



# Memorandum

**TO:** HONORABLE MAYOR AND  
CITY COUNCIL

**FROM:** Debra Figone

**SUBJECT:** FISCAL REFORM PLAN

**DATE:** May 2, 2011

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## **EXECUTIVE SUMMARY**

The following are the recommendations contained in this memorandum to achieve \$216 million in General Fund savings by Fiscal Year 2015-2016. It is important to note that this may only be achieved if retirement costs do not escalate for other reasons, including assumption and experience changes. In addition, many of the recommendations are subject to the meet and confer process with the City's bargaining units.

### **1. REDUCING COMPENSATION FOR EXISTING EMPLOYEES:**

- a. Continue current City Council direction to achieve a 10% ongoing total compensation reduction with the remaining six bargaining units:
  - i. Association of Legal Professionals (ALP)
  - ii. San Jose Police Officers' Association (POA)
  - iii. Municipal Employees' Federation, AFSCME Local 101 (MEF)
  - iv. Confidential Employees' Organization, AFSCME Local 101 (CEO)
  - v. The International Union of Operating Engineers, Local No. 3 (OE#3)
  - vi. International Brotherhood of Electrical Workers (IBEW)

**TOTAL SAVINGS: \$39.6 million**

### **2. REFORMING WORKERS' COMPENSATION AND DISABILITY RETIREMENT SYSTEMS:**

- a. Continue implementation of recommendations contained in the City Auditor's audit reports on workers' compensation and disability retirements
- b. Continue with implementation of the workers' compensation offset for the Police and Fire Department Retirement Plan for an estimated savings of \$2.8 million
- c. Continue with current Council direction and achieve elimination of disability leave supplement with the five remaining bargaining units by Fiscal Year 2012-2013 (ALP, MEF, CEO, OE#3 and IBEW)

**TOTAL SAVINGS: \$2.8 million (minimum savings)**

### **3. REDUCING COSTS FOR SICK LEAVE PAYOUTS, VACATION BUYBACKS AND OVERTIME PAY:**

- a. Eliminate sick leave payout by Fiscal Year 2012-2013 for an estimated savings of \$9.5 million
- b. Eliminate vacation sellback by Fiscal Year 2013-2014 for the remaining bargaining unit (ALP)
- c. Eliminate overtime pay for Fire Department Battalion Chiefs, Police Captains, employees represented by the Association of Maintenance Supervisory Personnel and any other classification as deemed applicable for an estimated minimum savings of \$1.2 million
- d. Continue pursuing only hours worked counting towards the calculation for overtime

**TOTAL SAVINGS: \$10.7 million (minimum savings)**

**4. MODIFYING HEALTHCARE PLANS AND COST SHARING:**

- a. Continue pursuing healthcare cost containment measures with 4 remaining bargaining units (MEF, CEO, OE#3 and IBEW)
- b. Consider changes to plan design to reduce the City and employees retiree healthcare costs, as discussed in the retirement section below

**TOTAL SAVINGS: \$0.0 million (savings attributed in 10% total compensation reduction and retirement savings)**

**5. ORGANIZATIONAL CHANGES AND EFFICIENCIES**

- a. Continue analyzing potential organizational changes, efficiencies and alternate service delivery models
- b. Continue the meet and confer process with the bargaining units for the implementation of the outsourcing of Airport Police and Fire Services, graffiti abatement and park maintenance as contained in the 2011-2012 Proposed Operating Budget for a total General Fund savings of \$2.9 million and additional significant savings for the Airport Department
- c. Implement Human Resources and Office of Employee Relations management consolidation and Public Works and General Services Department consolidation as contained in the 2011-2012 Proposed Operating Budget for a total savings of \$1.5 million
- d. Pursue a City Charter change to allow changes in the organizational structure related to Charter Departments
- e. Pursue making any pay increases in the future based solely on performance

**TOTAL SAVINGS: \$4.4 million (minimum savings)**

**6. AVOIDING INCREASES IN RETIREMENT COSTS BEYOND THE AMOUNTS REQUIRED IN FISCAL YEAR 2010-2011**

- a. Supplemental Retiree Benefit Reserve (SRBR)
  - i. Extend moratorium to January 1, 2012, to allow for sufficient time to complete the outreach and meet and confer process to the extent required
  - ii. Eliminate SRBR and transfer balances as of June 30, 2011, back into the main pension accounts to fund current retirement benefits for a total savings of \$4.7 million (all funds)
  - iii. When plans become fully funded, revisit SRBR to decide if it should be reinstated and if so, if a different distribution method should be used
- b. Retiree Healthcare
  - i. Pursue a new healthcare plan available to active employees that reduces the lowest cost plan premium by 25% for a total savings of \$17.9 million (all funds)
  - ii. Continue pursuing elimination of the reimbursement of Medicare Part B in the Police and Fire Department Retirement Plan

- iii. Implement a new tier of retiree healthcare benefits for new employees where new employees are part of the same plan, but at an even lower, fixed cost
  
- c. Pension- New Employees (Second Tier)
  - i. Revisit current City Council direction and pursue a hybrid plan (Social Security and defined contribution plan) for new employees hired on or after January 1, 2012, to provide for more flexibility and less risk for the City, taxpayers, and employees
  
- d. Pension- Retirees and Current Employees (First Tier)
  - i. Pursue changes to future, unaccrued benefits for current employees and retirees to achieve the savings needed to keep retirement costs at the Fiscal Year 2010-2011 level for a total savings of \$194 million (all funds)  
Changes may include:
    - 1. Elimination/reduction in Cost of Living Adjustment (COLA)
    - 2. Change in time period for determining final maximum compensation
    - 3. Change in benefit accrual rate for future years of service
    - 4. Change in the age at which someone can retire
    - 5. Increased employee cost sharing
  - ii. Maintain flexibility to change benefits in the future
  - iii. Create an opt-in program for current employees to opt into the second tier retirement benefit to lower employee costs
  - iv. Periodically review retirement plan and costs to determine if additional changes should be made
  - v. If retirement plan costs continue to escalate or our options become limited because of legal issues, create further incentives for employees to move into Tier 2

**TOTAL SAVINGS: \$216.6 million (all funds)**

**7. REVENUES:**

- a. Pursue four different revenue opportunities after implementation of other fiscal reforms
  - i. Sales Tax increase of ¼ cent for an estimated revenue of \$34 million
  - ii. Municipal Water System tax on gross receipts for an estimated revenue of \$2.5 million
  - iii. Business Tax increase for an estimated revenue of \$5 million
  - iv. Disposal Facility Tax increase for an estimated revenue of \$5 million

**TOTAL REVENUES: \$46.5 million**

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The total General Fund savings contained in this plan is summarized in the following chart, reaching the Council direction of achieving \$216 million in savings at the end of the five years. We have planned for additional savings to leave options open for the City Council in their decision making, as well as to have a back up plan in case revenues are not pursued or are not passed by the voters.

Area of Savings	Fiscal Year 2011-2012 Savings	Fiscal Year 2012-2013 Savings	Fiscal Year 2013-2014 Savings	Fiscal Year 2014-2015 Savings	Fiscal Year 2015-2016 Savings
Reducing Compensation	\$39.6 M				
Workers' Compensation Offset		\$2.8 M			
Sick Leave Payout		\$9.5 M			
Overtime			\$1.2 M		
Organizational Changes/Efficiencies	\$4.4 M				
SRBR		\$3.7 M			
Retiree Healthcare			\$13.9 M		
First Tier Retirement			\$127.5 M	\$16.8 M	\$7.0 M
Revenues		\$36.5 M		\$10.0 M	
<b>TOTAL SAVINGS</b>	<b>\$44.0 M</b>	<b>\$52.5 M</b>	<b>\$142.6 M</b>	<b>\$26.8 M</b>	<b>\$7.0 M</b>
<b>TOTAL CUMULATIVE SAVINGS</b>		<b>\$96.5 M</b>	<b>\$239.1 M</b>	<b>\$265.9 M</b>	<b>\$272.9 M</b>

*Note: For savings from SRBR, retiree healthcare and other retirement savings, because the savings is difficult to attribute to General Fund versus all funds, we have applied a general percentage of 78% to the all funds savings to determine an approximate General Fund savings.*

## **RECOMMENDATION**

Accept Fiscal Reform Plan and direct staff to proceed with the steps necessary to implement the plan, including meeting and conferring with the bargaining units, as applicable.

## **INTRODUCTION**

Additional background information regarding retirement benefits can be found on the City's internet site:

<http://www.sanjoseca.gov/employeeRelations/RetirementBenefits.asp>

<http://www.sjretirement.com/>

In addition, attached is a glossary of actuarial terms from the Pew Report, Promises with a Price. These actuarial terms are frequently used in this memorandum (Attachment 1). This glossary can also be found on the City's internet site on Retirement Benefits: [Glossary of Commonly Used Pension Terms \(Excerpt from Pew Report, Promises with a Price\)](#).

The [Mayor's March Budget Message](#) that was unanimously approved by the City Council on March 22, 2011, included the following:

*Direct the City Manager to present recommendations on May 2, 2011 based on the above principles to achieve \$216 million per year of cost reductions and/or new revenues for the General Fund that will allow us to restore services to the levels of January 1, 2011 [Police, Fire, libraries, and community centers] and to open the libraries, community centers, and fire stations built or under construction, and the police substation within five years. Recommendations should include cost savings from:*

- a. Reducing compensation for existing employees.*
- b. Avoiding increases in retirement costs beyond the amounts paid for this fiscal year.*
- c. Reforming workers' compensation and disability retirement systems.*
- d. Reducing costs for sick leave payouts, vacation buybacks, and overtime pay.*
- e. Modifying healthcare plans and cost sharing.*
- f. Organizational changes and efficiencies.*

In addition to this direction, the City Council approved guiding principles in developing this fiscal reform plan, which will be discussed in more detail in the retirement reform section of this memorandum.

Developing a plan to save \$216 million in five years is difficult, but necessary. With our retirement costs projected as they are, the City must make cost cutting measures to ensure that we are still able to provide necessary and basic services to the public.

It is projected that in the next five years, our cumulative retirement contributions will exceed **\$1.7 billion** in all funds. This is not sustainable.

**PROJECTED RETIREMENT COSTS  
 ALL FUNDS**

<b>Retirement Plan (Pension and Retiree Healthcare)</b>	<b>FY 10-11</b>	<b>FY 11-12</b>	<b>FY 12-13</b>	<b>FY 13-14</b>	<b>FY 14-15</b>	<b>FY 15-16</b>
<b>TOTAL (ALL FUNDS)</b>	<b>\$186.0M</b>	<b>\$256.2M</b>	<b>\$310.5M</b>	<b>\$360.2M</b>	<b>\$388.9M</b>	<b>\$400.7M</b>

*Note:*

*Includes both pension and retiree healthcare. FY 10-11 includes the City's pre-payment discount and is what the City's cost would have been had several bargaining units not paid a portion of the contributions. FY 11-12 to FY 15-16 does not include the City's pre-payment discount. The pre-payment discount is the discount the City received for paying the City retirement contributions all at once for the Fiscal Year, rather than on an incremental basis.*

We must recognize that this is the reality we are facing with projections of at least \$400 million of our City dollars going towards retirement costs in Fiscal Year 2015-2016. It should be noted that of this \$400 million, approximately \$331 million is for pensions and \$70 million for retiree healthcare. This is not the worst case scenario. As the Boards of the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan continue reviewing actuarial assumptions to make them more realistic, this could very well require more contributions into the retirement funds.

I want to be clear, as I have stated many times in the past, that the financial state of the City's pension system is not our employees' fault. There is no reason to place blame, but rather, we should work together to come up with a solution that is necessary and reasonable so that we all have a sustainable system to ensure there is a pension benefit for City employees when they retire, whether that be five years from now or twenty years from now. Reasonable solutions are also necessary in order to keep from eliminating and reducing City services to the public in order to pay retirement costs.

The City Council direction was for the City Manager to develop a plan to save \$216 million in the General Fund over the next five years and that retirement costs should be maintained at the Fiscal Year 2010-2011 levels. Because of the difficulty of attributing a General Fund savings to retirement scenarios, we have calculated the all funds retirement savings needed as follows:

<b>Fiscal Year</b>	<b>ALL FUNDS Retirement Costs</b>
2010-2011	\$186.0 million
2015-2016 <sup>1</sup>	\$400.7 million
<b>Difference</b>	<b>\$214.7 million</b>

<sup>1</sup> These costs are just projections and are subject to change.



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The plan contained in this memorandum saves at least \$215 million in **all funds** in retirement costs under the current assumptions. It is important to point out that these assumptions may change.

I firmly believe in the principle of fairness and have considered fairness in the development of this plan. To the extent possible, this plan recommends changes for employees, retirees and taxpayers in order to share in addressing this crisis. There are significant legal issues that the City Council will have to consider in making any changes for current employees and retirees. However, there is also risk with not addressing the dramatic escalation of retirement costs and the resulting impact of services to the public. It is important to be fair to employees and retirees by recommending reasonable changes. Per the City Council direction, this plan does not recommend taking away anything that has already been accrued for years of service that current employees have already worked, and it does not recommend any changes that aren't absolutely necessary given the crisis this City continues to face.

This recommendation is also fair to taxpayers. Although this plan recommends small revenue changes, this recommendation does not include any drastic tax measures. The public's sentiment of needing to get our compensation and benefits at a sustainable level before asking for revenue increases was taken into consideration in the development of this plan.

I also firmly believe that we need to rethink the City's compensation and benefit systems. The City's compensation increases for non-management bargaining units come through automatic step increases and negotiated general wage increases, neither of which give any consideration to performance. It is reasonable to expect that any wage increases given in the future be solely based on performance and this has been built into the recommendations.

San Jose needs to mirror the creativity and entrepreneurial thinking of Silicon Valley. We are the tenth largest City in the United States, and we are a leader. We should put our best foot forward in solving this problem and be in the forefront of making changes. It will not be easy, but it is necessary. Together we can find a solution in order to maintain City services and City jobs.

It has been said that the City of San Jose will no longer be a competitive employer when we make changes to retirement benefits. Although the pension crisis and changes to retirement benefits are being discussed at a national level, we are at the forefront of making changes and as such, we must rethink what competitiveness means. The City of San Jose is a very large public agency, and it is difficult to compare us to smaller agencies within the Bay Area. Not only do we have significantly different fiscal situations, but a very major difference between the City of San Jose and most other agencies is that we are not in the state-run retirement system (CalPERS) and have our own independent retirement plans established by the City Charter ([City Charter, Article XV](#)). One benefit to this is that the City of San Jose is not tied to retirement benefits that CalPERS offers, and we are able to come up with a solution that fits our situation.

In addition, when looking at competitiveness one cannot look at retirement benefits alone. Pay, health and other benefits and promotional opportunities are also factors. San Jose is an attractive

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place to work for various reasons and since we are such a large agency, we are able to provide employees with opportunities that may not exist in other agencies. Lastly, we cannot just compare ourselves to public sector agencies. Many of our new employees may come from the private sector where defined benefit pension plans are rare. Attracting employees with a commitment to public service and specifically to San Jose needs to be reemphasized.

In addition, it is important to recognize that controlling our retirement costs may provide us the flexibility in the long term to make changes to pay. High retirement costs limit our ability to make changes in other areas of total compensation. It has been said that some employees would prefer more take-home pay. But with our retirement costs as high as they are, this limits the funds available to make changes to pay as the City's retirement costs are taking up more and more of an employee's total compensation.

The plan contained in this memo recommends shared sacrifice among current employees and current retirees. To the extent we can share in this burden, there will be more reasonable solutions. If we are limited in our options, this unfortunately makes the remaining options more drastic.

Again, the recommendations in this plan are based on what is reasonable and necessary for the long term sustainability of the City's retirement systems and the preservation of core City services and City jobs. It is recognized that there will always be arguments for or against changing retirement benefits, but we must work together to achieve solutions where everyone can share in the sacrifice in order for San Jose to continue to be a great place to work and live.

***Retirement Costs***

When discussing the City’s retirement costs, it is important to understand how we have gotten here and what we are facing so that there is an understanding that the changes we are recommending are absolutely necessary for the fiscal health of the City.

Retirement benefit costs, both pension and retiree healthcare, have increased significantly and are projected to continue to increase in the next several years. The costs are expected to be high for many years--this is **not** simply a short term issue. These costs are unsustainable in that they are growing at a rate and are of a magnitude that they are requiring an ever increasing share of the City’s overall revenue stream, regardless of source of funds. Retirement reform is needed for the long-term sustainability of the retirement plans and in order to continue to provide even the most basic municipal services to the public.

These rising retirement costs account for approximately half of the Fiscal Year 2011-2012 General Fund shortfall, as shown in the chart below.

	<b>2011-2012 General Fund Shortfall</b>
Carry-Over from 2010-2011 Adopted Budget	\$ 20.5 M
<b>Increased Retirement Contribution Rates (Police - \$25.4 M; Fire - \$17.2 M; Federated - \$14.6 M)</b>	<b>57.2 M</b>
Increased Health and Other Fringe Benefits	6.4 M
Salary Step/Performance Increases	3.3 M
2011-2012 Committed Additions	6.7 M
Public Safety Vehicle Replacement	4.7 M
Other Expenditure Adjustments	(7.0 M)
Decreased Revenue Estimates	23.3 M
<b>TOTAL 2011-2012 GENERAL FUND SHORTFALL</b>	<b>\$ 115.1 M</b>

*Note: Reflects Federated and Police and Fire Retirement Boards’ actions regarding the interest earnings assumptions and the methodology change for setting the City’s Annual Required Contribution.*

Over the next five years, the cumulative General Fund contributions to cover retirement costs are expected to total **\$1.3 billion**. The annual General Fund retirement costs increase from \$192 million assumed in the Fiscal Year 2011-2012 Proposed Budget to \$305 million by Fiscal Year 2015-2016.

**2012-2016 GENERAL FUND RETIREMENT CONTRIBUTIONS (\$ in Millions)**

Retirement Plan	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016	Total
<b>Federated Retirement Plan</b>	\$ 54.5	\$65.1	\$78.1	\$84.7	\$87.3	<b>\$369.7</b>
<b>Police Retirement Plan</b>	\$86.3	\$106.6	\$121.6	\$131.3	\$135.4	<b>\$581.2</b>
<b>Fire Retirement Plan</b>	\$50.7	\$63.9	\$72.8	\$78.6	\$81.1	<b>\$347.1</b>
<b>Other Retirement Costs</b>	\$0.5	\$0.6	\$0.6	\$0.7	\$0.7	<b>\$3.1</b>
<b>Total</b>	<b>\$192.0</b>	<b>\$236.2</b>	<b>\$273.1</b>	<b>\$295.3</b>	<b>\$304.5</b>	<b>\$1,301.1</b>

The City of San Jose is not alone. Public entities across the nation are faced with significant retirement cost obligations, while revenues are not keeping pace with expenditure growth. These rising costs are consequently diverting limited resources from direct service delivery to our communities.

Recent reports published emphasize the need for retirement reform, including the following:

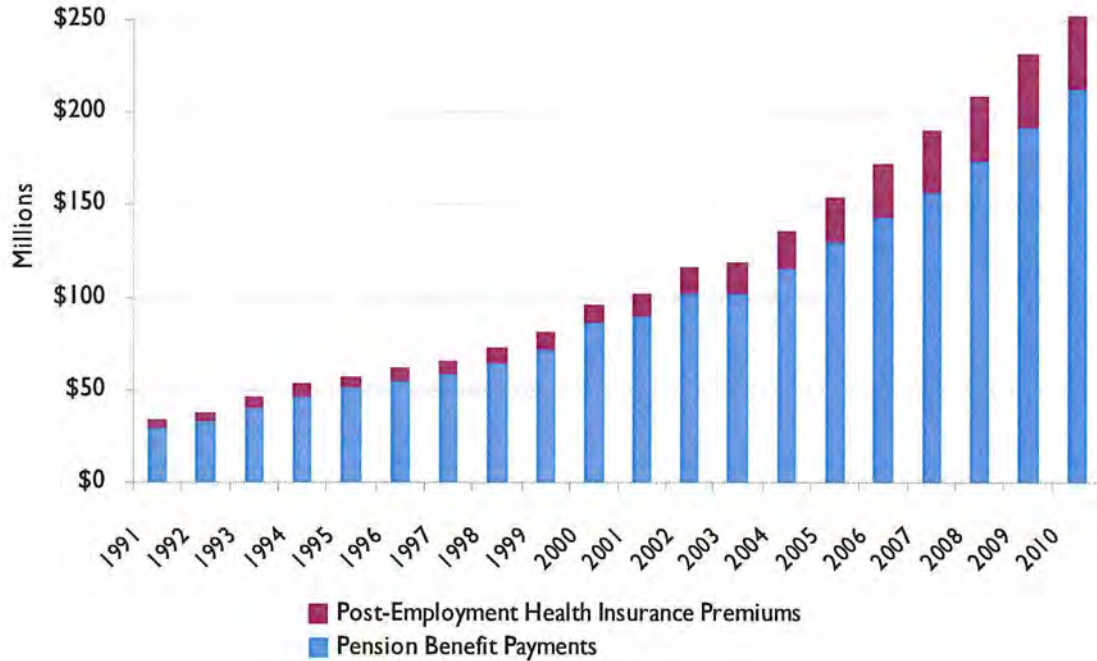
- Santa Clara County Grand Jury: [Cities Must Rein In Unsustainable Employee Costs](#)
- City Auditor: [Pension Sustainability Rising Pension Costs Threaten The City’s Ability to Maintain Service Levels – Alternatives For A Sustainable Future](#)
- Santa Clara and San Mateo County City Managers’ Associations: [Policy Statement on Local Government Retirement Benefits](#)
- [Little Hoover Commission Report: Public Pensions for Retirement Security dated February 2011](#)

The Little Hoover Commission reviewed California pension plans, including San Jose’s, and noted the following, showing that San Jose is not alone in this problem:

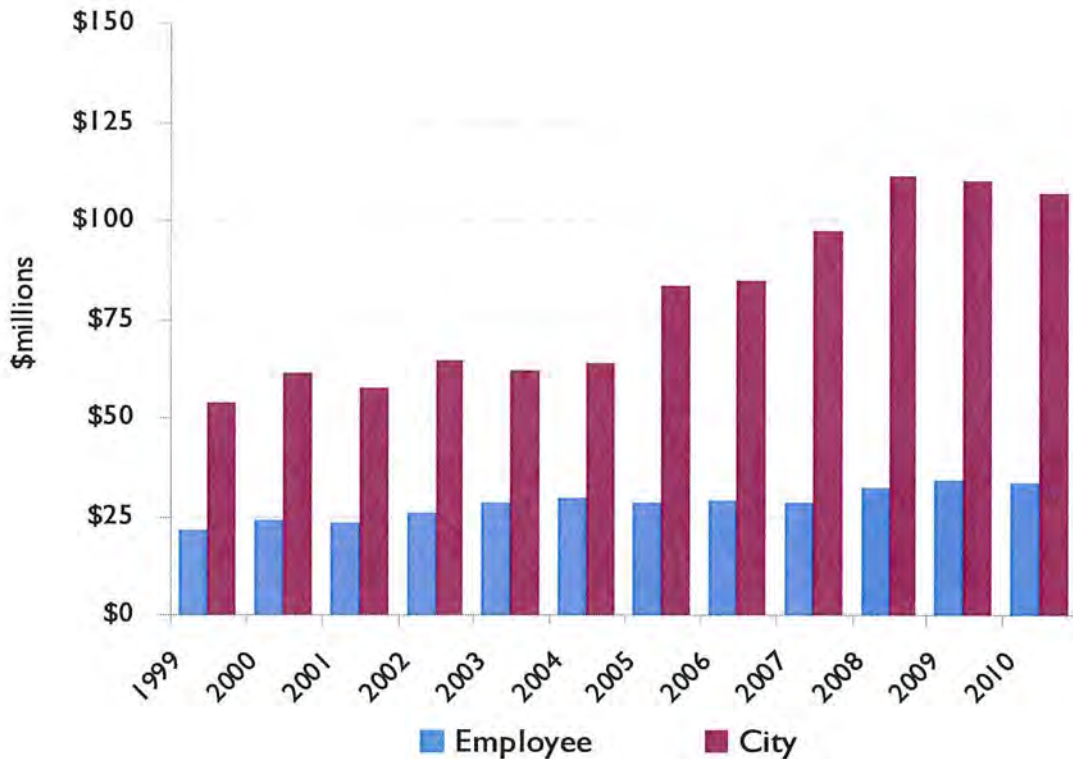
*California’s pension plans are dangerously underfunded, the result of overly generous benefit promises, wishful thinking and an unwillingness to plan prudently. Unless aggressive reforms are implemented now, the problem will get far worse, forcing counties and cities to severely reduce services and layoff employees to meet pension obligations.*

As noted above, on September 29, 2010, the City Auditor issued an audit entitled, “Pension Sustainability: Rising Pension Costs Threaten the City’s Ability to Maintain Service Levels – Alternatives for a Sustainable Future.” The audit focused on the rising costs of City retirement benefits, identifying the major cost drivers and provided recommendations to achieve more sustainable retirement costs for the future. One of the findings in the City Auditor’s report is that rising pension costs threaten the City’s ability to maintain service levels. On October 26, 2010, the City Council took action to accept the City Auditor’s recommendations.

It is important to recognize how the dramatically increased retirement costs developed. The City Auditor noted in her report that benefit payments have increased seven fold over the last 20 years, as shown in the chart below.

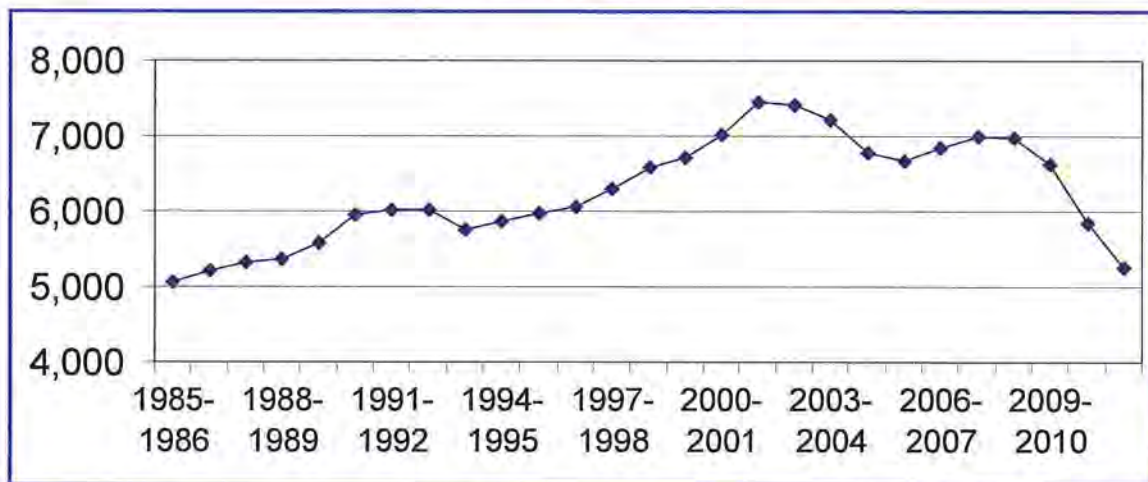


In addition, the City Auditor also showed that City and employee contributions have increased drastically in the last decade, as shown in the chart below.



As retirement costs have continued to escalate, the City has had to reduce costs in other areas, specifically in the drastic reduction of City services and City jobs. In 2000, when the retirement costs were at almost the lowest in the last decade, the City had 7,013 full time equivalent employees. In 2010, when retirement costs were at the highest in the last decade, full-time equivalent employees were significantly reduced to 5,889. With the position reductions in the Fiscal Year 2011-2012 Proposed Operating Budget, we will be at the employee levels we were at 25 years ago, as shown in the chart below (5,252 positions). We cannot allow this to continue, as it is resulting in the loss of vital services to the community.

### TOTAL CITY POSITIONS



### Retirement Contribution Rates

The City's current retirement benefits are the most expensive employee benefit, and as noted above, costs are projected to increase significantly in the future. In Fiscal Year 2011-2012, \$192 million in the General Fund will go towards retirement benefits, as shown in the chart on page 12. The following chart provides the contribution rates for Fiscal Year 2011-2012, that were adopted by the Boards for each plan.<sup>2</sup> It is important to note that the City does not determine the contribution rates—the independent retirement boards determine the amounts that need to be contributed to the retirement funds based upon actuarial valuations performed by actuaries hired by the boards.

<sup>2</sup> These rates do not include the discount rate for the City because of the prepayment of retirement contributions.

<b>Federated City Employees' Retirement System</b>			
Pension	City	Employees	Total
Normal Cost	12.76%	4.68%	17.44%
Unfunded Liability – Prior Service Cost	15.58%	0%	15.58%
<b>Subtotal</b>	<b>28.34%</b>	<b>4.68%</b>	<b>33.02%</b>
Medical and Dental	7.16%	6.51%	13.67%
<b>Total</b>	<b>35.50%</b>	<b>11.19%</b>	<b>46.69%</b>
<b>Police and Fire Department Retirement Plan (Police)</b>			
Pension	City	Employees	Total
Normal Cost	27.69%	10.38%	38.07%
Unfunded Liability – Prior Service Cost	22.09%	0.08%	22.17%
<b>Subtotal</b>	<b>49.78%<sup>3</sup></b>	<b>10.46%</b>	<b>60.24%</b>
Medical and Dental <sup>4</sup>	7.61%	7.01%	14.62%
<b>Total</b>	<b>57.39%</b>	<b>17.47%</b>	<b>74.86%</b>
<b>Police and Fire Department Retirement Plan (Fire)</b>			
Pension	City	Employees	Total
Normal Cost	28.53%	10.70%	39.23%
Unfunded Liability – Prior Service Cost	23.01%	0.06%	23.07%
<b>Subtotal</b>	<b>51.54%</b>	<b>10.76%</b>	<b>62.30%</b>
Medical and Dental <sup>5</sup>	5.27%	4.86%	10.13%
<b>Total</b>	<b>56.81%</b>	<b>15.62%</b>	<b>72.43%</b>

Using Fire contribution rates as an example, for an employee making \$100,000 a year, this means that the City will contribute an additional \$56,000 towards that employee's retirement. With retirement costs increasing so dramatically, an employee's pay may not be able to be increased or may have to be decreased as the retirement costs grow because the City has no flexibility in reducing retirement costs for an employee unless we work towards reducing the cost of retirement benefits.

Although the above chart lists contribution rates, it is important to note that the City has planned for the recent change adopted by the Boards that will require the Annual Required Contribution (ARC) to be the greater of the dollar amount reported in the actuarial valuation (adjusted for interest based on the time of the contributions) or the dollar amount determined by applying the percent of payroll contribution reported in the actuarial valuation to the actual payroll for the fiscal year. The actuaries determine the ARC, which is based on projected payroll data, calculating how much money they determine will be necessary for the plan in that year. Whenever payroll declines, the contribution rates will not generate the sufficient amount of money for the ARC and therefore, this change ensures that the City contributes the full ARC.

<sup>3</sup> Before applying the charge to reduce the contribution rate by 0.49% of pay for 2011-2012 only.

<sup>4</sup> The Medical and Dental rates for the City and Employees are projections. It is anticipated that the funding (contribution) report will be available in May 2011.

<sup>5</sup> The Medical and Dental rates for the City and Employees are projections. It is anticipated that the funding (contribution) report will be available in May 2011.

Due to the contraction in City positions, with this newly adopted contribution methodology, the City is required to pay a minimum dollar amount regardless of actual payroll experienced to ensure that the plans are funded in accordance with the annual actuarial valuation. This change adopted by the retirement boards serves to avoid creating additional unfunded liabilities.

Unfunded Liabilities and Funding Ratios

As of June 30, 2010, the unfunded liability and funding ratios under both calculations for each pension plan are detailed below. Based on the current difference between the market value of assets and the actuarial value of assets, a further decline in the funded status is expected over the next few years, as the asset losses for the 2008-2009 market downturn are fully recognized in the actuarial value of assets. When a retirement plan is considered “fully” or “100%” funded, it means that the assets are equal to the liabilities. As a result of the significant unfunded liability, funding ratios for both plans have fallen.

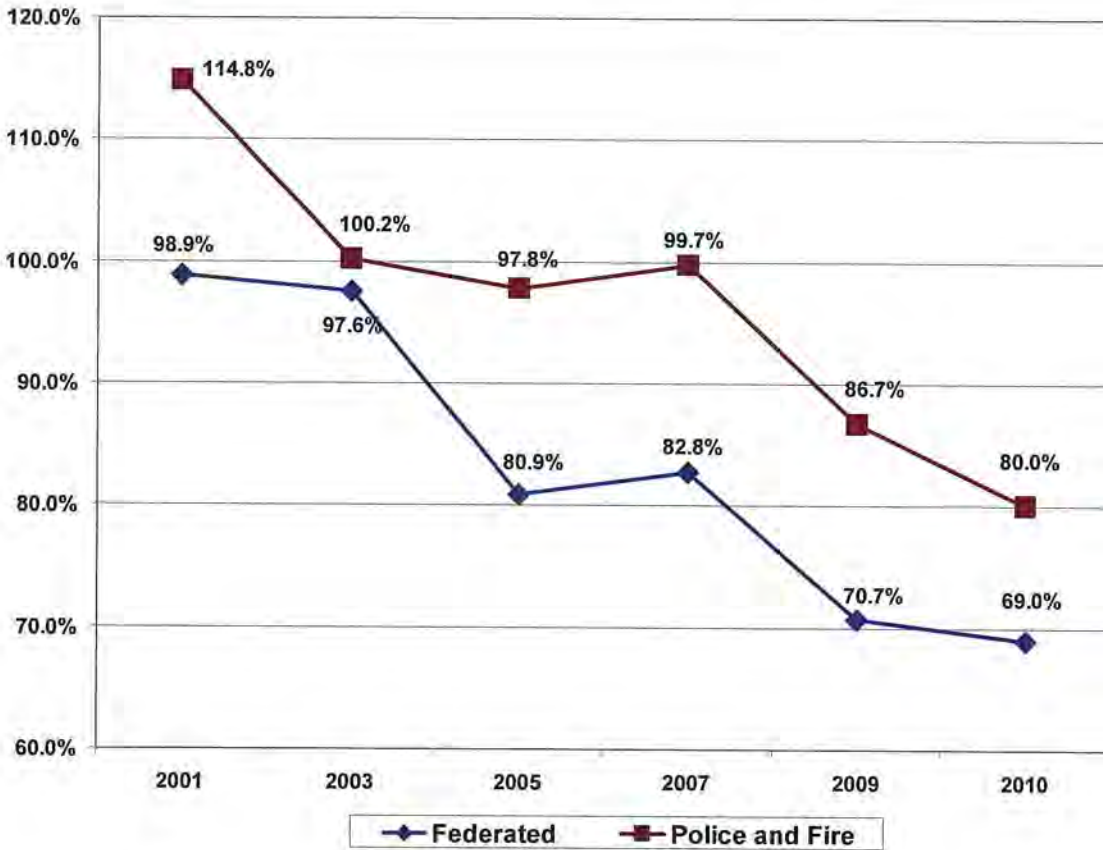
<b>Pension Unfunded Liability As of June 30, 2010</b>			
	<b>Federated</b>	<b>Police and Fire</b>	<b>Total</b>
Market Value	\$1.0 billion	\$1.0 billion	\$2.0 billion
Funding Ratio	60%	69%	65%
<hr/>			
Actuarial Value	\$0.78 billion	\$0.65 billion	\$1.43 billion
Funding Ratio	69%	80%	75%

<b>Retiree Healthcare (OPEB) Unfunded Liability As of June 30, 2010</b>			
	<b>Federated</b>	<b>Police and Fire<sup>6</sup></b>	<b>Total</b>
Market Value	\$0.82 billion	\$0.72 billion	\$1.54 billion
Funding Ratio	12%	7%	9%
<hr/>			
Actuarial Value	\$0.82 billion	\$0.71 billion	\$1.53 billion
Funding Ratio	12%	6%	10%

<sup>6</sup> The June 30, 2010, OPEB (retiree healthcare) valuation has not been completed. It is anticipated that the funding (contribution) report will be available in May 2011. The retiree healthcare liability for Police and Fire demonstrated in this chart is the unfunded liability as of the June 30, 2009 valuation.



The chart below details the dramatic decline in funding ratios using the actuarial value.



The San Jose Municipal Code provides that the City, and ultimately the taxpayers, are responsible for 100% of the unfunded liability for the pension benefit. This is not in the City Charter, and who pays the unfunded liability for pensions could be changed through the negotiation process. The retiree medical liability, however, is shared 50/50 between the City and employees. Unlike the unfunded liability, the “normal cost” for pensions is in the City Charter. The normal cost is the cost of funding the retirement benefit for each year of service. The City Charter provides for a sharing of the normal cost for pension benefits at a ratio of 8:3 for current City employees. Therefore, a change in that cost sharing for current employees would require a City Charter change. It should be noted that Measure W provides for the City to be able to have different benefits and cost sharing for new employees.

As the City considers alternative retirement benefits for new employees, any changes for new employees will **not** reduce the unfunded liability that already currently exists. The City is currently ultimately responsible for 100% of the existing unfunded liability for the pension benefit.

There is a misperception that we will be able to invest our way out of this problem. That is not the case. As the City Auditor has said, "If you have \$100 and lose 50%, you have \$50. Even if you are able to earn 50 percent on what's left, you still only have \$75." While the gains we have recently had in our investments have helped, we are still facing at least a \$2 billion unfunded liability. As the boards invest the retirement funds, the level of risk that they take in making investments decisions is critical. To the extent that they take more risk to increase returns, the higher the risk to the City of future losses.

### Realistic Changes to Actuarial Assumptions and Methodologies

To project the cost and liabilities of the plans, assumptions are made, and each year actual experience is compared against the projected experience. If assumptions are changed, contribution requirements are adjusted to take into account a change in the projected experience in future years.

It is critical that realistic actuarial assumptions are used. The Boards need to adhere to funding policies that are based on sound actuarial methods to avoid underfunding the plans and intergenerational transfers of benefit costs. In the report dated November 22, 2010, prepared by The Segal Company, the Police and Fire Department Retirement Board's actuary states:

*"The use of realistic actuarial assumptions is important to maintain adequate funding, while fulfilling benefit commitments to participants already retired and to those near retirement. The actuarial assumptions do not determine the "actual cost" of the plan. The actual cost is determined solely by the benefits and administrative expenses paid out, offset by investment income received. However, it is desirable to estimate as closely as possible what the actual cost will be so as to permit an orderly method for setting aside contributions today to provide benefits in the future, and to maintain equity among generations of participants and taxpayers." (Emphasis added.)*

In order to address these objectives, both retirement Boards have made revisions to actuarial assumptions and methodologies for the pension valuations that have been used to establish the City and employee retirement contributions for Fiscal Year 2011-2012.

In analyzing the potential cost savings of any changes to retirement benefits, it will be critical to utilize realistic actuarial assumptions since overly optimistic assumptions may overstate the potential cost savings and then result in a need to make further changes. To address this concern, when providing examples in this memorandum, we have used two different earnings assumptions, 7.75% and 6.75%, each of which have a different probability of being reached, as shown below.

Earnings Assumption	Probability of Achieving Assumed Rate of Return
7.75%	25%
6.75%	50%

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A 7.75% earnings assumption is currently approved to use by both Boards for Fiscal Year 2011-2012. As noted above, the probability of achieving this rate of return is only **25%**, meaning that there is only a one in four chance of achieving it. Based upon the actuarial reports, the Boards may be making further reductions to the earnings assumptions in the future. For example, in its November 22, 2010 report, The Segal Company's model produces a net investment return assumption of **6.93%**, which is significantly lower than the current assumption. The Federated Plan actuary has also indicated that the earnings assumption may need to be decreased further. Even if the boards reduce the assumption to 6.75%, it still only results in a 50% probability of achieving it. The City Administration has supported and will continue to support the Boards' efforts to make changes to assumptions to make them as realistic as possible.

Selecting an earnings assumption does not make the benefit less or more expensive, although it appears that way since even small changes have dramatic effects on the contribution rates. It is critical to keep in mind that the cost of retirement benefits are **not** determined by the earnings assumption. The costs are determined by the benefits provided, offset by the **actual** investment earnings.

Choosing the earnings assumption on which to base cost savings highlights the risk involved in defined benefit programs. The risk is not only to the City, but also to employees. The more optimistic the assumptions are, the greater the risk is that the cost estimates will not be achieved, thereby creating additional unfunded liabilities. The more we discuss the risk of our defined benefit retirement plans, the more difficult the conversation becomes. However, we must not avoid this issue and take it head on so as not to continue or repeat the problems we are facing now and for decades to come.

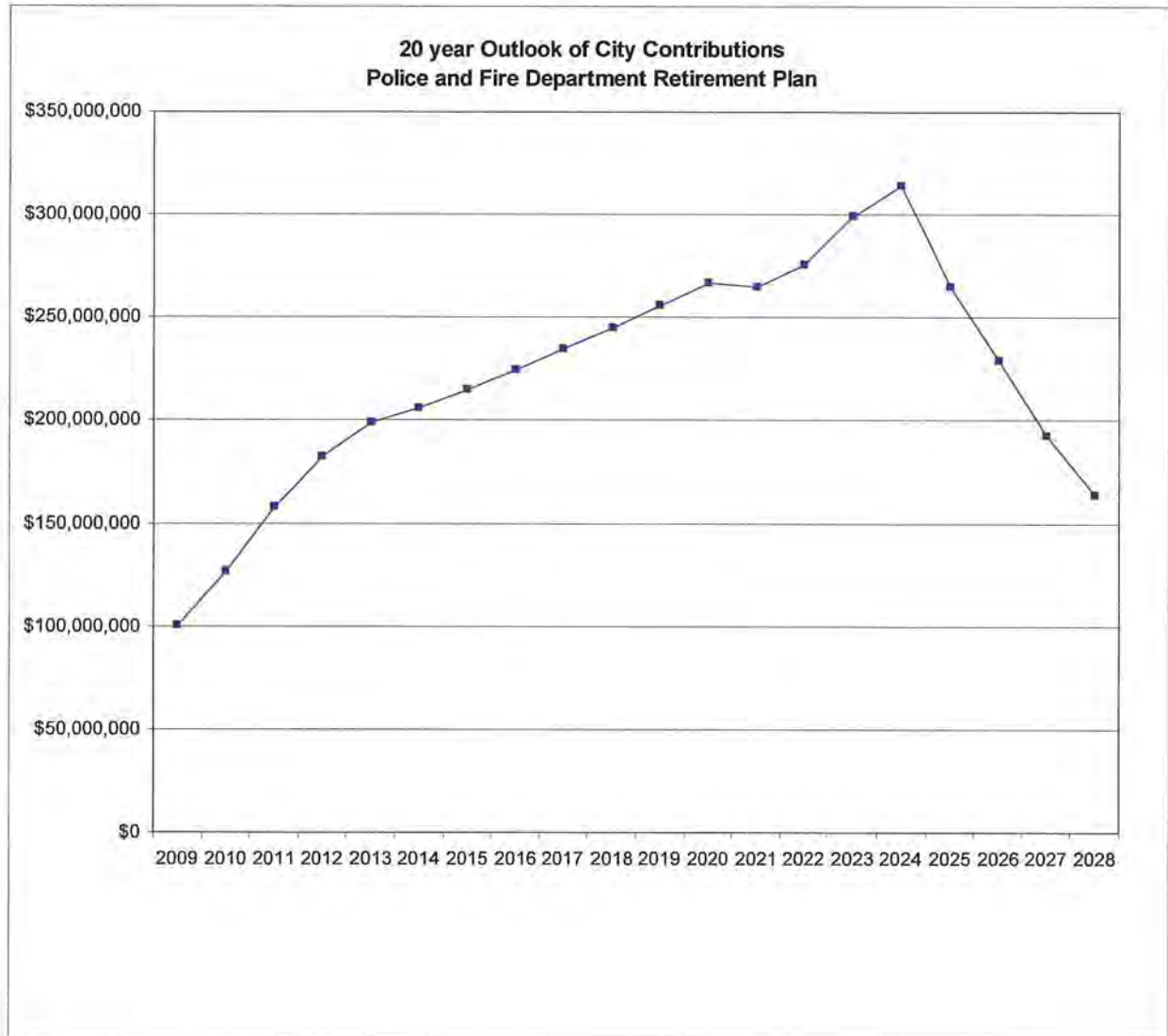
### Retirement Cost Outlook

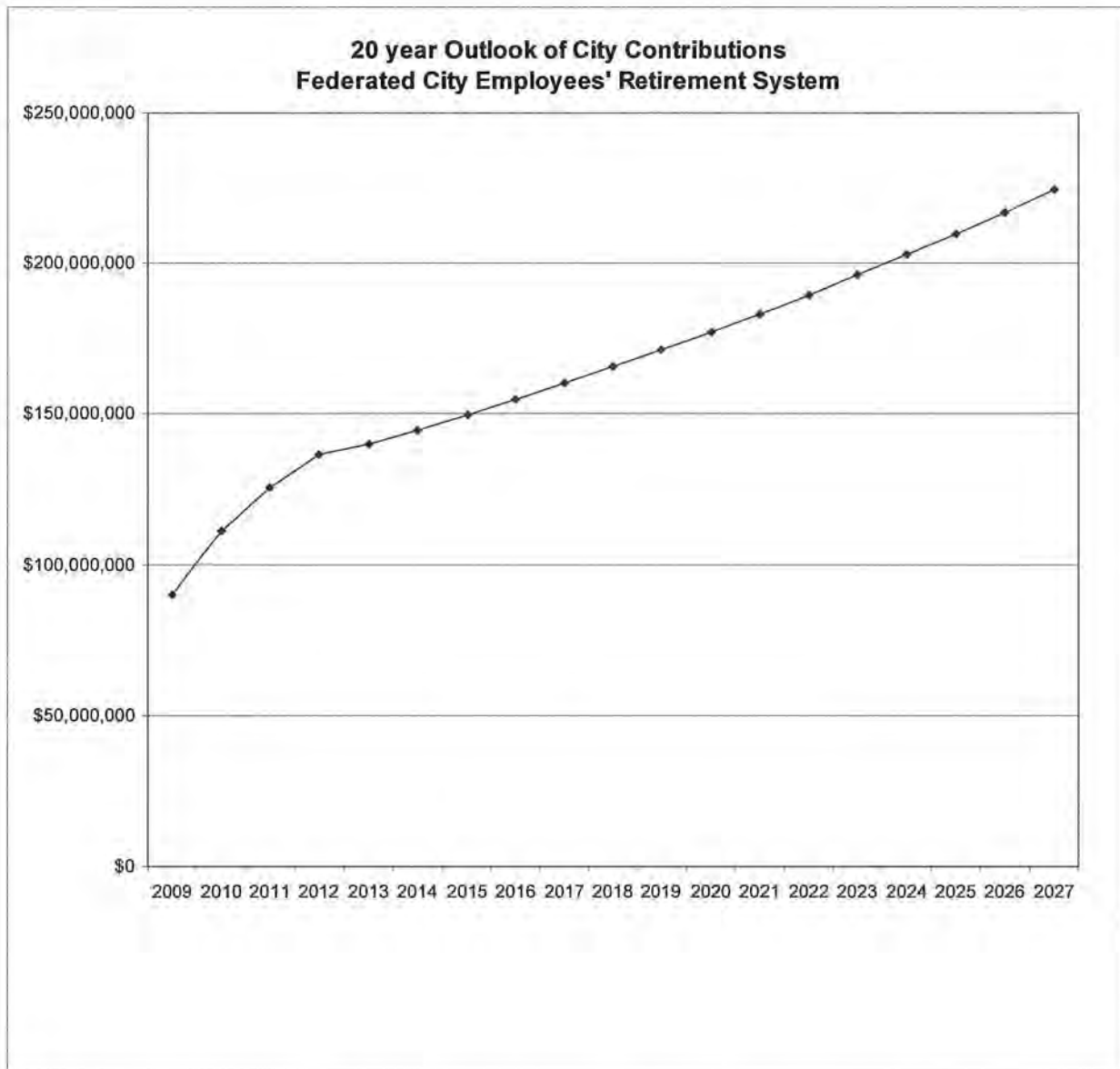
Although we are focused on the next five years in this memorandum, it is important to recognize that retirement costs are only projected to get worse, not better, unless changes are made to reduce costs. Below are 20 year outlook charts for both the Police and Fire Department Retirement Plan and the Federated City Employees' Retirement System. This also does not take into account any further assumption changes that the Boards' trustees may make such as adopting more realistic earnings assumptions and modification to the life expectancy assumption. The modification to the life expectancy assumption is critical because as people live longer, it increases the cost of the benefit. The Police and Fire Department Retirement Plan 20 year outlook chart shows a decline starting in 2024. This is because the Police and Fire Department Retirement Plan uses a 16 year amortization period. The Federated Employees' Retirement System chart does not show a decline because the plan uses a 28 and 20 year amortization period and any decline would be in the years past what is shown on the chart.

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Due to the significant cost to the City, alternatives for creating sustainable retirement benefits are necessary. The current retirement benefits are not fiscally sustainable, and as the City Auditor concluded, rising pension costs threaten the City's ability to maintain service levels. The costs are diverting limited resources from direct service delivery to the community. This is evident in the significant deficits the City faced in Fiscal Year 2010-2011, and now again in Fiscal Year 2011-2012. Any changes to retirement benefits for retirees, current employees and future employees should be reasonable, necessary and sustainable for taxpayers and the City. Providing reasonable retirement benefits that are cost effective and sustainable in the long term are important, but most importantly, retirement reform is needed to continue services to the community.

## **FISCAL REFORM PLAN**

In my proposed operating budget for Fiscal Year 2011-2012, we have balanced the \$115 million deficit primarily on service cuts. This is the tenth year of budget deficits and next year is not expected to get any better. We are currently projecting an approximately \$78 million shortfall for Fiscal Year 2012-2013.

Each of the items in this plan have varying potential implementation dates. Almost all are subject to the meet and confer process with the City's bargaining units and therefore, implementation of these items is dependent upon completion of that process. It should be noted that it is likely that some bargaining units will refuse to negotiate changes to some items such as retirement benefits for current employees and changes to sick leave payout based on their view that these are vested rights that may not be bargained away. After consideration of the various legal issues, the City Council may be faced with different decisions for those bargaining units such as potential implementation after efforts to meet and confer in good faith and interest arbitration for the San Jose Police Officers' Association and the San Jose Fire Fighters, IAFF, Local 230. However, we must have a sense of urgency because as every year continues without reducing costs, the more services we will have to cut in that year in order to balance the budget.

In addition, because of the lag time between when an actuarial valuation is completed and when the contribution rates go into effect, there would be no immediate savings achieved for retirement changes even if we were to complete the meet and confer process with the bargaining units quickly. For purposes of my recommendations, we have assumed an effective date of January 1, 2012, for both first and second tier changes. Under normal actuarial processes this would not affect contribution rates until Fiscal Year 2013-2014. However, the City could request that the Retirement Boards have a mid-Fiscal Year actuarial valuation, which would result in an adjustment to the contribution rates. This decision will be up to the Boards. In the past, when there have been benefit enhancements, the Boards have changed contribution rates even if it occurred between actuarial valuations. Similarly, subject to the Boards' discretion, we think that these adjustments could be made when the benefit is reduced. However, because it is unknown if this will occur, we are anticipating an effective date of the retirement savings for Fiscal Year 2013-2014.

The following sections are separated by each of the different categories that the City Council directed to achieve savings in.

## Reducing Compensation for Existing Employees

Public entities throughout the state have experienced significant increases in personnel costs, while revenues have not kept pace with expenditures, resulting in significant cuts in services to their communities. In May 2010, the Santa Clara County Civil Grand Jury issued a report entitled, "Cities Must Rein in Unsustainable Employee Costs." The report states, "The overall costs to cities are not sustainable. Cities need to negotiate, approve and implement considerable cost containment measures so that employee financial obligations do not continue to escalate."

The Grand Jury report and the City's response can be viewed at:

<http://www.sanjoseca.gov/employeerelations/totalcomp/CityResponsetoSantaClaraCountyCivilGrandJuryReport09.21.10.pdf>

As a service driven organization, the majority of the City's costs are for the employees who provide those services. Over the last several years, the City has experienced a significant increase in those costs. It is projected that increases in personnel costs will continue. From Fiscal Year 2000-2001 to Fiscal Year 2011-2012<sup>7</sup>, the average cost per employee is projected to increase by 100.6% from \$73,581 in Fiscal Year 2000-2001 to \$147,628 in Fiscal Year 2011-2012. The City's workforce has been reduced from 7,013 in 2000-2001 to 5,252 in 2011-2012, as referenced in the 2011-2012 Proposed Operating Budget.

On November 18, 2010, as part of the 2011-2012 Organizational and Budget Planning Special City Council Meeting during which staff projected a \$70 million General Fund shortfall<sup>8</sup> given information available at the time, the City Council approved staff recommendations for direction in labor negotiations. This direction included continuing the prior direction of March 2010, of achieving a 10% reduction in total compensation for Fiscal Year 2010-2011, with modifications that the entire 10% be an ongoing reduction in total compensation, roll back any general wage increases received in Fiscal Year 2010-2011, include the City Auditor's recommendations for healthcare cost containment, and achieve reform in the areas of sick leave payout, compensation structure (eliminate automatic step increases, modify step structure and modify overtime eligibility), and retirement. Guiding principles were also approved for the upcoming labor negotiations. The memo regarding this direction and guiding principles is available at [www.sanjoseca.gov/clerk/Agenda/20101118/20101118\\_0303a1sup.pdf](http://www.sanjoseca.gov/clerk/Agenda/20101118/20101118_0303a1sup.pdf). In addition, Council has also directed achieving reforms in the areas of disability leave supplement and vacation sellback.

If a 10% total compensation reduction is achieved with all employee units, this will result in approximately \$58.5 million in savings to the General Fund (including fee programs), offset by annual required retirement contributions of \$18.9 million, resulting in total net savings of \$39.6 million in General Fund. As of the date of this memorandum, the City has achieved the 10% total compensation reduction with four bargaining units: San Jose Fire Fighters, IAFF Local 230, Association of Engineers and Architects, IFPTE Local 21 (AEA, Units 41/42 and 43), City Association of Management Personnel, IFPTE Local 21 (CAMP) and the Association of

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<sup>7</sup> Source: City of San Jose Salary and Fringe Benefit Costs by Bargaining Unit & Fund for 2000-2001 through 2011-2012 Base Budget as of February 2011.

<sup>8</sup> The General Fund shortfall for Fiscal Year 2011-2012 is now \$115 million.

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Maintenance and Supervisory Personnel (AMSP), and three unrepresented employee units (Unit 99, Unit 81 and Unit 82), yielding an approximate savings of \$11.0 million towards the \$39.6 million. In addition, the City just reached a Tentative Agreement with the Association of Building, Mechanical and Electrical Inspectors (ABMEI) achieving a 10% total compensation reduction, and this agreement is pending ratification of the members and approval by the City Council. Achieving the 10% total compensation reduction is assumed in the Fiscal Year 2011-2012 Proposed Operating Budget and we should continue to work to achieve the City Council direction with the remaining bargaining units.

***REDUCING COMPENSATION TOTAL SAVINGS: \$39.6 million***



## Reforming Workers' Compensation and Disability Retirement Systems

Part of the City Council's direction was to consider reforming the workers' compensation and disability retirement systems. The City Auditor performed an audit of the workers' compensation program in 2009 and just recently, an audit of disability retirements. The workers' compensation audit recommendations were approved by the City Council and the disability retirement audit recommendations are before the City Council for approval on May 3, 2011. The recommendations include, but are not limited to:

- Implementing a workers' compensation offset for the Police and Fire Department Retirement Plan
- Reducing or eliminating the disability leave supplement
- Continue implementation of wellness programs
- Consider amending the City Charter and Municipal Code to clarify that the purpose of the disability retirement benefit is to provide a stable source of income for employees who are incapable of engaging in any gainful employment but are not yet eligible to retire and to limit disability retirement benefits to those employees who are incapable of engaging in any gainful employment
- Recommend that the City take aggressive steps to collect the outstanding balances it is owed from those retirees who still have not fully repaid the City the amounts they were overpaid for their unused sick leave

Many of the recommendations are items that we either currently have as a subject in our ongoing negotiations or will be pursuing in upcoming negotiations. The agreements recently reached with AEA, CAMP, AMSP and ABMEI include the phasing out of disability leave supplement, with full elimination by Fiscal Year 2012-2013. We will continue our efforts to achieve the current City Council direction. As disability leave supplement is required by law for sworn Police and Fire, it is only able to be eliminated for the non-sworn bargaining units.

In Fiscal Year 2009-2010, the total cost of the City's Workers' Compensation program (including administration, claims, disability leave costs, contractual services, and claims investigation) was approximately \$30.9 million. The costs are expected to increase in Fiscal Year 2010-2011, to approximately \$32.7 million. Included in these costs are disability leave supplement costs of \$7.5 million, which are not separately budgeted expenditures. Disability leave payments are expended from department's personal services budget from the vacancy savings of the incumbents' position.

Further implementation of these items will go a long way in reducing our costs. In addition, a very important goal of reforming the workers' compensation system is to get our employees back to work sooner after an injury. Not only will this save in dollars, but will also increase the productivity of our workforce, which is important with the reduction in services the City has experienced. In addition, any changes in the disability retirement program may have an effect on the City's retirement costs, but it is difficult to estimate what those savings might be at this time.

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It is recommended that we continue with the current City Council direction regarding disability leave supplement and further implementation of the City Council approved recommendations from the City Auditor's audits. Because these savings are either difficult to estimate or are funds that are not currently budgeted, we have not counted the savings towards the savings needed for this plan, other than the workers' compensation offset. However, controlling these costs and getting employees back to work sooner will not only have a positive fiscal and productivity impact, but a positive impact on the well-being of our employees who are injured on the job.

Given that the City's total costs associated with Workers' Compensation will be approximately \$32.7 million for Fiscal Year 2011-2012, there is a great chance of significant savings as we work through the reforms mentioned herein, but at a minimum, the City Auditor's Office estimated a \$2.8 million savings for the workers' compensation offset, which has been attributed towards the savings needed for this plan.

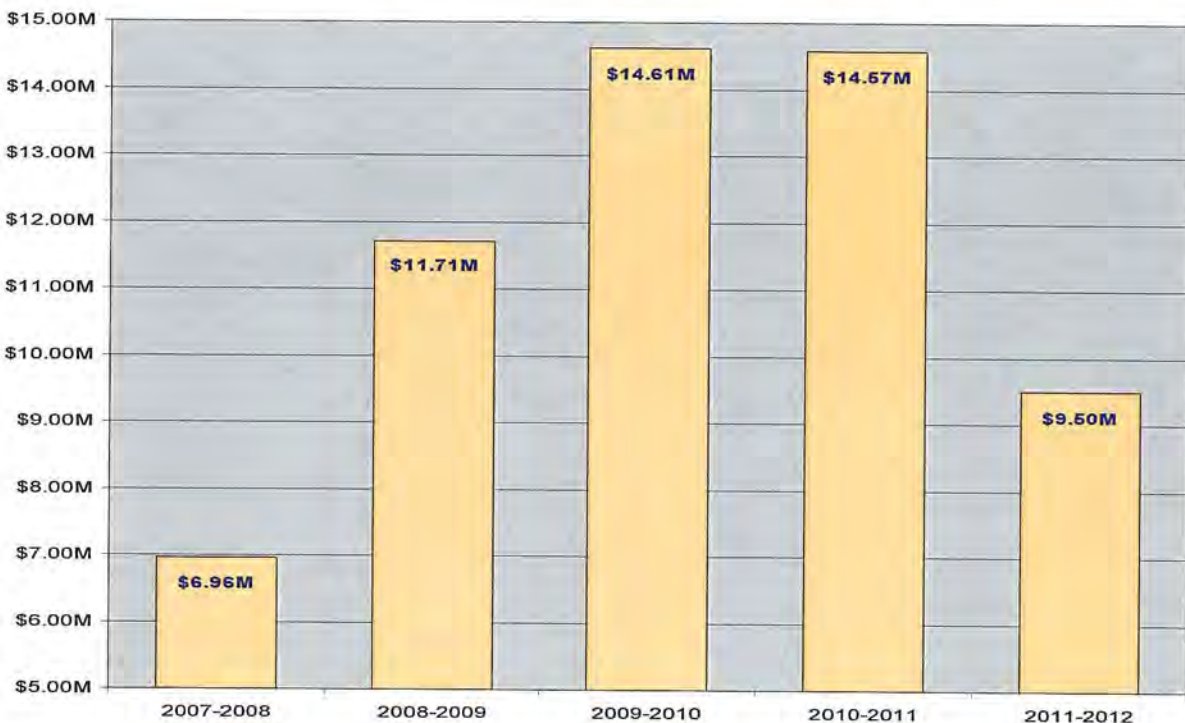
***REFORMING WORKERS' COMPENSATION AND DISABILITY  
RETIREMENT SYSTEMS: \$2.8 million (minimum savings)***

Reducing Costs for Sick Leave Payouts, Vacation Buybacks and Overtime Pay

***Sick Leave Payouts***

There has been a tremendous amount of focus on the City’s sick leave payouts upon retirement. The costs of this benefit have been increasing considerably, thereby increasing the General Fund expenditures for sick leave payouts. For Fiscal Year 2010-2011, the General Fund allocation for sick leave payouts is budgeted at \$14.6 million. The 2011-2012 Proposed Operating Budget includes \$9.5 million in the General Fund for sick leave payouts based on the potential retirements and estimated payouts for that fiscal year.

**Sick Leave Payouts  
Fiscal Year Actuals 2007-2008 to 2009-2010  
and Budgeted for 2010-2011 to 2011-2012**



The City Council has already provided direction regarding sick leave payouts and based on this direction, the City has made proposals to eliminate sick leave payout. The agreements reached with the five bargaining units as of the date of this memorandum include agreements to continue negotiations on sick leave payouts.

It is imperative that all areas for cost reductions be considered, and eliminating sick leave payout would yield a significant savings to the General Fund of \$9.5 million in Fiscal Year 2011-2012. Since we have not reached an agreement with any bargaining unit to eliminate sick leave

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payouts, this savings could be achieved by Fiscal Year 2012-2013. We will continue to work towards achieving the City Council direction with all employee units.

***SICK LEAVE PAYOUT TOTAL SAVINGS: \$9.5 million***

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### ***Vacation Buybacks (Sellback)***

The following employee units are eligible for vacation sellback, which provides for allowing an employee to sellback up to a certain amount of their vacation per year (from 80 to 120 hours depending on the employee unit):

- Association of Legal Professionals (ALP)
- Association of Maintenance Supervisory Personnel (AMSP)
- City Association of Management Personnel (CAMP), IFPTE Local 21
- Association of Engineers and Architects (AEA, Units 41/42 and 43), IFPTE Local 21
- Executive Management and Professional Employees (Unit 99)

The Council has already provided direction regarding vacation sellback and we have agreements with AMSP, CAMP and AEA (Units 41/42 and 43) to phase out the elimination of vacation sellback over two years to be completely eliminated by January 2013. The same phase out to elimination was approved for Unit 99. Although vacation sellback is not budgeted, the elimination of vacation sellback will provide Departments with additional funds in their budgets to avoid further cuts. It is expected that for Fiscal Year 2010-2011, the vacation sellback costs will be approximately \$4.8 million. We will continue to work to achieve the City Council direction for the one remaining bargaining unit with vacation sellback, the Association of Legal Professionals (ALP). It should be noted that vacation balances on the books at the time of an employee's separation from the City will still be cashed out as required by law.

### ***Overtime Pay***

In Fiscal Year 2009-2010, the City paid approximately \$24 million in overtime and of that, over \$20 million was paid to Police and Fire employees. As part of current City Council direction, the City is pursuing a change to overtime of not allowing paid leave to be counted towards the calculation of overtime. Currently the agreements with the City's bargaining units who are eligible for overtime, except AMSP, allow for any paid leave hours in a workweek to count towards an employee's 40 hour workweek. This is above and beyond what is required under the Fair Labor Standards Act (FLSA), which are the federal laws regulating overtime. It is important that employees only receive overtime when they *work* additional hours over the normal forty hour workweek. In addition, there are various positions that are currently receiving overtime that can be considered exempt under the FLSA and not eligible for overtime. We should continue pursuing changes to overtime to reduce these costs through the meet and confer process. This will continue to remain a priority for the City.

It is difficult to estimate the savings in overtime costs by not counting paid leave towards the calculation of overtime. However, if the City were to continue pursuing elimination of overtime for the following classifications that can be considered exempt (salaried and ineligible for overtime), the City Auditor's Office has estimated that this would result in an approximate savings of \$1.2 million.

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<b>Job Position</b>	<b>Overtime Earned in Fiscal Year 2009-2010</b>
Fire Department Battalion Chiefs	\$713,000
Maintenance Supervisory Positions	\$244,000
Police Captains	\$203,000
<b>TOTAL</b>	<b>\$1,160,000</b>

It is important to note that we would also conduct a thorough review of any other classifications that could be considered exempt and not eligible for overtime and therefore, these are not the only classifications the City may pursue making salaried.

It is my recommendation that we continue with the City Council direction of overtime reform in order to achieve additional savings. Because the agreements we have achieved thus far extend through June 30, 2013, any changes we make to overtime for employees represented by those bargaining units will not be able to be achieved until Fiscal Year 2013-2014.

***OVERTIME TOTAL SAVINGS: \$1.2 million (minimum savings)***

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### Modifying Healthcare Plans and Cost Sharing

In June 2009, the City Auditor released a report entitled, "Audit of The Employee Medical Benefits," which contained recommendations that were approved by the City Council. These recommendations included various cost containment strategies for healthcare, including increasing medical plan co-pays, increased employee cost sharing, elimination of dual coverage and a reduction in health and dental in lieu programs. The City has made significant progress toward achieving these areas of cost containment with almost all of the City's bargaining units, and it is currently a subject in the negotiations with the others. These savings are already included in the 10% total compensation reduction, equating to an approximate \$39.6 million in savings if achieved with all employee units. We should continue with the current City Council direction in pursuing these changes with the remaining bargaining units.

However, there are modifications to healthcare plans that can be made in order to substantially reduce the City and employees retiree healthcare costs. This is discussed further in the retirement savings section of this memorandum.

## Organizational Changes and Efficiencies

Analyzing potential organizational changes and efficiencies is very important. This should be done on a continual basis through the City's Alternate Service Delivery Policy. We have and will continue to be exploring alternate service delivery models and should do this even if we are able to achieve the needed savings to restore services. In Fiscal Year 2010-2011, the City outsourced various services, including custodial services. This resulted in a savings of \$4.2 million. In the Fiscal Year 2011-2012, Proposed Operating Budget, the City is proposing the outsourcing of other services, such as Airport Police and Fire services, graffiti abatement and park maintenance. These should continue to be explored and discussed with the affected bargaining units through the meet and confer process. We will continue to use this Alternate Service Delivery policy and process to identify other areas of potential alternate service delivery models.

If for some reason we are unable to achieve substantial reforms in retirement because of legal or other issues, outsourcing is an option that will need to be explored more closely. To the extent we are able to find areas where services could be provided by non-City employees that is cost effective and provides quality services, this avoids the current City retirement cost obligations for that employee. Although we hope this is not the case, outsourcing may become one of the City's primary cost saving options.

In addition, options for organizational changes and efficiencies in consolidation of different areas will continue to be explored. As an example, the consolidation of Public Works and General Services saves approximately \$1.0 million. This is something that we should be considering when the situation arises. In order to further explore this, it is recommended that the City Council consider a City Charter change to allow such changes in the organizational structure related to Charter Departments. For example, to allow for a consolidation of a Charter Department or outsourcing of a Charter specified Department, it is recommended that the City Charter be changed to recognize Charter functions, rather than departments. This will give flexibility in service delivery options.

We also need to rethink compensation and benefit systems. The City's compensation increases for non-management bargaining units come through automatic 5% step increases and negotiated general wage increases, neither of which give any consideration to performance. It is reasonable to expect that any wage increases given in the future be solely based on performance as it is in the private sector. When the City does have money in the future to provide pay increases, it is recommended that it be done solely based on performance.

During each year's budget process, alternate service delivery models will be evaluated and those will be brought forth in the proposed budget for that Fiscal Year. This plan includes those alternate service delivery models and consolidations contained in the Fiscal Year 2011-2012 Proposed Operating Budget. In addition, because we are recommending that increases continue but on a merit based system, the funds currently budgeted for automatic step increases will be instead used for performance based increases and therefore, there are no recognized savings for



this in this plan. However, there would be discretion not to provide performance based pay depending on the City's fiscal situation.

The following alternate service delivery models and consolidations in the Fiscal Year 2011-2012 Proposed Operating Budget are recommended to be approved. The savings for those are as follows:

<b>Alternate Service Delivery Model</b>	<b>Fiscal Year 2011-2012 Savings</b>
Outsourcing Park Maintenance	\$2.5 M
Outsourcing Graffiti Abatement	\$0.4 M
Outsourcing Police and Fire Services at the Airport	\$0.0 M
Human Resources and Office of Employee Relations Management Consolidation	\$0.5 M
Public Works Department and General Services Department Consolidation	\$1.0 M
<b>TOTAL</b>	<b>\$4.4 M</b>

For purposes of this plan, the \$4.4 million in anticipated savings in Fiscal Year 2011-2012, is reflected but this should be viewed as minimum savings because alternate service delivery models and organizational changes will continue to be reviewed. Although there are no savings to the General Fund from outsourcing Police and Fire Services at the Airport, there is a very significant and much needed savings to the Airport Department of approximately \$15.5 million for a full year of outsourcing.

***ORGANIZATIONAL CHANGES AND EFFICIENCIES TOTAL SAVINGS: \$4.4 million (minimum savings)***

### Avoiding Increases in Retirement Costs Beyond the Amounts Required in Fiscal Year 2010-2011

As noted in the background section of this memorandum, because it is difficult to estimate retirement savings for the General Fund only, for the purposes of estimating savings, we have developed a target for an all funds savings of \$215 million as explained in the chart on page 8.

Per the City Council approved guiding principles below, the City will continue to make the Annual Required Contribution (ARC) towards retirement as determined by the Retirement Boards. We then need to lower the cost of the benefits so as not to reach \$400 million in retirement costs in five years, as projected. **However, it is very important to note that although our goal is to lower costs, retirement contributions could rise for other reasons, such as the Retirement Boards continuing to review and make actuarial assumptions more realistic.**

The City Council approved the following fiscal reform guiding principles to be used in the development of this plan, all of which involved retirement:

- a. *The primary goal of these reforms is to save services, jobs, and ensure the solvency of the retirement fund.*
- b. *Service levels for Police, Fire, libraries, and community centers should be restored to services levels as of January 1, 2011.*
- c. *The City's annual cost for retirement benefits should be maintained at no more than the 2010-2011 cost.*
- d. *The City must continue to make the full retirement contribution each year as determined by the retirement boards.*
- e. *Retirement reforms for current employees should alter the future, unaccrued retirement benefits.*
- f. *Pension costs shall not be pushed onto future generations, and we will not borrow our way out of this problem.*
- g. *Any proposed hybrid or optional retirement programs must lower costs and preserve services.*
- h. *Weaknesses of the current defined benefit retirement plan must be addressed.*
- i. *The retirement age should be raised.*
- j. *Guaranteed annual increases in pension benefits should be eliminated.*

- k. The rate of accrual for pension benefits should be lowered.*
- l. Spiking of pension benefits should be prohibited, including lengthening the period used to calculate final average salary.*
- m. Bonus payments for retirees should be eliminated, except for long term service retirees who fall below the poverty level.*
- n. The maximum percentage of salary that retirement benefits are based on should be reduced.*
- o. Unfunded retirement liabilities need to be addressed, including risk analysis and sharing of risk with employees.*

As mentioned previously, this plan calls for shared sacrifice and this will be difficult for some to accept. However, this is a reasonable and fair option so the burden doesn't fall disproportionately on any one group. To the extent we only affect one group, such as current employees and not retirees, it results in a more drastic option for that group. If we are all able to share in the changes, this results in more reasonable changes for all, including the residents we serve.

In addition to changes for new employees (second tier), the following are the four categories of retirement populations for which we are recommending changes:

1. Police and Fire Current Employees
2. Federated Current Employees
3. Police and Fire Retirees
4. Federated Retirees

It should be noted that any changes to benefits for current employees and retirees raise significant legal questions. However, changes to benefits must be made given the severity of the challenges of funding the retirement benefits and the resulting cuts in the services to the community in order to fund those benefits. It is in all of our best interest to make reasonable and necessary changes. If for some reason we cannot make changes to existing employees and retirees, the City has to then develop other options so that we do not have to continue to reduce services. This may be as drastic as outsourcing almost all services so that we are able to reduce the increasing retirement costs of the current level of benefits or changing the cost sharing of retirement benefits so that employees pay a significantly higher portion of the costs. In addition, in looking at options for changes to the first tier, to the extent we are unable to make changes to the first tier and the only option is for employees to opt into the second tier, we may be faced with having employees who choose to stay in the first tier pay significantly more than they currently pay.

There are a multitude of options for changes to retirement benefits. While this memorandum explores a few examples of changes that can be made to maintain the Fiscal Year 2010-2011, City retirement costs for the next five years, there are many more variations to the options

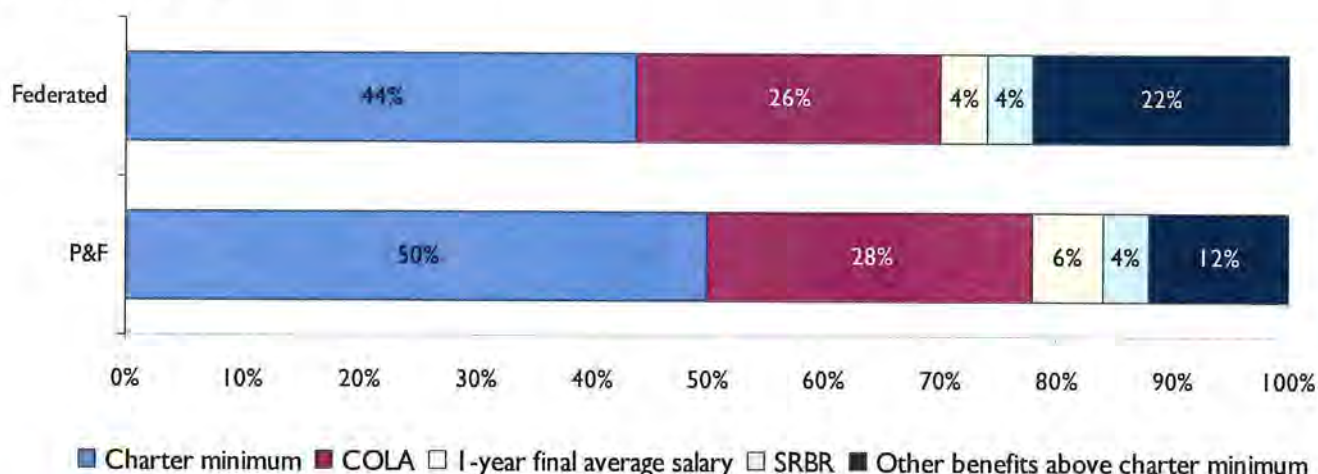
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provided that can be pursued. Through the meet and confer process with the bargaining units, we will explore these different options to achieve a solution. Per the City Council direction in the Mayor's March Budget Message, we are recommending changes to the future, unaccrued retirement benefits. For example, this can include changing the amount earned for every year of service in the future, not for years of service already earned.

When reviewing potential changes to the current retirement benefits, it is important to consider the cost components of the retirement system. The following chart is from the City Auditor's Pension Sustainability Audit and shows a breakdown of the cost components of the retirement contribution rates.



What is most significant about the chart above, is the cost attributed to the 3% fixed Cost Of Living Adjustment (COLA). This benefit is something that each retiree receives annually regardless of the Consumer Price Index (CPI). It serves not as a COLA, but as an automatic increase in the pension regardless of CPI and regardless of the fiscal health of the retirement funds. The COLA makes up approximately 26% of the costs in the Federated City Employees' Retirement System and 28% of the costs in the Police and Fire Department Retirement plan. In addition, approximately 40% of the pension unfunded liabilities are because of the COLA.

Because the COLA is such a big part of the City's retirement costs, it is not surprising that changes to it can have a big impact on our retirement costs.

If the COLA were to be completely eliminated from the Police and Fire Department Retirement Plan, this would significantly reduce the costs of the plan. For example, if all assumptions and benefits including the COLA stay the same, it is projected that in 2024 when the costs peak, our costs would be over \$300 million for the Police and Fire Department Retirement Plan. If we were to eliminate the COLA, in 2024, the costs are projected to be just over \$140 million. This is a very significant difference.

If the COLA were to be completely eliminated from the Federated City Employees' Retirement System, this would also significantly reduce the costs of that system. For example, if all assumptions and benefits including the COLA stay the same, it is projected that in 2028, our costs would be over \$200 million for the Federated City Employees' Retirement System. If we

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were to eliminate the COLA, in 2028, the costs are projected to be just over \$100 million. This is also a very significant difference.

Some current City employees and members of the public have raised the question as to how retirees can continue to receive a 3% raise every year, regardless of the City's fiscal situation or the funding level of the retirement system. This is an understandable question, especially last year when many City employees took a 10% total compensation reduction. If an employee retired that year, they would have received a 3% cost of living *increase* even though the unfunded liabilities of the retirement plans are in the billions.

As discussed in the background section of this memorandum, when evaluating the cost or savings of any change in the retirement system, it is very important to use realistic assumptions. We have used the earnings assumption of 6.75% in our estimated cost savings because if we do not use realistic assumptions and those assumptions change, the benefit may turn out to be more expensive than we thought and may result in needing to make more changes. An earnings assumption of 6.75% may still be overly optimistic since it provides only a 50/50 probability of achieving it, but this number was selected based upon the recent actuarial reports. It is also important to note that we have assumed that all variables will stay the same, which we know it will not. For example, the total number of employees, projected payroll and assumptions may change.

The following are recommendations related to the Supplemental Retiree Benefit Reserve (SRBR), retiree healthcare, benefits for new employees (second tier), and scenarios for each of the retirement populations (current employees and retirees) in order to save \$215 million in all funds, as described on page 8. Because of the severity of the problem and the threat to maintain City services, it is necessary for the City Council to consider these reasonable changes, even with the risk of possible legal challenges.

### ***Supplemental Retiree Benefit Reserve (SRBR)***

The Council has already directed the Administration to explore various options for the SRBR when the moratorium was approved to suspend any payments of the SRBR. This moratorium ends on June 30, 2011, which is why it is very important to make a decision about the SRBR quickly. In the City Auditor's audit entitled, "Pension Sustainability Rising Pension Costs Threaten The City's Ability to Maintain Service Levels – Alternatives For A Sustainable Future," one of the City Auditor's recommendations was to consider eliminating the SRBR or at least prohibiting SRBR payments when the retirement plans are underfunded.

As of June 30, 2010, the SRBR balance for the Federated City Employees' Retirement System was \$28.3 million. If these funds were to be put back into the system by June 30, 2011, it is estimated that the Fiscal Year 2012-2013, contributions could be offset by approximately **\$2.1 million**.

As of June 30, 2010, the SRBR balance for the Police and Fire Department Retirement Plan was \$32 million. If these funds were to be put back into the plan by June 30, 2011, it is estimated that the Fiscal Year 2012-2013, contributions could be offset by approximately **\$2.6 million**.

Had there been a distribution after June 30, 2011, the funds that would have been distributed out of the Police and Fire Department Retirement Plan would have been approximately **\$1 million** and out of the Federated City Employees' Retirement System, **\$5.6 million**. This is a significant amount of money to be paying out considering the plans' significant unfunded liabilities.

This is one of the only retirement areas where we believe we could achieve savings that could be recognized for Fiscal Year 2012-2013. Given the significant unfunded liabilities related to retirement benefits for current City employees and retirees, we recommend the elimination of the SRBR and a transfer of the SRBR balances as of June 30, 2011, back into the main pension accounts to fund current retirement benefits.

When the plans become fully funded again, the SRBR can be revisited at that time and then it can be decided if a different distribution method should be instituted. Since the plans may not be fully funded for decades, we recommend the decisions over what to do with any truly excess funds should be made by the City Council at that time. For example, when the plans are over 100% funded, it may be decided that additional amounts should be put into a reserve in order to plan for times when plans are not fully funded. Alternatively, if a program is designed to pay additional cash to retirees, it should be funded. Options for funding can be additional contributions to the retirement fund or directly out of the City's General Fund.

Even if a "bonus" program is properly funded, designing such a program around poverty level poses significant issues. For example, a retiree may be receiving what appears to be a low pension that falls under a poverty level, but it could be only one source of income for that retiree. In addition, a low retirement benefit could also be the result of the benefit being split due to divorce. The administration of pension benefits does not normally place the pension administrators in a role of determining net worth or total household income. If this type of

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program is pursued in the future, it is recommended that further research be conducted to find if other public agencies have such a program, and if so, how they are funded, designed and administered.

Because the moratorium on the SRBR payment ends June 30, 2011, we recommend extending the moratorium to January 1, 2012, to allow for sufficient time to complete the outreach and meet and confer process, to the extent required. As noted above, implementing this recommendation to eliminate the SRBR and put the SRBR balances as of June 30, 2011, back into the main pension accounts will save approximately \$4.7 million each year starting in Fiscal Year 2012-2013.

***SRBR ELIMINATION TOTAL SAVINGS: \$4.7 million***

***Retiree Healthcare***

As noted below, the retiree healthcare benefit is severely underfunded. As of June 30, 2010, the retiree healthcare unfunded liability was approximately **\$1.5 billion** and has a funding ratio of only approximately **10%**. The City and all employees are contributing so that the benefit can start to be funded at the amounts necessary to pay for the benefit. However, funding the current retiree healthcare benefit highlights how expensive of a benefit it is for both the City and the employees.

<b>Retiree Healthcare (OPEB) Unfunded Liability As of June 30, 2010</b>			
	<b>Federated</b>	<b>Police and Fire<sup>9</sup></b>	<b>Total</b>
Market Value	\$0.82 billion	\$0.72 billion	\$1.54 billion
Funding Ratio	12%	7%	9%
Actuarial Value	\$0.82 billion	\$0.71 billion	\$1.53 billion
Funding Ratio	12%	6%	10%

The level and eligibility for retiree healthcare benefits are contained in the San Jose Municipal Code as part of the retirement plans. Generally, employees are eligible for retiree medical insurance coverage at fifteen (15) years of service. Because employees are eligible to retire at such an early pre-Medicare age (55 for Federated and 50 for Police and Fire), this contributes to the significant cost of the benefit.

For eligible retirees, the benefit provides for 100% of the premium cost for the lowest priced plan available to active employees for either single or family coverage. This is a better benefit than is provided to active employees who pay a portion of the premium. This is very unusual in that retiree healthcare benefits are commonly less than what is provided to active employees and are often a fixed dollar amount rather than being tied to the full cost of the premium for single or family coverage.

Because the retiree healthcare benefit is tied to the lowest cost plan for active employees, changes can be made to the lowest cost plan that can reduce the retiree healthcare costs. For example, when the City went from a \$0 co-pay plan to a \$10 co-pay plan for current employees, this resulted in the implementation of a \$10 co-pay plan for retirees in the lowest priced plan, reducing the retiree healthcare costs. There is now a \$25 co-pay plan as the lowest cost plan available for City employees, which will result in additional savings for retiree healthcare benefits.

Because of the structure of the City’s retiree healthcare benefits, there is a direct correlation between the cost of the lowest priced healthcare premiums and the liability of the benefit. For example, if we were to have a low priced plan that reduced the lowest cost plan premium by 25%, this would reduce the retiree healthcare unfunded liability by 25%. This is an option that

<sup>9</sup> The June 30, 2010, OPEB (retiree healthcare) valuation has not been completed. It is anticipated that the funding (contribution) report will be available in May 2011. The retiree healthcare liability for Police and Fire demonstrated in this chart is the unfunded liability as of the June 30, 2009 valuation.



would yield immediate savings. An example of a Kaiser deductible plan that reduces the lowest priced plan by 25% includes the following items:

<b>Example of Lowest Priced Plan That Reduces Premium By 25%</b>
\$10 generic prescription co-pay for up to a 100 day supply (no deductible) \$30 brand name prescription co-pay for up to a 100 day supply (after \$250 deductible is met)
No charge/deductible not applicable preventative care such as routine physical maintenance exams
No charge after deductible for allergy injections (including allergy serum)
\$30 per visit after deductible for most primary and specialty care consultations and exams and urgent care services
\$10 for most x-rays and laboratory encounters; \$50 for MRI, most CT, and PET scans
30% coinsurance after deductible for hospital services, including emergency room care, outpatient surgery, inpatient care, skilled nursing, medical tests and pharmacy
\$150 per trip after deductible for ambulance services
20% coinsurance for most covered durable equipment
\$1000 individual/\$2,000 family calendar year maximum deductible \$250 per member deductible for certain drugs
\$3000 individual/ \$6,000 family out of pocket maximum after deductibles

Although the City does not currently offer a deductible plan, this is a plan that is fairly common in the private sector. Retirees would also have the option to purchase a higher level plan. In addition, once a retiree becomes Medicare eligible, Medicare would coordinate with the plan the retiree is in and the medical benefit will be richer.

This may also be a preferred option for current City employees, who are responsible for 50% of the retiree healthcare costs. Reducing the medical plan premium costs by 25%, also reduces the current City employees' contributions towards retiree healthcare. Because the plan must be available to active employees, we can explore with the bargaining units a different cost sharing structure for current employees. For example, we could tie the employees cost sharing benefit structure to the second lowest priced plan. However, some City employees may prefer a reduced lowest priced plan to lower their own costs for medical benefits, and this option would be available to them.

For these reasons, we recommend pursuing a new healthcare plan that reduces the lowest cost plan premium by 25%, thereby reducing the retiree healthcare unfunded liability by 25%. Further, we should also continue pursuing the elimination of the reimbursement of Medicare Part B in the Police and Fire Department Retirement Plan, which is already a part of the City Council's current direction.

We also recommend implementing a new tier of retiree healthcare benefits, where new employees are part of the same plan, but at an even lower, fixed cost. For example, it could be set up so that new employees receive a fixed dollar amount for retiree healthcare costs based on how many years of service they have when they retire. To the extent the retirement age is raised for both current employees and new employees (second tier), this will further serve to reduce

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retiree healthcare costs because there will be less pre-Medicare years the retiree healthcare is paid.

***REDUCING RETIREE HEALTHCARE BY 25% TOTAL SAVINGS:  
\$17.9 million***

### ***Pension- New Employees (Tier 2)***

It is important to note that even with a 2<sup>nd</sup> Tier retirement benefit, the existing unfunded liability is **not** reduced, and that very significant cost must continue to be paid to the City's retirement plans. However, it is critical to have a second tier in place for any employee hired on or after January 1, 2012. The City Council has already provided direction for a new benefit for new employees. This direction was given on January 25, 2011, and included the following:

- The total normal cost<sup>10</sup> of 2<sup>nd</sup> Tier retirement benefits should be equal to or less than 12.4% of pensionable payroll, with the City and employees sharing the cost equally
- Future unfunded liabilities in a 2<sup>nd</sup> Tier shall be shared equally between the City and employees
- If a defined benefit plan is sought, the following should be considered:
  - Increased minimum retirement age and/or reduced pension for early retirement
  - Reduced benefit formula, reduced maximum benefit, and revised vesting schedule for both pension and retiree healthcare benefits
  - Cost of living adjustment (COLA) that is tied to the Consumer Price Index (CPI) with a maximum that is less than the current 3% fixed annual increase with consideration to the funded status of each plan when providing a COLA
  - Increased time period for calculation of final compensation
  - Revised survivorship benefits

In addition, the City Council directed during the January 25, 2011, City Council meeting that a defined benefit plan should be "better" than social security.

Given that we are now considering changes for current employees and retirees and considering that we need to build a plan that saves \$215 million in all funds in retirement costs, it is recommended that this direction be revisited. There are two main options for a second tier, a defined benefit plan or a hybrid, defined as social security plus a defined contribution plan (401k or 457 in the public sector).

As explained above, this plan assumes that anyone hired on or after an effective date of January 1, 2012, will be in the new tier. Under normal actuarial practices, this would not affect contribution rates until Fiscal Year 2013-2014. However, the City could request that the Retirement Boards have a mid-Fiscal Year actuarial valuation and adjustment to the contribution rates. This decision will be up to the Boards. It is also important to note that we have assumed that all variables will stay the same, which we know will not. For example, the total number of employees, projected payroll and actuarial assumptions, such as earnings assumptions, may change.

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<sup>10</sup> Normal Cost: The cost of funding the retirement benefit for each year of service. The normal cost does not include unfunded liabilities.

A. DEFINED BENEFIT PLAN IN LIEU OF SOCIAL SECURITY

The following are examples of defined benefit plans under two possible earnings assumptions as explained on page 18. As noted previously, the earnings assumption used is very important. If we use an earnings assumption that is not realistic, we will not achieve the savings we thought would be achieved. Therefore, it is recommended that we use a more realistic earnings assumption when designing changes to the retirement benefits and calculating the resulting savings.

All examples do not exceed a 12.4% normal cost, which would be split 50/50 between the City and employees consistent with current City Council direction. In addition, any unfunded liabilities will also be shared 50/50.

One criticism of public sector retirement benefits is that the age at which we are eligible to retire is far earlier than private sector employees, especially in comparison to the age at which someone is eligible to receive Social Security, which is 67 for the full benefit. If it is decided to continue with a defined benefit plan for a second tier, it is recommended that it must include increasing the retirement age.

It is important to note that in order for the City not to be in Social Security, an adequate alternative for Social Security must be provided that meets the minimum requirements under Social Security. Any options will need to be further studied to ensure that they meet those requirements.

The following are **examples** of defined benefit plans reaching a 12.4% normal cost. These are only examples and there are many more options that could be sought and these options can be discussed and evaluated through the meet and confer process.

<b>Federated City Employees' Retirement System</b> <b>Second Tier Example</b> <b>With Normal Cost Not to Exceed 12.4%</b>		
	<b>7.75% Earnings Assumption<sup>11</sup></b> <b>(25% Probability)</b>	<b>6.75% Earnings Assumption</b> <b>(50% Probability)</b>
New Tier Defined Benefit at age 60	2.0% at 60 1% COLA 3 years final average salary	2.0% at 60 1% COLA 3 years final average salary

<sup>11</sup> The Federated City Employees' Retirement System Board approved a 7.95% earnings assumption for the 2010 valuation that would be used to establish the Fiscal Year 2011-2012 rates and a 7.75% earnings assumption for the 2011 valuation that would be used to establish the Fiscal Year 2012-2013 rates.

<b>Police and Fire Department Retirement Plan Second Tier Example With Normal Cost Not to Exceed 12.4%</b>		
	<b>7.75% Earnings Assumption<sup>12</sup> (25% Probability)</b>	<b>6.75% Earnings Assumption (50% Probability)</b>
New Tier Defined Benefit at age 60	1.00% at 60 1% COLA 3 years final average salary	.75% at 60 1% COLA 3 years final average salary

As can be seen in the charts above, for the same 12.4% normal cost, a better benefit can be provided in the Federated City Employees' Retirement System. The reasons for this are listed below:

- For the Police and Fire Department Retirement Plan, retirements are generally four years earlier on average than for the Federated City Employees' Retirement System
- The life expectancy for the Police and Fire Department Retirement Plan is longer than it is for the Federated City Employees' Retirement System
- For the Police and Fire Department Retirement Plan, there is a higher rate of disability retirements and those disability retirements typically occur at an earlier age than in the Federated City Employees' Retirement System
- The pay increases are generally higher for employees in the Police and Fire Department Retirement Plan
- A higher percentage of employees in the Police and Fire Department Retirement Plan retire from service

If a defined benefit plan is considered, the key principles included in the January 25, 2011, Council direction as well as the key principles approved by the City Council in the Mayor's March Budget Message will be considered, including the following:

- Weaknesses of the current defined benefit retirement plan must be addressed.
- The retirement age should be raised.
- Guaranteed annual increases in pension benefits should be eliminated.
- The rate of accrual for pension benefits should be lowered.

<sup>12</sup> The Police and Fire Department Retirement Plan Board approved a 7.75% earnings assumption for the 2010 valuation that would be used to establish the Fiscal Year 2011-2012 rates.

- Spiking of pension benefits should be prohibited, including lengthening the period used to calculate final average salary.
- The maximum percentage of salary that retirement benefits are based on should be reduced.
- Unfunded retirement liabilities need to be addressed, including risk analysis and sharing of risk with employees.

In addition, if the City Council considers another defined benefit plan, we should allow for optimal flexibility for the City to make changes to this plan.

#### B. HYBRID (SOCIAL SECURITY AND DEFINED CONTRIBUTION)

As we continue to study the issue of retirement costs and the risks of continuing with a defined benefit plan for a second tier, it is recommended that we do not repeat the risks of a defined benefit plan for new employees. In addition, sharing the costs 50/50 in a defined benefit plan may not be realistic in the event of another big loss. For example, in the event of another big investment loss, we could be faced with a situation where future employees are required to contribute almost all of their paycheck towards retirement. These are the considerations which drive the recommendation to revisit earlier Council direction on a second tier.

In a hybrid plan (Social Security and defined contribution), the City has much more flexibility in regards to costs and greatly reduced risks. For Social Security, the current cost to the City would be 6.2% and 6.2% for employees. The City then has the flexibility to put money into a defined contribution plan for employees, which we recommend be some match to employee contributions into a defined contribution plan. Given the City's current fiscal situation, there may not initially be an employer contribution into a defined contribution plan, but it can be increased as the City's fiscal situation improves or if made a funding priority. Similarly, the City match into a defined contribution plan can be reduced in years in which the fiscal situation deteriorates. In addition, as the City's finances recover and the unfunded liability is paid off, the City could stay in Social Security, but add in a very modest defined benefit plan that is risk free.

In this option, the age of retirement will be set by Social Security (currently a minimum of 62, with full benefits at 67). The funds in the defined contribution plan can be withdrawn subject to current laws, currently at age 59 ½.

This option is much less risky to the City, taxpayers, and employees than developing another defined benefit plan for new employees and is more flexible in order to address the fluctuations in the City's fiscal situation. Participation in Social Security is also consistent with what is provided to most taxpayers.

However, it is important to note that this would close off the current plan, which means that the populations in the first tier would change and may increase contribution rates in the short term.

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Even given this issue, we think that this is worth the initial extra cost in order to save money in the long term and provide the City with flexibility and less risk to both taxpayers and employees. The projected additional cost of doing this would be approximately \$29 million, not including any costs to changes in investment strategies, which would offset any projected savings of this new tier and therefore, we have not counted any additional savings for a second tier in this plan. There will definitely be savings, but not within the five years this plan covers due to the initial cost of closing off the current plan. If the City were to pursue this, there would need to be additional actuarial work to determine the initial cost and options available to fund that cost.

Again, given the limitations with having another defined benefit plan and the considerations that having a hybrid (Social Security and a defined contribution plan) will provide taxpayers and employees with more flexibility and is less riskier, we are recommending a hybrid plan for a second tier. Because there will initially be a cost, we have not counted any savings for the first five years of having a second tier, but there will definitely be significant savings in the long term and a significant reduction and possibly elimination of risk.

***Pension- Current Employees and Retirees (Tier 1)***

As mentioned previously, it can not be ignored that there will be significant legal risks and challenges with making changes to retirement benefits for current employees and retirees. However, this is a risk we must take on in order to ensure that we continue to provide services to our community. We cannot simply continue to layoff employees to pay for the cost of the current benefits. The recommendations regarding current employees and retirees are reasonable and necessary. Per the City Council direction, this plan is not recommending changing the benefit formula for years of service already worked by current employees and will not reduce the current monthly pension payment to retirees. Changes for current employees and retirees can include the following:

- Elimination/reduction in Cost of Living Adjustment (COLA)
- Change in time period for determining final maximum compensation
- Change in benefit accrual rate for future years of service
- Change in the age at which someone can retire

As explained previously, this plan assumes that the changes will be effective January 1, 2012, however, this will not affect contribution rates until Fiscal Year 2013-2014. However, the City could request that the Retirement Boards make a mid-Fiscal Year change to the contribution rates, and this decision will be up to the Boards. We have also assumed that all things will stay the same for purposes of projections, even though we know that they will not.

There are a multitude of options in regards to a benefit structure and we have provided a few examples of these options below. These examples provide the cost savings necessary to keep retirement costs at the Fiscal Year 2010-2011, level. Although there are options that do not change the age at which someone can retire, these options involve increasing the retirement age, which is a common concern we hear from taxpayers, who are in Social Security and often wait until age 67 to retire. Again, these are simply examples--there are many other options that could be explored through the meet and confer process.

<b>Federated City Employees' Retirement System</b>		
<b>Examples of Changes to Current Benefits</b>		
	<b>7.75% Earnings Assumption (25% Probability)</b>	<b>6.75% Earnings Assumption (50% Probability)</b>
Retirees	Reduce COLA to 1%	Reduce COLA to 1%
Current Employees	2.5% at 60 Retire at 55 with reduced benefit 1% COLA 3 year final average salary	.50% at 60 Retire at 55 with reduced benefit 1% COLA 3 year final average salary



<b>Police and Fire Department Retirement Plan</b>		
<b>Examples of Changes to Current Benefits</b>		
	<b>7.75% Earnings Assumption (25% Probability)</b>	<b>6.75% Earnings Assumption (50% Probability)</b>
Retirees	Reduce COLA to 1%	Reduce COLA to 1%
Current Employees	1.5% at 55 Retire at 50 with reduced benefit 1% COLA 3 year final average salary	0.25% at 55 Retire at 50 with reduced benefit 1% COLA 3 year final average salary

*Note: These are only examples.*

These examples provide for an increase in the retirement ages by 5 years, but with the ability for employees to still retire at 50 for Police and Fire and 55 for Federated, but at a reduced benefit. Another option is to phase-in the increase in the retirement age. For example, the retirement age could be increased by 6 months every year.

As noted previously, the earnings assumption used is critical. If we use an earnings assumption that is not realistic, we will not achieve the savings we thought would be achieved. Therefore, it is recommended that we use a more realistic earnings assumption when determining savings and therefore, have included a 6.75% earnings assumption.

It is important to note that although not considered in the example above, part of the savings or additional savings can be achieved by having employees pay more of the costs. We have also not assumed a change in the ability for an employee to retire at 30 years of service at any age.

In addition to reducing the COLA to 1% based on Bay Area CPI, it is recommended that the COLA be changed so that it is prorated depending on the amount of months a retiree has been retired prior to it going into effect. Currently, a retiree receives the full 3% COLA in the first year of their retirement regardless of how many months they have been retired.

It is also recommend that any changes made to the retirement benefits also include a provision that ensures the City retains the flexibility to change benefits in the future as was recommended with the second tier retirement benefit.

An opt-in program will allow employees in the first tier to voluntarily opt into the second tier with incentives. This incentive would be a lower cost retirement benefit for both the City and employees and therefore, an employee would make lower retirement contributions and receive more take home pay. However if retirement plan costs continue to escalate or our options become limited because of legal issues, we will need to go back and create further incentives for employees to move into Tier 2. Because it is unknown as to how many employees would choose to opt into Tier 2, the savings is unknown and is not included.

There will also need to be a periodic review of the plan in order to determine if further adjustments are needed, including a review any time the ARC changes. This will become necessary to the extent the Boards make any further assumption changes, thereby increasing the City's costs. For example, if the Boards were to decrease the earnings assumption by .25%, this results currently in an additional cost to the City of \$25 million. This might make it necessary to make further changes, such as eliminate the 3% fixed COLA completely.

It is recommended that the City pursue changes to future, unaccrued benefits for current employees and retirees to achieve the savings needed to keep retirement costs at the Fiscal Year 2010-2011 level. Changes may include elimination/reduction in the Cost of Living Adjustment (COLA), change in time period for determining final maximum compensation, change in benefit accrual rate for future years of service, change in the age at which someone can retire and increased employee cost sharing. We should maintain flexibility to change benefits in the future, create an opt-in program for current employees to opt into the second tier and periodically review the plan and retirement costs to determine if additional changes should be made. In addition, if retirement plan costs continue to escalate or our options become limited because of legal issues, we must create further incentives for employees to move into Tier 2.

The estimated first tier savings, using the examples above, are as follows:

<b>ESTIMATED FIRST TIER SAVINGS USING 6.75% EARNINGS ASSUMPTION</b>	
Retirees (Police and Fire)	\$18 M
Retirees (Federated)	\$10 M
Current Employees (Police and Fire)	\$98 M
Current Employees (Federated)	\$68 M
<b>TOTAL</b>	<b>\$194 M</b>

***FIRST TIER RETIREMENT BENEFIT TOTAL SAVINGS: \$194 million (all funds)***

## Revenues

There are a number of revenue strategies that could be pursued to address a portion of the structural imbalance between General Fund revenues and expenditures. Listed below are four potential strategies that could be brought forward over the next five years as part of the Fiscal Reform Plan. Once fully implemented, these strategies are projected to generate \$46.5 million annually. Regardless of which strategy or combination of strategies, \$46.5 million in increased revenues is assumed to be in place by the end of the five year planning period. The majority of these strategies were identified in the General Fund Structural Deficit Elimination Plan that was first released in November 2008 and updated in February 2009. This Plan recommended several strategies in three broad areas to address the General Fund Structural Deficit: cost savings strategies, revenue strategies, and service reduction/elimination strategies.

### Potential General Fund Revenue Strategies

No.	Revenue Opportunity	Potential Revenue	Potential Timeline	Key Stakeholders
1.	Sales Tax Increase (one-quarter cent increase)	\$34 M	2012	San Jose residents and businesses
2.	Municipal Water System (Tax on Gross Receipts)	\$2.5 M	2012	Municipal Water System users
3.	Business Tax Modernization (increase/restructure tax)	\$5.0 M	2014	Business owners
4.	Disposal Facility Tax Increase	\$5.0 M	2014	Garbage haulers and disposal facilities
	<b>TOTAL</b>	<b>\$46.5 M</b>		

Each of these potential revenue strategies requires voter approval. To place a measure on the ballot, two-thirds City Council approval is needed. For general tax measures, 50% +1 voter approval is needed to pass the measure; while for special purpose tax measures (service-specific parcel tax), two-thirds voter approval is required.

Polling is the primary tool to determine the likely level of support for specific ballot measures, allowing jurisdictions to pursue those measures with a higher probability of success. The annual community budget surveys have incorporated questions on potential revenue strategies to provide a preliminary indication of the level of support of the various ballot measures. Additional polling efforts will be necessary for each potential ballot measure that the City Council would like to pursue. Targeted polling is projected to cost \$45,000 to \$50,000. This will help determine whether the election costs of approximately \$500,000 to \$1 million per ballot measure are warranted.

It is anticipated that only 1-2 ballot measures would be brought forward for each election cycle to increase the likelihood of success for these measures. The potential timeline on the chart

above groups the measures based on the amount of revenue generated, City Council interest in the measure, and previous polling results. The potential timelines are presented as scenarios. Staff is aware that in the case of seeking revenue increases from voters, Council considerations are more political than technical. Given voter sentiment about new revenues, it is likely voters would not consider new revenues unless there are significant fiscal reforms. The timelines represent scenarios where revenue measures would follow fiscal reforms. It is important to note that should the City Council wish to pursue a general tax in an off-year (i.e. not a municipal election), this could not occur without a unanimous declaration of a fiscal emergency.

The following is a description of each of the revenue strategies included in the Fiscal Reform Plan. The results from previous polling associated with these measures are also included to provide information on community support for these measures.

### ***Sales Tax***

A Transaction and Use Tax measure (which is very similar to a Sales Tax, and for purposes of discussion, referred to as a “Sales Tax”) would generate the most General Fund revenue of the four potential tax measures in the Fiscal Reform Plan. Per State law, the City could propose a maximum Sales Tax increase of up to 1 cent, in increments of a one-quarter cent. The increase could be structured as a general purpose or special purpose tax and it could be proposed with or without a sunset provision.

Currently, the 1% allocated to San José is expected to generate \$137 million annually. A one-quarter cent Sales Tax increase is anticipated to generate additional General Fund revenue of \$34 million annually. This figure would double to \$68 million if a one-half cent increase was approved by the voters. A potential one-quarter cent Sales Tax measure is included in the Fiscal Reform Plan as a potential ballot measure in 2012 based on the level of revenue that could be generated from this measure, the most recent polling results, and the comparability of the tax with other large jurisdictions.

### **Polling Results**

San Jose residents have been polled on their support for a potential Sales Tax increase for several years. In the latest survey, 60% of likely voters were supportive of a one-quarter cent Sales Tax increase. Of these supporters, 53% responded “definitely” yes (36%) or “probably” yes (17%).

Below are the results of recent surveys.

#### **Support for a Ballot Measure Enacting a ¼ Cent Sales Tax Increase**

	<b>Yes</b>	<b>No</b>	<b>Undecided</b>
<b>January 2011 Community Survey</b>	60%	35%	5%
<b>January 2010 Community Survey</b>	54%	43%	3%
<b>January 2009 Community Survey</b>	62%	36%	2%
<b>January 2008 Community Survey*</b>	28%	71%	1%

\* increase amount not specified

**Comparison with Other Jurisdictions**

The State Sales Tax rate is currently at 8.25%. Listed below are the combined Sales Tax and Transaction Tax rates (together, “Sales Tax”) for large California cities as well as other cities in Santa Clara County. San José’s current Sales Tax rate of 9.25% is lower than Oakland (9.75%) and San Francisco (9.5%), but is consistent with all of the cities in Santa Clara County except Campbell, which approved a one-quarter percent City sales tax increase in April 2009, bringing its Sales Tax rate to 9.50%. With a one-quarter cent increase, the Sales Tax rate would be remain in the range for large cities but would be higher than most cities in Santa Clara County.

	<b>Large California Cities</b>	<b>Sales Tax Rate</b>
1.	Los Angeles	9.75%
2.	Long Beach	9.75%
3.	Oakland	9.75%
4.	San Francisco	9.50%
5.	<b>San José</b>	<b>9.25%</b>
6.	Sacramento	8.75%
7.	San Diego	8.75%

	<b>Santa Clara County Cities</b>	<b>Sales Tax Rate</b>
1.	City of Campbell	9.50%
2.	<b>San José</b>	<b>9.25%</b>
3.	All other cities	9.25%

***Municipal Water Utility System Tax***

In the 2010-2011 Mayor’s March Budget Message, staff was directed to “re-evaluate the feasibility of leasing Municipal Water to private companies that could generate millions of dollars of revenue for the City, as well as current alternatives to generate a rate of return on the system.” In June 2010, the City Council directed staff to conduct further analysis of opportunities to generate General Fund revenue from the Municipal Water System. In response to that direction, staff presented a preliminary Work Plan and options for maximizing financial benefits from the San Jose Municipal Water System at the November 9, 2010, City Council meeting. At that meeting, staff was directed to focus on the option to evaluate the viability of a voter-approved transfer of 10% of gross revenues generated by the Municipal Water System. It should be noted that a transfer is not allowed under Prop 218, therefore it would have to be a tax.

**Polling Results**

To gauge the potential public support for a ballot measure that would allow the transfer of gross Municipal Water System revenues to the City, the following survey question was included in the 2011 Community Budget Survey that was completed in January 2011:

*Another way the City could generate revenue for essential City services would be to allow the Municipal Water system – which provides water to parts of Evergreen and North San Jose – to transfer additional money from the municipal water service to the City. This transfer would not exceed the rate of return authorized by the Public Utilities Commission for San Jose Water Company, which serves the majority of residents in San Jose. Does this sound like something you would support or oppose?*

A majority (52%) of likely voters expressed support for this potential transfer from the Municipal Water System, while 29% opposed the measure, and 19% did not know whether they would support the measure.

Based on the results of this January 2011 Community Budget survey, combined with the further internal due diligence, staff has completed the preliminary analysis on the viability of a potential ballot measure related to a tax of the Municipal Water System. A next step would be to prioritize such a measure among other prospective measures to be brought to the voters for approval in 2012. If this is determined to be one of the highest priority measures, staff will return to the City Council in late 2011 or early 2012 for voter polling and specific proposed ballot language. Staff will also continue to evaluate opportunities to broaden the ratepayer base from which such a tax is collected.

### ***Business Tax***

The City's Business Tax was adopted in 1984 and has not been increased since that time. In the intervening decades, the buying power associated with that revenue has eroded significantly. This Tax, which is charged to business owners, currently generates approximately \$12 million annually. There are a number of options to modify the Business Tax, including:

- Increasing the tax to account for CPI changes;
- Adding a CPI adjustment factor going forward; and
- Modernizing the tax to reflect the current business environment.

It is anticipated that these adjustments could double the current Business Tax revenues. If a CPI adjustment had been factored into this tax since its inception in 1984, Business Tax collections would be more than twice the current level. Minor changes could be implemented to adjust exemptions and ensure various types of businesses are addressed. The changes to the Business Tax would have to be considered in context of the overall cost of doing business in San Jose and the competitiveness of San Jose when compared to surrounding jurisdictions. For purposes of this analysis, it is assumed that a combination of CPI adjustments as well as modernization efforts would conservatively generate at least an additional \$5 million annually.

The modernization of the Business Tax was included in the General Fund Structural Deficit Elimination Plan (GFSDEP). As part of the development of that Plan, a GFSDEP Stakeholder Group provided feedback on potential strategies. As discussed in the GFSDEP, the Stakeholder Group expressed an interest in a potential restructuring of the tax for a future ballot measure after extensive outreach to businesses. The Group also expressed an interest in the City thoroughly examining its policies and procedures which could be burdensome to business and making improvements before going to voters for approval of a Business Tax increase.

Given the extensive coordination with the business community that will likely be necessary before proposing changes to the Business Tax, the Fiscal Reform Plan includes revenue from a potential Business Tax ballot measure in 2014.

**Polling Results**

As shown in the chart below, support for a potential Business Tax increase was higher in the latest survey than in recent years. However, of the 57% in support of the measure, only 29% would “definitely” vote for the measure, while 18% responded “probably” yes and 10% were “leaning” yes. As described in the 2011 Budget Priorities Survey Report of Findings prepared by Fairbank, Maslin, Metz & Associates, “the relatively low number of committed voters (“definitely yes”) and the sizable fluctuations over the past three years suggest that while voters are currently inclined to support such a measure, that they are far from solid in their support and are likely affected significantly by external factors, such as their perceptions of City needs and the local business climate and economy.”

**Support for a Ballot Measure Changing the Business Tax**

	Support for Adjusting Business Tax		
	Yes	No	Undecided
January 2011 Community Survey	57%	37%	6%
January 2010 Community Survey	43%	49%	8%
January 2009 Community Survey	45%	38%	17%
January 2008 Community Survey	60%	35%	5%

***Disposal Facility Tax***

By Ordinance, the City established the Disposal Facility Tax in 1987 and revised the tax in 1992 to its current rate of \$13 per ton of solid waste for disposal sites. This tax currently generates approximately \$11 million annually.

There are a number of options to increase and broaden this tax. An increase of up to \$5 million annually is expected to be generated from the following options:

- Increase the Disposal Facility Tax from \$13 to \$17.50/ton. This tax, which has not been revised since 1992, generates approximately \$11 million annually (previously as high as \$20 million per year, revenue from this tax has been dropping as County-wide waste diversion increases, as landfills report increased use of waste for cover material or on-site construction and exempt it from the tax, as the economy experienced a significant downturn, and as more waste is hauled to landfills in other counties). Raising the tax to \$17.50/ton is projected to generate approximately \$2 million annually, which allows for a drop in disposal or increase in out-of-county waste exports. This increase is only projected to last a few years, unless measures to mitigate out of county waste exports were implemented.
- Expand the Tax to cover residue from Materials Recovery Facilities (MRFs), waste delivered to transfer facilities, and any waste handled by local haulers if it is delivered to a disposal facility that is not subject to the Tax. This would generate up to \$1.5 million and eliminate the risk of increased exports.

- Broaden the definition of "disposed", making some exempt activities taxable, perhaps at a lower rate, and limiting or removing exemptions for Alternate Daily Cover and other waste materials that are used at landfills and not recycled off-site. This is projected to generate approximately \$1.5 million annually.
- Allow Council by resolution to exempt, in whole or in part, specific waste materials, waste generators, or facilities in order to maximize revenue or to support the City's Green Vision goals, especially the clean conversion of waste to energy.

### **Polling Results**

In the most recent community survey conducted in January 2011, 55% of respondents were supportive of an increase to the Disposal Facility Tax, up from 44% in January 2010. Of these supporters, 48% responded "definitely" yes (30%) or "probably" yes (18%).

#### **Support for a Ballot Measure Increasing the Disposal Tax Increase\***

	Support for Adjusting Disposal Facility Tax		
	Yes	No	Undecided
<b>January 2011 Community Survey</b>	55%	38%	7%
<b>January 2010 Community Survey</b>	44%	51%	5%

\* In 2010, respondents were surveyed about an increase from \$13 to \$17.50/ton; while in 2011, respondents were surveyed about an increase to \$17/ton.

### ***Other Tax Measures***

While not incorporated into the Fiscal Reform Plan, other potential revenue measures could be brought forward in future years. The General Fund Structural Deficit Elimination Plan had included a new 10% Parking Tax as well as service-specific assessments (landscape and lighting districts to cover the costs related to the City's transportation infrastructure assets and operations). These options may be pursued to address particular needs, such as ensuring the City's Parking Fund has enough resources to meet all of the parking-related obligations or ensuring the City's infrastructure is adequately maintained.

In addition to considering new potential revenue sources, it is anticipated that the City will pursue extending the Library Parcel Tax, which is scheduled to sunset in 2014. This Tax, which generates approximately \$7 million annually, is used to supplement the funding for the Library system and addresses critical needs, such as investments to automate services (which has enabled the system to operate with much fewer staff), the purchase of library materials, and staffing.

### **Timeline and Funding for Potential Tax Measures**

To bring forward a tax measure, it will be necessary to conduct targeting polling, perform stakeholder outreach, and place the measure on the ballot. Generally, a minimum of one to three months should be allocated to polling and stakeholder outreach. In some instances, such as the



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Business Tax modernization, additional time will be necessary for stakeholder outreach. Several months are also necessary to place an item on a ballot. Typically, June ballot measures need to be approved by the City Council and placed on the ballot by March and November ballot measures need to be brought forward by August.

For planning purposes, approximately six months is needed to place an item on a ballot. The Fiscal Year 2011-2012 Proposed Budget includes \$1.4 million for election costs. This funding is expected to cover the cost of the five Council District elections as well as one city-wide ballot measure. Additional funding of up to \$300,000 would be necessary for a second ballot measure if it was brought forward in Fiscal Year 2011-2012.

***TOTAL REVENUES: \$46.5 million***

## **RESTORATION OF SERVICES**

The Fiscal Reform Plan has been formulated with the goal of restoring services to the levels of January 1, 2011, for Police, Fire, Libraries, and Community Centers within five years. However, it is critical to note that the ability to restore these services is predicated on achieving the savings estimated in this plan and that retirement costs do not escalate for other reasons, including assumption and experience changes. These costs are estimated at \$55.4 million as summarized in the chart below.

### **Estimated Service Restoration Costs\***

<b>Service Restoration</b>	<b>Restoration Cost (\$ in Millions)</b>
Police	\$ 29.7 M
Fire	\$ 15.8 M
Libraries	\$ 5.5 M
Community Centers	\$4.4 M
<b>Total</b>	<b>\$ 55.4 M</b>

\* Assumes 2011-2012 net costs with concessions.

The Restoration Plan addresses many of the direct services that are the highest priority to San Jose residents and visitors, including front-line public safety services, such as Police patrol and investigations as well as Fire companies that respond to emergency calls for service. The libraries and community centers address the quality-of-life needs in San Jose and help ensure that San Jose remains a place where residents want to live. The Fiscal Year 2011-2012 Proposed Budget includes significant reductions in each of these areas that are targeted for restoration in this plan.

The Plan also calls for the opening of the libraries, community centers, fire stations, and the Police substation within five-years. The cost of opening these facilities has been incorporated in the General Fund Five-Year Forecast. However, in Fiscal Year 2011-2012, the openings of libraries, a community center, and the Police substation are proposed to be delayed to generate one-time savings in Fiscal Year 2011-2012.

A complete listing of all of the services and programs in the Restoration Plan is included as Attachment 2 to this document.

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## **SUMMARY**

If all the recommendations above were to be achieved and the savings were able to be accounted for in the Fiscal Year projected, as discussed in this section, we have developed a plan to save \$216 million in the General Fund at the end of Fiscal Year 2015-2016. As mentioned previously, this would be if everything (costs, retirement assumptions, etc.) stay the same, which we know that they will not. Because it is likely that costs will go up, this plan may be cost avoidance, rather than resulting in actual savings. To the extent there are actual savings, we will use the savings to restore services in the areas of Police, Fire, libraries and community centers in accordance with the City Council direction.

As mentioned previously, we were directed to reduce retirement costs by Fiscal Year 2015-2016 to the Fiscal Year 2010-2011 level. This resulted in needing to come up with a savings of \$215 million in all funds as described on page 8. With my recommendations, we have achieved this as follows:

<b>Retirement Area of Savings</b>	<b>Fiscal Year 2012-2013 Savings ALL FUNDS</b>	<b>Fiscal Year 2013-2014 Savings ALL FUNDS</b>	<b>Fiscal Year 2014-2015 Savings ALL FUNDS</b>	<b>Fiscal Year 2015-2016 Savings ALL FUNDS</b>
SRBR	\$4.7 M			
Retiree Healthcare		\$17.9 M		
First Tier		\$163.4 M	\$21.5 M	\$9.1 M
<b>TOTAL SAVINGS</b>	\$4.7 M	\$181.3 M	\$21.5 M	\$9.1 M
<b>TOTAL CUMULATIVE SAVINGS</b>	\$4.7 M	\$186.0 M	\$207.5 M	\$216.6 M

The chart below summarizes the total General Fund savings based on the recommendations contained in this memorandum. It should be noted that for the SRBR, retiree healthcare and other retirement changes, because the savings is difficult to attribute to General Fund versus all funds, we have applied a general percentage of 78% to the all funds savings to determine an approximate General Fund savings.

Area of Savings	Fiscal Year 2011-2012 Savings	Fiscal Year 2012-2013 Savings	Fiscal Year 2013-2014 Savings	Fiscal Year 2014-2015 Savings	Fiscal Year 2015-2016 Savings
Reducing Compensation	\$39.6 M				
Workers' Compensation Offset		\$2.8 M			
Sick Leave Payout		\$9.5 M			
Overtime			\$1.2 M		
Organizational Changes/Efficiencies	\$4.4 M				
SRBR		\$3.7 M			
Retiree Healthcare			\$13.9 M		
First Tier Retirement			\$127.5 M	\$16.8 M	\$7.0 M
Revenues		\$36.5 M		\$10.0 M	
<b>TOTAL SAVINGS</b>	<b>\$44.0 M</b>	<b>\$52.5 M</b>	<b>\$142.6 M</b>	<b>\$26.8 M</b>	<b>\$7.0 M</b>
<b>TOTAL CUMULATIVE SAVINGS</b>		<b>\$96.5 M</b>	<b>\$239.1 M</b>	<b>\$265.9 M</b>	<b>\$272.9 M</b>

*Note: For savings from SRBR, retiree healthcare and other retirement savings, because the savings is difficult to attribute to General Fund versus all funds, we have applied a general percentage of 78% to the all funds savings to determine an approximate General Fund savings.*

This plan comes up with a total savings of \$272.9 million in the General Fund at the end of the five years. Although the direction was to come up with a savings of \$216 million in the General Fund, we have planned for additional savings to leave options for the City Council in their decision making, as well as to have a back up plan in case revenues are not pursued or not passed by the voters.

It should be noted that if any of these options are not able to be achieved because of any legal issues or other reasons, there will need to be another plan. In my recommendation under retirement, the City should consider stronger incentives for employees to move into the Tier 2 retirement system such as increased cost sharing, including potentially paying the difference between Tier 1 and Tier 2, and additional alternative service delivery models (outsourcing). An additional value of having a second tier is that in the future, the City would have the ability to increase compensation since the first tier benefits comprise such a large portion of the City's total compensation.

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It is important with a plan of this magnitude, that we have a stakeholder process so that there is an understanding of the issues prior to trying to work together towards a solution. We have already begun extensive education on retirement, started by the City Auditor. This must continue to ensure that those who have the viewpoint that there isn't really a pension crisis get the correct facts about the City's fiscal situation, especially our retirement costs outlook.

In addition, many of the recommendations are subject to the meet and confer process with the City's bargaining units.

It is my sincere wish that we were not facing the fiscal situation that we are facing, including next year having a \$78 million shortfall after solving this year's \$115 million shortfall. Unfortunately, that is our reality that we must confront and make structural and long standing changes to ensure fiscal stability for our residents and our employees. This is absolutely necessary for the sustainability of this City.

## **COORDINATION**

This memorandum has been coordinated with the City Attorney's Office, the Department of Retirement Services and the City Manager's Budget Office and Office of Employee Relations.



DEBRA FIGONE  
City Manager

Attachment 1: [Glossary of Commonly Used Pension Terms \(Excerpt from Pew Report, Promises with a Price\)](#)

Attachment 2: Fiscal Reform Plan: Estimated Costs to Restore Services to January 1, 2011 Levels

## Glossary

**ACTUARIAL ACCRUED LIABILITY (AAL)** – The total value of pension benefits owed to current and retired employees or dependents based on past years of service.

**AMORTIZATION PERIOD** – The span of time set to fully pay for actuarial accrued liabilities. To adhere to generally accepted accounting principles (GAAP), governments must use a period of 30 years or less to calculate their net pension or other post-employment benefits obligation and their expense on an annual basis. Some states, which are not in compliance with GAAP, choose longer periods for funding purposes to reduce current contributions.

**ANNUAL REQUIRED CONTRIBUTION or ACTUARILY REQUIRED CONTRIBUTION (ARC)** – The amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period. (This calculation assumes the employer will continue contributing the ARC on a consistent basis.) The ARC is made up of “normal cost” (sometimes referred to as “service cost”)—the cost of benefits earned by employees in the current year—and an additional amount that will enable the government to reduce unfunded past service costs to zero by the end of the amortization period.

**ASSETS** – The amount of money that a pension fund has on hand to fund benefits. The assets (also known as plan assets) build up over time, generally from three sources: employee contributions, employer contributions and investment returns. Plan assets generally are expended to pay pension benefits when due, refund contributions of members who leave

the plan before qualifying for benefits and cover the plan’s administrative expenses.

**ASSUMPTIONS** – Estimates made by actuaries about the future behavior of various economic and demographic factors that will impact the amount of pension benefits owed over time. These estimates, of factors such as investment returns, inflation rates and retiree life spans, are used by actuaries to calculate the AAL and the ARC.

**DEFINED BENEFIT PLAN** – A plan that promises its recipients a set level of benefits, generally for life. In the case of pension benefits, it is based on a “defining” formula that usually includes the number of years served and an employee’s salary multiplied by a preset figure (e.g., 30 years x \$40,000 x 1.75). In the case of retiree health, the promised benefit is typically the payment of a portion of (or the entire) medical insurance premium. However, it can also be based on a defined formula much like a pension. In this case, a certain monthly income is promised that must be used for health expenses.

**DEFINED CONTRIBUTION PLAN** – A plan to which the employer, and often the employee, contributes a defined amount (e.g., 8 percent of salary) to an individual account in the employee’s name while the employee is in active service, but which does not guarantee any set benefit. The amount available for retirement is based solely on the amount of money that has been saved, along with investment income credited to the employee’s account. When these funds are used up by the retiree, the benefit is exhausted.

**NORMAL COST** – The cost of benefits earned by employees in any given year.

**OTHER POST-EMPLOYMENT BENEFITS**

**(OPEB)** – Benefits other than pension benefits that an employer provides to former employees as a deferred form of compensation for their services. OPEB is defined by GASB as including (1) post-employment health care benefits and (2) other types of post-employment benefits—for example, life insurance—if provided separately from a pension plan.

**PAY-AS-YOU-GO** – A method of financing pension benefits or OPEB in which the amount contributed by the employers or employees each year is approximately the amount needed to pay the benefits currently due and payable to retirees (or the premiums currently due and payable to provide for health care coverage or other non-pension benefits for retirees for the current period). Under this method, the source of financing for current benefits often is the employer’s current collections.

**SMOOTHING** – To counter the natural volatility of the stock market, the vast majority of states do not measure the funded status of pension benefits using the current market values of plan assets. Instead, most use methods of determining the actuarial value of plan assets that average out the effects of increases or decreases in market values each year over several years (generally four or five). The effect of this approach is to mute the immediate impact during a severe market drop or spike in growth and to spread it out over time.

**UNFUNDED ACTUARIAL ACCRUED LIABILITY**

**(UAAL)** – The difference between the actuarial accrued liability and the actuarial value of plan assets on hand. This is the unfunded obligation for past service.



## Fiscal Reform Plan

### Estimated Costs to Restore Services to January 1, 2011 Levels

	FTE Restored	2011-2012 Costs	2011-2012 Revenues	Net Cost
<b>Library Services</b>				
Restore branch library hours/days from 4.0 to 4.5 days (eliminated in 2011-2012 Base)	21.67	1,709,504	(150,000)	1,559,504
Restore Main Library services (eliminated in 2011-2012 Base)	5.63	413,142	0	413,142
Restore branch library hours/days from 3.0 days to 4.0 days eliminated in 2011-2012	40.63	3,634,406	(300,000)	3,334,406
Restore cuts to Main Library eliminated in 2011-2012	2.00	159,358	0	159,358
<b>Sub-Total Library Services</b>	<b>69.93</b>	<b>5,916,411</b>	<b>(450,000)</b>	<b>5,466,411</b>
<b>Community Centers</b>				
Community Centers (restore 2011-12 base reductions - satellite/neighborhood community centers)	38.47	4,424,411	(896,056)	3,528,355
Restore Community Center hours reduced in 2011-2012 Proposed Budget	5.35	846,320		846,320
<b>Sub-Total Community Centers</b>	<b>43.82</b>	<b>5,270,731</b>	<b>(896,056)</b>	<b>4,374,675</b>
<b>Fire Services</b>				
Fire Company Restoration (eliminated in 2011-2012 Base)	13.00	2,710,191		2,710,191
Fire Truck Apparatus Minimum Staffing (may be redeployed differently)	28.00	4,153,803		4,153,803
Flexible Brown-Outs/Minimum Staffing Overtime	0.00	3,579,700		3,579,700
Firefighter Recruit Academy	0.00	2,402,927		2,402,927
Fire Hazardous Incident Team	6.00	1,315,850		1,315,850
Fire Operations Management (3 Battalion Chiefs)	3.00	771,117		771,117
Fire Department Discretionary Overtime	0.00	670,371		670,371
Fire Management Staffing (Deputy Director)	1.00	225,922		225,922
<b>Total Fire Services</b>	<b>51.00</b>	<b>15,829,881</b>	<b>0</b>	<b>15,829,881</b>
<b>Police Services</b>				
Police Patrol (restore 62 positions - 2011-2012 Base)	62.00	10,947,494		10,947,494
Police Sexual Assaults Unit (restore 3 positions - 2011-2012 Base)	3.00	634,144		634,144
Police Patrol	23.00	4,969,851		4,969,851
Police Investigations	20.00	3,705,908		3,705,908
Police Recruit Academy Suspension	11.00	1,996,157		1,996,157
Pre-Processing Center	11.00	1,832,992		1,832,992
Police School Liaison Program	9.00	1,561,238		1,561,238
Police Helicopter Program	5.00	1,233,874		1,233,874
Police Special Investigations	5.00	861,626		861,626
Police Non-Personal/Equipment	0.00	590,821		590,821
School Safety Unit	9.28	353,843		353,843
Reserves Unit	2.00	331,292		331,292
Main Lobby Staff on Midnight Shift	2.00	293,680		293,680
Training Unit Staffing	1.00	182,600		182,600
Administrative Staffing	2.00	171,241		171,241



## Fiscal Reform Plan

### Estimated Costs to Restore Services to January 1, 2011 Levels

Sub-Total Police Services	165.28	29,666,761	0	29,666,761
TOTAL	330.03	56,683,783	(1,346,056)	55,337,727