.

The compounded annual return would be lower. Further, the County's current UAAL, based on what may be an optimistic 7.25% assumption, totals approximately $1.26 Billion. Accordingly, the County faces a long period of already large and growing retirement costs with substantial risks of unforeseen further cost increases. Such increases could arise in any year arising from drops in the investment returns on its pension funds, a likely prospect given experience that shows stock markets do not increase for indefinite periods. They also drop.

3. **Pension Fund Rate of Return Assumptions**.

Using a higher rate of return assumption for the pension fund means that the County and its members would be charged a lower "annual required contribution" to fund the pension benefit. In CCCERA's case, for example, the County and the members would reduce their regular contributions by an amount equal to 2% of pay for each 1% increase in the rate of return assumption. This is one of the reasons a strong temptation exists on the part of employers and employees to set overly optimistic assumptions for pension fund rates of return. A higher rate of return assumption would keep contribution rates lower for both the County and its employees, reducing the strain on both the County's and the employee's budget. The downside for the County, however, is that when returns fail to meet the assumed rate, the County will incur an additional UAAL debt, as calculated by the actuaries.

If the pension fund fails to meet the assumed rate of return in any year, it must make up the difference from one of two sources: drawing on reserves established in prior years when the returns exceeded the target rate or assessing the County for an additional contribution to make up the difference. The County is obligated to pay an additional amount each year to retire this liability over a period of 18 years. Other pension plans, including CALPERS, have longer periods, thereby taking on additional risk that the UAAL will not be fully funded by the time it is needed.

As noted in the text of the report, CALPERS charges its employee members a lower pension contribution rate for a like pension offered to a CCCERA employee member. From the employee's standpoint, it is clearly more attractive to have the higher take-home pay in the CALPERS plan because any shortfall in the pension funding will have to be made up by the employer and not by the employee. That assumes the employer manages to stay solvent and avoid the complete fiscal downfall that hit Stockton, Vallejo, and Detroit, putting them into bankruptcy. In that dire situation, employees should be very glad of the prudent financial management that protected their pension benefits.

4. **Federal Funding Issues**.

The peculiar features of California law related to pensions compared to the rest of the country bring added urgency to resolving the issue. California is one of a minority of states that prohibit reductions in future, unearned pension benefits. The California rule also differs from the pension rules governing private employers set forth in the federal Employee Retirement Income Security Act (ERISA) legislation passed in 1974. Congress, which has shown increasing willingness in its “sequestration” and other legislation to cut back federal funding of state programs it views as excessive may turn its attention to the cost implications of the peculiar California protections for future pension benefits. Any pension-related restrictions the Congress might impose on federal funding streams for state and county programs could have a major impact on the County. Approximately 45.9% of its funding streams are from state and federal sources. Such funding typically pays the full cost of pension benefits (including full UAAL charges) of employees engaged in such programs. Federal funding restrictions tied to caps based on pension plan rules more generally followed in the country as opposed to the much more costly rule in California would have very serious financial consequences for the County.

SOURCES AND REFERENCE MATERIALS

For purposes of this report the Grand Jury interviewed or met with 13 different County, city, state, CCCERA, and employee organization officials or representatives who had responsibility for certain aspects of pension and retirement benefit issues. We reviewed a number of relevant reports and articles, including the following:

1. The County Consolidated Annual Financial Reports for Fiscal Years ended June 30, 2014 and June 30, 2013.
2. The County’s Recommended Budget for Fiscal Year 2014-2015.
3. The CCCERA Actuarial Valuation and Review as of December 31, 2013, prepared by its actuary, Segal Consulting.
4. Task Force Report to the Finance Committee on Other Post Employment Benefits Challenge, dated March 1, 2007; Report to the County Board of Supervisors dated September 25, 2007 transmitting Task Force Report on OPEB Strategic Plan.
5. Little Hoover Commission, report entitled “Public Pensions for Retirement Security,” published in February, 2011.

We also reviewed a number of California reported legal cases on pension or employeebenefit issues, including those cited in the text of our report. These are the full case citations for the cases mentioned in our report:

1. <u>Kern vs. City of Long Beach</u>, 29 Cal.2d 848 (1947).

2. <u>Allen vs. City of Long Beach</u>, 45 Cal.2d 128 (1955).

3. <u>San Bernardino Public Employees Association v. City of Fontana</u>, 67 Cal. App. 4th 1215 (1998).

4. <u>In re City of Stockton, California, Debtor</u>; US Bankruptcy Court, Eastern District of California; Case No. 12-32118-C-9; Decision Filed February 27, 2015.

The words quoted from Warren Buffett in the Background section were from his prophetic memorandum dated October 14, 1975 to Katharine Graham, the then publisher of the Washington Post. It was included as an exhibit to the 2013 Annual Report of Berkshire Hathaway Inc. and can be found at the following link: http://www.berkshirehathaway.com/reports.html.

The chart on page five of the report is from the County's Recommended Budget for Fiscal Year 2014 – 2015. The projected expenses shown in that chart assume the County is able to fill all of its vacant positions and that CCCERA earns at least 7.25% each year on its invested pension funds. Expenses will decrease if the vacant positions are not filled and will increase if the projected 7.25% return is not achieved each year.

The text of the Meyers-Milias-Brown Act can be found at California Government Code, sections 3500 – 3511.

REQUIRED RESPONSES

	Findings	**Recommendations**
Board of Supervisors	1-7	1-3
Board of Directors for the CCCFPD	1,2,4,6	1-3