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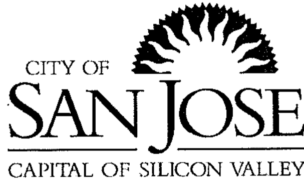

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: **ARTICLES REGARDING IMPACT OF PENSION COSTS ON LOCAL GOVERNMENT AGENCIES**

DATE: April 13, 2010

INFORMATION

I wanted to share the attached articles and editorials from The Sacramento Bee regarding the impact of pension costs on local government agencies.

We are continuing our work on researching options for the City to consider to address the significant increases in the costs of pension and retiree healthcare benefits, and we will continue to update the Council.

Debra Figone
City Manager

Attachments
Attachment A: The Public Eyes: Pension promises threaten California cities, counties
(The Sacramento Bee, April 11, 2010)
Attachment B: From the Editor: $28 billion pension gap is ours to repair
(The Sacramento Bee, April 11, 2010)
Attachment C: In assessing blame, don't forget the number crunchers, critics say
(The Sacramento Bee, April 11, 2010)
Attachment D: Editorial: Perks of the past return to haunt
(The Sacramento Bee, April 12, 2010)

THE SACRAMENTO BEE sacbee.com

The Public Eye: Pension promises threaten California cities, counties

Published Sunday, Apr. 11, 2010

This year, the city of Roseville will spend about as much to fund its pension plan as it does on parks and recreation.

San Luis Obispo County will spend five times as much on pensions as it does prosecuting criminals.

And Stanislaus County's pension costs will be nearly double its $23.5 million general fund budget deficit.

The initial logic of increasing retirement benefits to retain quality employees has been turned on its head: Paying for those benefits is forcing local governments to lay off employees – and cut programs.

"The old joke is that General Motors is just a health insurance company that makes cars on the side," San Luis Obispo County Supervisor Adam Hill said during a pension presentation at a recent board meeting. "My concern is that the county government is becoming a pension provider that provides government services on the side."

Yet today's escalating annual pension payments barely touch the looming shortfall: $28 billion in unfunded liabilities – the difference between what pension systems have and the pension benefits their employees have earned – at the 80 largest city and county governments in California, according to an extensive Sacramento Bee review of pension plan valuation reports.

On top of that, those cities and counties owe about $8 billion in pension-related bond debt – all in a time of shrinking budgets. In many areas, the total pension shortfall is more than the annual payroll; in some, it is more than the general fund budget.

Spread that debt evenly, and it comes out to about $4,000 per household in those cities and counties.

Already, Californians feel the impact of the rising costs. Local governments are cutting unrelated programs – everything from parks to public safety – to help pay for pension plans. Downsizing likely will continue both because pension contributions often are legal mandates, and, even with a recovering economy, because much damage already has been done.

A very few places are whispering about the nuclear option: bankruptcy. The Bay Area port city of Vallejo already went this route, largely to break its agreements with its employees.

It wasn't supposed to turn out this way.

When local governments passed enhanced retirement benefits at the turn of the millennium, the stock market was humming. Government leaders could just sit back, watch their employees smile and let the market do the heavy lifting.

"We're not creating an unfunded liability," then-Fresno County administrative officer Linzie L. Daniel vowed in 2000, when the county approved better retirement benefits to be offset by expected investment returns.

Since then, unfunded liabilities have increased from less than $100 million to $800 million in Fresno County.

'Five-year pain plan'

San Luis Obispo County's chief number cruncher, Assistant County Administrator Dan Buckshi, fiddled with his PowerPoint presentation a few months ago and warned his listeners that what he was about to show them was only the third year in the county's "five-year pain plan."

The county supervisors in front of him chuckled feebly. They were well aware of the pain the county had endured.

They had watched their work force dwindle by nearly 13 percent, from 2,700 in 2002-03 to an expected 2,350 later this year. They had instituted a hiring freeze, consolidated jobs, encouraged early retirement, scaled back capital projects and amortized losses over 10 years instead of five.

They also limited health care access for the poor by cutting community health clinic funding.

And they knew it wasn't enough. The county still had a 2010-11 projected budget deficit of $19 million and an annual pension bill that ate 11.2 percent of the total budget.

"I wish I had something comforting to say," county Supervisor Frank Mecham told the San Luis Obispo Tribune last month. "If you sit there and watch the (stock) market every day, it will drive you to drink."

That pain is being felt all over.

Northeast of the state Capitol in Roseville, officials have cut 150 of 1,150 staff positions during the last year – more than 10 percent of its work force. The $18 million the city must legally pay in pension contributions this year could have preserved those jobs plus several new hires.

The south Placer County city faces $111 million in unfunded pension liabilities, double the figure from just five years ago. As it stands now, the city will be able to cover just 75 percent of its future pension expenses. An 80 percent funded ratio is generally considered healthy.

"Roseville has built a retirement compensation system that was based on an old model of revenues," said city Finance Director Russ Branson. "Clearly, that is a driver of costs."

And, down in the San Joaquin Valley, unfunded liabilities have quadrupled during the past five years in Fresno County. The county also has about $550 million in outstanding pension obligation bonds.

Fresno County expects to pay more than $140 million into its pension system next fiscal year – up 13 percent from this year. According to a recent report, that contribution requirement is likely to grow during the next four years.

With revenue also falling, services are affected. The total number of Fresno County employees dropped by 700, or 10 percent, from 2008 to 2009, financial audits show. The county drastically cut its mental heath services budget, reducing care for the homeless and indigent, and, like many other places, it released a slew of jail inmates.

The worst-case scenario for these local governments isn't more cuts – it's bankruptcy, a step that most insist is unlikely.

"Last time I checked, government is not going out of business; Merced County is not going out of business," said county CEO Larry Combs.

Even places like Merced County that can cover just 65 percent or 70 percent of their future liabilities are doing amazingly well, given the depth of the recession, according to Dave Low, chairman of Californians for Health Care and Retirement Security, which represents more than a million public employees on pension, health care and labor issues.

"The very worst are still probably in very good condition," Low said.

Still, a decade ago, few would have predicted that Vallejo would go under. Today, the city remains hung up in court, trying to cancel provisions in its labor agreements that promised benefits it no longer can afford to pay.

As of its bankruptcy filing in 2008, Vallejo had roughly $88 million in unfunded pension liabilities. Those liabilities equaled about 112 percent of the city's annual general fund budget.

Combs' own county, Merced, is slipping toward that figure: Its pension bonds and unfunded liabilities equal about 85 percent of its annual general fund budget.

San Luis Obispo's situation is worse, with pension obligations now equal to roughly 119 percent of its general fund.

How it came to this

About 85 former members of the Sacramento Metropolitan Fire District earn annual pension benefits of more than $100,000, including former chief Donald Mette, who makes almost $241,000 a year in retirement, according to a list obtained from CalPERS by advocacy group California Pension Reform.

In Roseville, 17 former employees earn north of $100,000. In Merced County, it's 37. In Stanislaus County, it's 50.

All of them can thank former Gov. Gray Davis.

In 1999, Davis and the state Legislature passed a generous set of pension upgrades. Most public safety officers came out on top, eventually receiving 3 percent of their salary per year of service for life, after reaching age 50. The improvements were heavily supported by labor unions, which had contributed large sums to Davis' election war chest.

Nearly all California cities and counties followed Davis' lead, often passing clauses that mandated better pay or benefits if a neighboring jurisdiction received them.

While those "me too" enhancements get the most ink, they're only one factor – and probably not the largest one at that – behind the pension morass facing cities and counties. The other three factors:

- Faulty assumptions about the stock market.
- Bad advice from some professional advisers.
- Hiring followed by a plethora of raises.

It's a simple calculus: The more money government employees make, the more they'll get in retirement.

Average pay at all California local governments rose 40 percent from $46,073 in 2000 to $64,284 in 2008 – a much faster rate of growth than inflation, according to the U.S. Census Bureau. To keep up with inflation, those employees would have needed just a 25 percent raise.

Unions pushed heavily for the raises, saying public employees had been ignored during previous, leaner years.

In the city of Sacramento, the average pay of public safety employees grew 50 percent during that time frame, to $82,897, according to the city's latest valuation report. In Oakland, average pay for police and fire employees has tripled to $114,741 since 2000.

Combined with enhanced retirement plans, the salary jumps caused startling leaps in pension payouts.

Using the same cities for comparison, in Sacramento, the average annual benefit to former public safety employees who took a service retirement during the past five years was $64,521, up 58 percent from a decade ago, valuation reports show. In Oakland, the average annual benefit for recently retired public safety employees has more than tripled since 2000 to $83,946 today.

While payroll and benefits packages are largely within the control of city leaders, other influences on pension costs are not.

Roughly three-fourths of benefits are typically paid with returns on investments. Once the recession hit and dragged down the stock market, the burden fell to local governments to pick up the slack.

Local governments generally have counted on about an 8 percent annual return on their investments. Between 2007 and 2008, many instead saw declines of 15 percent or more.

In Stanislaus County, for example, officials watched their retirement portfolio lose more than $400 million – 30 percent – between early 2008 and mid-2009. About half of those losses have been erased by recent stock market gains.

On top of all this, many counties were getting bad advice about the costs of their pension plans – advice that haunts them in today's budget talks.

Governments hire actuaries to make educated guesses about how much a plan will need to meets its obligation to retirees over two or three decades. Their assumptions are based on everything from when the average employee will retire to how long they will live and how the market will perform.

A recent audit in Stanislaus County found that its former actuarial firm had made mistakes in predicting how many employees would draw pension benefits. The actuary assumed that more employees would opt for retirement cashouts, which are cheaper to fund, instead of monthly benefits. Based largely on those predictions, the county seriously underfunded its plan.

Fresno County claims its actuary had employees paying a share of pension obligations that should have been covered by the county. The county eventually had to cough up millions.

Just as damaging, actuaries told local governments during the boom years that they didn't need to put any money into the retirement system because the market was performing so well. That wasn't a mandate; local governments could still sock money away, but few did.

"Most of the cities took pension holidays," said Low, the public employee advocate. "That is a pretty big reason for all this."

Search for solutions

At a glance, the city of Fresno looks to be in far better shape than Fresno County. Its pension plan is fully funded, and its annual contributions to that plan are relatively small.

Dig deeper, though, and some of that advantage is an illusion, conjured up by pension obligation bonds. One-third of pension plans are well-funded – they can meet 90 percent of their future obligations – but half of those well-funded plans are saddled with bonds.

They've borrowed to buy down debt, offloading the bill to future taxpayers.

Having already deeply cut services and being wary of raising taxes, many local governments hope to pass pension costs on to employees by making them pay a larger share of their pension contributions.

The most dramatic version of this approach follows Gov. Arnold Schwarzenegger's lead and tries to repeal many of the enhanced benefits approved during the Davis regime.

In Merced County, Combs – the county chief executive – and the current board of supervisors favor a plan in which new employees would receive a scaled back annual pension equal to 2 percent of their yearly salary multiplied by their years of employment. Merced's current plan is 3 percent at age 50 for safety workers, and 3 percent at age 60 for others.

Such shifts sound minuscule, but they would make a significant difference. A 55-year-old Merced County sheriff's deputy with a final annual salary of $75,000 and 30 years of service gets an annual pension of about $68,000 currently, but would get only $45,000 under the new plan.

"I have to believe everyone understands that pension costs are going to break all of the local governments in California," said Vito Chiesa, a supervisor in Stanislaus County, which soon will negotiate for similar reductions in benefits. "I think everyone will see it is unsustainable."

That's likely too optimistic. Stanislaus County, for example, has closed its sheriff's deputy training academy for the coming year, saying the market is flooded with laid-off candidates. Yet the local union still argues that the benefits are essential for attracting and retaining employees.

"The retirement benefit is a huge hiring point," said Vince Bizzini, president of the Stanislaus Sworn Deputies Association.

This month, Stanislaus County leaders reversed the enhanced benefits they gave to workers in 2002, but only for workers who are hired after the end of this year and who aren't represented by unions. The county has 413 unrepresented workers, mostly managers and elected officials.

Low, the employee advocate, predicted that unions will bargain on pension issues in good faith. But, he said, it's unfair to view them as the linchpin for fixing local government finance problems.

Regardless, asking employees to pay down a city's pension obligations is a little like trying to cut down a tree with a knife.

About one-third of the 80 cities and counties examined by The Bee – including Merced, Orange and Fresno counties – now have unfunded liabilities that equal or exceed the size of their annual payroll. So even if governments told their workers, "Sorry, but your entire salary will be diverted to pay off pension debt for the next year," there would be debt to spare.

That leaves taxpayers. The pension bill facing them likely will balloon in years to come.

Currently, 15 percent to 30 percent of local governments' annual payroll goes into their pension system – a quarter or so for every dollar spent on paychecks.

That adds up. Together, all local governments in the state paid $11 billion into their pension plans during 2008, or about $900 per California household, according to U.S. Census Bureau data. Millions more went toward paying off pension bonds.

Dwight Stenbakken, deputy executive director of the League of California Cities, predicts that contribution rates will expand to about 30 percent or 40 percent of payroll in most places. CalPERS officials partially agree, saying that, due to retirement and market projections, contributions will rise for the next decade.

It's a hard sell – cutting fat pension checks while cutting government services – that has exhausted many local government leaders.

"We're trying to maintain credibility with taxpayers," Stenbakken said, "but, right now, I'm not sure this is defensible."

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From the Editor: $28 billion pension gap is ours to repair

Published Sunday, Apr. 11, 2010

Public employee pensions have become one of the prickliest topics The Bee covers, and our front-page story today adds some sobering numbers to the discussion.

Here's one: $28 billion.

That's the collective gap, according to The Bee's analysis, between the amount of pension money that's invested and the amount that's promised to employees and retirees in California's 80 largest city and county governments.

McClatchy's California newspapers teamed up on this project after reporting on ways pension obligations were adding to budget headaches in one locality after another.

Our aim was to provide the bigger picture beyond a string of local decisions.

Phillip Reese, a Bee investigative reporter, led the work in gathering and analyzing information from local governments. His efforts yielded the best view so far of pension funding gaps statewide.

Graphics in our print editions tell part of the numbers story; at www.sacbee.com/investigations, you can find an interactive map with details by city and county.

Reese worked closely with reporters from the Fresno Bee, Modesto Bee, Merced Sun-Star and San Luis Obispo Tribune, and today's stories appear in those newspapers' print and online editions.

As Reese and his counterparts explain, the pension pressures didn't pop up overnight, nor are they easily solved.

The story isn't identical in every city or county, but there are some repeated themes:

• Many localities improved retirement benefits for public employees during healthier fiscal conditions early in the last decade.

• The stock market's declines during the recession caused investment values to drop, and a big debate about the gap hinges on future market returns.

• Many localities increased their pension tab by raising pay for public employees, also during happier times.

This reporting adds important context for local officials who, as stewards of public spending, make choices that affect all residents as well as employees.

Some are considering benefits changes (mostly for future hires) to address the longer-term picture; others have taken this step already, but many are using bond money or service cuts to close the gap.

While this report focuses on local governments, the picture that emerged mirrors state pension funding in certain ways.

Last week, a Stanford University report kicked up dust with findings that our state's giant pension funds, CalPERS, CalSTRS and the University of California retirement system, were understating the amount of their unfunded obligations.

The gap, according to the report, is $500 billion. (To which an ordinary person can only say, in polite terms, holy cow!)

The funds' leaders promptly contested the Stanford report's findings and its calculation methods. But the matter needs much more attention and public debate.

The Bee's own reporting, based on information from CalPERS and CalSTRS, has shown that government employers will have to increase their contributions in coming years to meet pension obligations.

Government's debt is our debt – taxpayers are the "employer" contributors to public pensions. So as stupefying as the large numbers can seem, we all have an interest in understanding them.

Today's stories are part of our commitment to digging into these complex matters and providing facts that can inform good decisions in the months ahead.

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In assessing blame, don't forget the number crunchers, critics say

Published Sunday, Apr. 11, 2010

Investment managers, labor unions and politicians often get the blame for exploding debt in government pension plans. But some critics point to another culprit: actuaries, the financial experts expected to make sure the plans are sound.

The case of one East Bay actuary shows the deep impact of inaccurate benefit calculations. Ira Summer and the firm he owns, Public Pension Professionals, have been accused of errors that cost local government plans in California and Florida millions.

Fresno and Kern counties were among the entities that sustained losses on Summer's watch. In both San Joaquin Valley communities, the growing shortfall now threatens the financial health of pension plans.

Actuaries are responsible for the economic and demographic assumptions that ensure employees and employers pay enough into a plan. They estimate how much a plan will make from investments, how long retirees will live, what will happen to salaries over time.

Pension boards approve the assumptions, but board members tend to rely on the expertise of actuaries because the estimates are based on complex information.

Summer has made millions of dollars from contracting with local governments in California, some of which retained him for several years. In one year alone, he earned about $400,000 total from five California counties where his firm provided actuarial service.

In separate lawsuits, Fresno and Kern counties successfully sued Summer and his firm for professional negligence. Fresno reached a settlement, and Kern won in court. The San Joaquin Valley Air Pollution Control District also won a judgment against Summer, and shoddy work has been alleged by pension managers in San Mateo, Tulare and Imperial counties.

Some communities may have skipped legal action because Summer let his insurance lapse in 2006, leaving little financial recourse for those who win suits.

Summer said he couldn't comment for this story because he's involved in a dispute with insurers.

Records show, however, that Summer has acknowledged mistakes in plans he handled. In 2006, when Fresno County's retirement board had his work audited, Summer promised to correct errors, according to board minutes. That same year, Summer told a retirement board in Palm Bay, Fla., that his firm had erred in some calculations, according to that board's minutes.

When one pension plan replaced Summer, the new actuary found that an error by Summer had had a significant financial impact, according to a report by the Conference of Consulting Actuaries. The report doesn't identify which plan, and the conference would not elaborate.

Summer declined to help the actuary get to the bottom of the mistake and failed to cooperate in the conference's investigation of his conduct, according to the conference, which took the rare step of publicly reprimanding Summer.

Fresno County's pension shortfall has grown fourfold in the last five years, to almost $800 million last year – one of the biggest increases among the state's largest local government plans.

Investment losses account for about one-third of that increased shortfall, records show. More debt was created by actuarial changes to the plan, including changes resulting from Summer's work.

In 2006, four years after he was hired, Fresno County requested an independent audit of Summer's work. Although aware of problems with Summer elsewhere, county retirement administrator Roberto Peña said the audit was done simply because it is good practice to do so.

The audit by actuaries in the San Francisco office of the Segal Co. turned up a number of problems. First, following Summer's advice, the county required employees to pay for cost-of-living increases in the plan, breaking the previous practice of splitting that cost with employers, and differing from other plans across the state, auditors found.

The Fresno County Employees' Retirement Association opted to reimburse the employees, further depleting the fund.

The audit also turned up problems with how Summer calculated inflation for some pensioners.

While those mistakes might not appear serious, they carried high costs.

"All of the changes that affect plan cost, the impact is multiplied for plans that have relatively larger benefits," said Paul Angelo, the Segal actuary who audited Summer and later replaced him as Fresno's actuary.

Fresno County has one of the most generous plans in the state. The county had to set up a supplemental pension because then-Gov. Gray Davis vetoed the higher benefit approved by county leaders in 2000.

As a result of corrections made after the audit, the county's pension shortfall grew by almost $160 million, records show.

In its lawsuit, Fresno County's retirement association accused Summer and his firm of causing $99 million in damages to the plan. The association's attorney claimed Summer was running a "sham company" out of his home, and said the company had "a long and exotic history of failing to ensure that they have the assets or insurance necessary to satisfy the many claims against it."

Because of Summer's insurance problems, the retirement association agreed to settle the suit for $250,000 last year, Peña said.

In retrospect, he said, the association erred by not checking Summer's insurance. It routinely makes those checks now.

In a brief conversation with The Bee, Summer said he continues to work as an actuary in California but declined to say where.

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THE SACRAMENTO BEE sacbee.com

Editorial: Perks of the past return to haunt

Published Monday, Apr. 12, 2010

Many local governments are in an economic tailspin. The recession slashed sales taxes and the collapsing housing market drastically lowered property taxes. Those losses of revenue translate into fewer cops, shuttered mental health clinics, neglected parks and dangerously high caseloads for social workers who watch over vulnerable children.

As city and county layoffs mount and services shrink, pension payouts soar, consuming a grossly disproportionate share of local government budgets. One official aptly described the phenomenon. "My concern," he told The Bee, "is that county government is becoming a pension provider that provides government services on the side."

But it's not just counties. Consider the city of Roseville. As Phillip Reese and other McClatchy reporters documented in Sunday's Bee, the city has had to lay off 150 workers – one-tenth of its work force – to balance its budget in the face of falling revenue. Still Roseville must pay $18 million into its employee pension fund this year, 12 percent more than it paid two years ago and more than it pays for all its park and recreation programs combined. Even with the contribution hike, the city's unfunded pension liability – the difference in what the city's pension system can pay and what it needs to cover its future obligations – stands at $111 million.

Not just the stock market

The tumbling stock market explains part of the problem. Local governments must backfill for massive market losses.

But huge pay hikes and retirement benefit boosts are equally, if not more, to blame. Between 2000 and 2008 the average pay for all local government employees in California shot up a staggering 40 percent, from $46,073 to $64,284.

Again, Roseville stands out. In 2006, the City Council there made headlines when it approved a contract that boosted its city manager's pay 16 percent, to $241,000, a record in the region at that time.

On top of generous pay raises, the Legislature approved and Gov. Gray Davis signed hefty public pension benefit increases.

Prodded by the state, most local governments approved "3 percent at age 50" pension formulas for safety workers, police and firefighters. Pensions are calculated by multiplying 3 percent times their years of service times their highest year's pay. After 30 years on the job most cops and firefighters earn 90 percent of pay in retirement.

In jurisdictions like Sacramento County that are governed by the 1937 Retirement Act, sheriff's deputies can earn 100 percent of pay when they retire. Given that, it's hardly surprising the $100,000 Pension Club, a list of retired public employee who collect more than $100,000 a year in pensions, is dominated by police and firefighters.

Non-safety local government workers earn generous pensions as well. Most receive 2 percent of their highest year's salary, times years of service at age 55. But some local governments have been even more generous.

Roseville stands out

Roseville, again, approved a 2.7 percent at 55 formula. After 30 years on the job, a non-safety Roseville employee earning $75,000 a year would collect $60,750 a year in retirement. That same worker in the city of Sacramento, which maintained a 2 percent at 55 formula, would collect a $45,000 annual pension.

High pay, lavish pensions and bad advice from actuaries about what higher pension benefits would cost have left some local governments on the brink of bankruptcy. The city of Vallejo filed for bankruptcy protection two years ago. Other local governments may be contemplating it. An increasing number of elected officials acknowledge that public employee pension costs are unsustainable both financially and politically. The public is being fleeced, forced to pay more for retired government workers while services shrink.

Many local elected leaders are considering pension rollbacks for newly hired workers. But rollbacks by a few cities or counties are not enough.

Pension bloat began in the Legislature and that's where a rollback to reasonable levels must begin. At minimum, the Legislature should lower pension benefits for all newly hired state and local government workers. If the Legislature does not act, eventually a disgusted public will.

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