CONTRA COSTA COUNTY GRAND JURY REPORT NO. 0409

Budget Woes and Layoffs: The Contributions of Pension Improvements

To: Contra Costa County Board of Supervisors

BACKGROUND

The Contra Costa County Employees Retirement Association (CCCERA) is a cost-sharing multiple-employer defined benefits pension plan governed by the County Employee Retirement Law of l937. While CCCERA also includes employees of several special districts within the county, this report considers Contra Costa County (County) employees only. When this report uses the word "employer" it means Contra Costa County.

The retirement plan is administered by a nine-member board (CCCERA Board) consisting of four members elected by retirees and active employees and four members appointed by the County Board of Supervisors (BOS). The County Treasurer-Tax Collector, an elected official, is also a board member.

The total cost of the employee retirement plan is covered by employer contributions, employee contributions and CCCERA investment earnings. A shortfall in any of these items must be made up by the County, and ultimately, the taxpayer.

Grand Jury report No. 0301 issued in November 2002 warned that pension benefit increases adopted in 2002 threatened future County financial stability. This topic is now addressed by the 2003-04 Grand Jury to show the county retirement costs while the BOS and County managers mull over service cuts and employee layoffs.

FINDINGS

1. The County's retirement plan provides for pensions based on an employee's age at retirement, years of service and highest one year's compensation. While age and years of service are relatively straightforward concepts, "compensation" creates certain problems because it is more than basic salary and, in fact, is likely to include adjustments to increase the employee's final year's income. The County uses the term "Retirement Base", which includes normal salary plus other pay determined by CCCERA to be included in retirement calculations.

2. Ideally, pension costs would be paid during employees' working years so that money paid into the pension system, plus investment income, is available in the future to pay pensions which begin at retirement and continue until ended by death. The County annually budgets for and pays a share of the estimated costs to keep the pension plan financially sound. There are several components to these annual costs:

a. The first component of the annual cost is the amount paid on account of the "employers standard rate", which is determined by CCCERA's actuary. This rate is derived from a prediction of how much should be paid now to fund the future expense for the pensions of current employees. Currently this component adds approximately 19 percent to the County's salary cost for non-safety employees and 35 percent for safety employees.

b. The second component of annual cost is an amount due CCCERA because the County has agreed to pay a part of the employees' contributions (called "subvention"). CCCERA is required by pension law to calculate a rate for employees. However, negotiated labor agreements compel the county to pay approximately 50% of the retirement contributions otherwise payable by County employees. For non-safety employees this subvention costs the County 2.4% of salary costs. For safety employees the County's subvention cost is 3.7%. (Only safety employees have agreed to pay a new additional 9 percent of wages, but that total is reached after a series of 2.25 % steps over the contract period. The County's agreement to pay the 50% covers only the basic rates; it has not agreed to pay 50% of the new additional rate).

c. The third component of the county's annual pension cost is the amount required to cover past and current shortages. Such shortfalls are determined by the CCCERA actuaries and are called an Unfunded Actuarial Accrued Liability (UAAL). A UAAL is created when the benefits expected to be due and paid by the retirement fund are less than the value of the assets expected to be available. Once a UAAL is created, the entire amount is the County's obligation to CCCERA. Employees have no obligation to contribute to reduce a UAAL. CCCERA permits the amount of a UAAL to be amortized and paid, with interest, over twenty years.

3. The County has in the past elected to pay off UAALs by issuing pension obligation bonds. In April 2003, for example, the county sold $322.7 million of pension obligation bonds and paid the proceeds to CCCERA to pay off its UAAL. This substituted one debt (bonds) for another (UAAL), with the county obtaining a more favorable interest rate by issuing the bonds. Annual debt service on pension obligation bonds is another direct pension cost to the county.

4. On October 1, 2002, the County granted significantly increased retirement benefits to all County employees, safety and non-safety. Safety employees (generally Sheriff's Deputies and other law enforcement personnel) become eligible to retire at 3% of salary per year of service at 50 years of age. Previously, the standard was 2% at 55 years of age. The jump from 2% to 3% created a 50% increase in retirement benefits, and since the age reduction encourages earlier retirement, pensions will be payable over a longer period. Non-safety employees, now receive the 2% retirement benefit at an earlier age, 55 years, instead of the 60 years which was the previous standard.

5. All of these benefit increases and retirement age reductions were retroactive for current employees. Any eligible employee could retire immediately with the new increased benefits before paying any increased pension contributions. The costs of retroactive increases are borne by the county.

6. Between October 1, 2002 and October 1, 2003, 286 County employees retired and received enhanced benefits. Approximately 22% of the new retirees had been safety employees. The retroactive costs became part of the enhanced benefits UAAL. (CCCERA did transfer $100 million from its Unrestricted Reserve to be applied against the UAAL, and the County received the benefit of a substantial part of the transfer. See Finding 11).

7. The County's obligations to CCCERA are paid from the same sources as the direct wages of employees. Almost half of the county's employees wages and benefits are paid by allocations from state or federal government grants or from county enterprise funds, while the remaining wages and benefits are paid from the county's general fund. (Enterprise funds are the operating funds of a government operation that is expected to be profitable or self-supporting). Obligations to CCCERA must be paid from the general fund in the event that government grants terminate, enterprise funds are reduced or allocations are insufficient.

8. Total retirement expense for the County as a percentage of the adopted General Fund Budget has risen dramatically.

	Total Retirement Expense	Per Cent of General Fund
1994-1995 Total Retirement	$37.8 million	5.60%
1998-1999 " "	$54.8 million	7.38%
2001-2002 " "	$69.6 million	6.72%
2003-2004 Budgeted	$102.6 million	9.43%
2004-2005 Preliminary Estimate	$143.4 million	not available

This 2003-04 Budgeted figure includes a one-time $20 million offset, resulting from the 2003 sale of pension obligation bonds. Otherwise 2003-2004 total retirement expenses would be $l22.6 million or 11.27% of the General Fund.

9. CCCERA uses a method called five-year smoothing to take investment gains and losses into income. High income was realized during the rising stock market which ended in 1999. Five year smoothing caused the retirement system to show gains in its investment returns during the 2000-2002 down market, despite the actual investment losses during the period. Such gains were reflected in its Unrestricted Reserve.

10. CCCERA also maintains a Market Stabilization Account, which represents the deferred return developed by smoothing realized and unrealized losses and gains

(using five year smoothing) but smoothing only the deviations from total market return from the return target adopted by CCCERA's Board. The target return during 2002 was 8.5%. Market losses over the down market period caused the following negative balances in the Market Stabilization Account:

Date	Balance
12/31/01	($385,448,325)
6/30/02	($568,385,973)

11. CCCERA's Unrestricted Reserve on 12/31/01 showed a positive balance of $404.6 million. The losses in the Market Stabilization Account however, showed that the apparent surplus in the Unrestricted Reserve was illusory. Nevertheless, $100 million was transferred by the CCCERA Board from its Unrestricted Reserve in 2002 to reduce the UAAL. (See Finding 6). The Unrestricted Reserve is no longer available to "bail out" the County as County retirement costs rise in the immediate future.

12. As of January 1, 2002, the County's total outstanding liability for past pension costs was over $832 million. As of October 31, 2003, this had increased to over $1.263 billion as follows:

Pension Obligation Bonds	$587,200,000
UAAL Liability as of 12-31-02	176,800,000
Paulson Liability (See Finding 14).	24,800,000
Market Stabilization Account (MSA) Losses As of 6-30-03	410,200,000
Actuarial recommended assumptions not Adopted in 2001 (See Finding 13 b and c.)	64,200,000
Total	$1,263,000,000

13. Any UAAL is not paid for proportionately by employers and employees. (See Finding 2.c.). It is the sole responsibility of the County and therefore, the taxpayers. The UAAL generally continued to increase every year since 2001, due to:

a. The BOS approved retroactive enhanced pension benefits.

b. The CCCERA Board selected overly optimistic rates of investment return against its actuary's recommendation.

c. The CCCERA Board refused to adopt their actuary's recommendations concerning employee morbidity and employee marriage benefits.

All of the above caused the employees' and employer's contributions to be underestimated. The employer alone must make up for the cost of the shortfall as part of the UAAL.

14. In February 2004, the CCCERA Board again refused to follow its actuary's recommendation concerning assumed rate of return on investment. In the near future CCCERA's actuary will issue a new report and recommendations, on the non-economic assumptions, including morbidity and marriage benefits.

15. As stated in Finding No. 1, a retiree's pension under the 1937 Retirement Law is based on three factors: age, years of service and final compensation. A 1997 California Supreme Court decision in the Ventura case included various types of payments in salary computations to establish "final compensation" for pension purposes. The Paulson case was brought by retired County employees to obtain, essentially, the same treatment. The Paulson litigation was settled and the settlement binds the County.

a. The most recent listing of county pay items lists some 69 separate items which are included in compensation to implement Ventura and Paulson The vast majority of the types of pay included are specialized in nature and take into account particular skills or qualifications of employees. Following are examples of types of remuneration included in final compensation since the Ventura/Paulson cases: Merit pay, longevity pay, standby pay, bilingual pay, holiday pay, educational incentive pay and uniform allowance.

b. Certain types of monetary remuneration are not included in compensation. Reimbursements for job-related expenses and overtime compensation (for work in excess of what is normal work time) are examples of such payments. Generally, the cash value of common fringe benefits such as employer paid health insurance and retirement contributions is not included in compensation for pension calculations.

16. Cash received by some management employees (both non-union and union members) in exchange for certain benefits (called a sell-back) during the final twelve months of employment may be used to "spike" the final year's compensation. A sell-back of accumulated vacation is an example.

a. Some managers, are permitted to sell-back unused vacation (within certain limits). Ventura/Paulson merely requires that amounts received for a sell-back be included in final compensation. Agreeing to allow employees to sell back the vacation is a concession made by the county. Without that concession, the spiking could not occur.

b. Managers who have unused vacation can spike their final year compensation by selling back the maximum permitted at the end of the calendar year preceding retirement and another maximum amount in the next calendar year. By retiring before twelve months passes after the first sale, both sale amounts are included in compensation for retirement purposes.

c. Hypothetically, a Manager with long tenure and many hours of unused vacation can spike his or her final compensation and pension by almost 20% by calculated use of this vacation.

17. Of the 50 highest paid county employees who retired in the year following October 1, 2002, 30 spiked their final compensation for retirement by selling-back unused accrued vacation. Twenty-six of those 30 sold back vacation in two calendar years but within a year of retirement.

18. No changes were made in 2002 to the County's rules on vacation sell-back to reduce the impact of rules which permit salary augmentation.

19. Assembly Bill 55, enacted in 2003, provides for purchase of additional service credit (called "air time"). This benefit is not available unless the BOS authorizes it, which it has not done. If authorized, employees could elect to purchase up to five years of service credit (to add to their years of actual employment) to add to their retirement. Since the employees pay the additional contributions (usually at or about the time of retirement) "air time" is claimed to be a "cost neutral" benefit. "Air time" would not be cost neutral if any subsequent increase in retirement benefits is approved by either the BOS or the CCCERA Board.

20. Senate Bill 274, enacted in 2003, authorized an optional benefit called "DROP" (Deferred Retirement Option Program) for specified safety members. "DROP" permits an employee who is eligible to retire to keep working at normal pay, but without any increase in pension benefits. The pension fund treats the employee as if retired and sends monthly retirement checks to an escrow account. When the employee does retire, a lump sum is paid from the escrow account and the retiree starts receiving monthly pension checks. The BOS has not elected to adopt this benefit. Although this benefit may appear to be cost neutral at the time of retirement, it would not be cost neutral if any subsequent increase in retirement benefits is approved.

21. A defined contribution pension plan is an alternative to a defined benefits plan. Under a defined contribution plan the employer agrees to make a fixed or determinable contribution, which may change over time. Contributed funds are invested, as in a defined benefits plan, but investment risk is borne by the employees who are members of the pension plan. The employer has no risk equivalent to the risk of being subject to a future UAAL.

ADDITIONAL BACKGROUND

In the weeks preceding the 2002 BOS action to adopt the increased pension benefits, and at various times in the year and one-half since their adoption, interested parties have informed the public of reasons believed to justify those increases. The public should be aware of certain facts and consider facts in light of several of the reasons asserted by advocates for improved benefits. Consider the following:

a. Reason asserted: *The benefits are necessary to recruit employees.*
Facts: This reason is heard most often in discussions of safety employees (primarily deputy sheriffs). There were numerous applicants for deputy positions and the percentage of applicants who were hired remained relatively constant. The following statistics showing applicants for and hiring of deputies by the Sheriff's Office are noteworthy:

	Applicants	Hirees	% Hired
2001 New recruits (No previous experience)	929	36	3.8
Lateral applicants (from other law agencies)	310	26	8.3
2002 New recruits	1953	85	4.4
Lateral applicants	269	29	10.8
2003 New Recruits	968	31	3.2
Lateral applicants	95	9	9.5

b. Reason asserted: *Employees are paying for the improved benefits themselves, through payroll deductions.*

Facts: Only Deputy Sheriffs and other safety employees have agreed to a new deduction for increased retirement benefits. This deduction began as 2.25% of wages, but increases cumulatively each year. See Finding 2.b. Although this new retirement deduction is not subject to the 50% share provision, the County in effect is paying for the employees' share because raises totaling 21% were granted to safety employees over the five year MOU. The raises of 21% fully offset the 9% increase in retirement deductions. Raises for non-safety employees were not as high as those granted to safety employees.

c. Reason asserted: *Doom and gloom predictions of the adverse impact of the improved retirement benefits will be shown to be without merit once the stock market rebounds and CCCERA's investment results improve.*

Facts: CCCERA uses a five year smoothing method to reduce the impact of changes (whether favorable or unfavorable) in investment performance. (See Findings 9 and 10). Although 2003 saw substantial investment profits, the losses which ended in about 2002 will still be included in overall investment results for several years. Moreover, the economic slump and bear market caused such substantial losses (in earnings and in CCCERA's portfolio) that the County's consulting actuary forecasts that 18% returns for the next five years will be required to bring back the fund to its earlier financial position.

CONCLUSIONS

As retirement costs continue to increase as a percentage of the General Fund, critical services, such as infrastructure repair, law enforcement, social welfare and health, will be reduced. Many of these reductions will fall upon those that can least afford to lose these services.

RECOMMENDATIONS

The 2003-04 Contra Costa County Grand Jury recommends that:

1. The BOS promptly close the existing defined benefits retirement plan to all new non-union employees and adopt a defined contributions plan for non-union employees hired after the new plan is adopted.

2. The BOS target pension provisions in labor agreements as they expire and negotiate changes to replace the defined benefits retirement plan with a defined contributions plan for all union employees hired after the effective dates of the changes in the labor agreements.

3. The BOS review, at the earliest practicable time, all pay provisions and other arrangements which can be used by an employee to spike final compensation at retirement. Following the review, the BOS eliminate those pay provisions and arrangements (e.g., vacation sell-back) which exceed the requirements of the County Employee Retirement Law of l937 and Ventura /Paulson.

4. The BOS enact the planned changes of recommendation 3 for non-union employees without delay and target the planned changes for labor agreements in the next negotiating cycles.

5. BOS not approve any pension benefit changes which would require additional funding from the County.

6. BOS not approve any pension benefit changes which are supposed to be cost neutral (such as provided by AB 55 and SB 274) unless CCCERA's actuary certifies that there is cost neutrality both at the time of adoption and in the future under any foreseeable circumstances.