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OCT - 7 2011

City Manager's Office

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Alex Gurza

SUBJECT: **JUNE 22nd OPT IN PROGRAM MEMO ANALYSIS**

DATE: October 7, 2011

Approved

Date 10/7/11

INFORMATION

BACKGROUND

On September 14, 2011, the Rules Committee requested staff to prepare an informational memorandum with analysis and data related to the June 22, 2011, memorandum from the Mayor, Vice Mayor and other Councilmembers related to opt in programs. (Please see Attachment A: September 8, 2011, Memorandum from Councilmember Rocha and Attachment B: June 22, 2011, Memorandum on Opt In Programs.)

It is important to note that although the June 22, 2011, Council memorandum was approved by the City Council on June 24, 2011, it has since been superseded by subsequent City Council direction as contained in the draft proposed ballot measure that was provided to the bargaining units on September 9, 2011.

As noted in a memorandum from City Administration dated June 23, 2011 (Attachment C), there has been significant focus in San Jose on retirement benefit opt in programs in which employees voluntarily choose to opt into a lower retirement benefit design. While opt in programs may be one component of an overall solution to the City's retirement costs, there are many aspects of opt in programs that need to be considered. The primary issues are receiving Internal Revenue Service (IRS) approval for a particular opt in program, as well as the difficulty in estimating cost savings for any such opt in program.

Because the June 22, 2011, memorandum was released only two days prior to the June 24, 2011, council meeting when it was approved, City staff was unable to complete a full analysis on that direction prior to the June 24, 2011, Council meeting. However, subsequent to that meeting, that particular direction was discussed with the City Council in closed session. This memorandum summarizes some of the issues related to the June 22, 2011, Council memorandum.

ANALYSIS

As discussed in the City Administration memorandum on opt in programs dated June 23, 2011, there are many considerations regarding opt in programs. The primary issues are discussed below.

IRS Approval Required Prior to Implementation of Opt In Programs

It is our understanding that in order for the tax contributions to a qualified account to remain pre-tax contributions an employee cannot be given the option of not making the contribution. Consequently, one critical aspect of an opt in program is the need to obtain IRS approval prior to implementation. It is our understanding that no California pension plan has an opt in program for current employees that has been approved by the IRS.

Implementation of any opt in program would have to be contingent upon receiving IRS approval, as specified in the recent agreement with the San Jose Police Officers' Association. Because of the uncertainty of when and if an opt in program would receive IRS approval, it is difficult to determine when and if any savings could be achieved.

Irrevocable Employee Election Required For Opt In Program

If an opt in program is approved by the IRS and is implemented, employees would be required to irrevocably opt out of their existing level of retirement benefits and voluntarily choose reduced benefits. Employees would need to sign a written agreement acknowledging that their decision is irrevocable and that they would not be able to change their minds in the future and go back to the previous benefit structure.

We have been advised that, an employee's spouse or domestic partner would also need to acknowledge the irrevocable election by the employee. As will be discussed in the following section, any cost savings from an opt in program are dependent upon the number of employees and demographics of those employees that choose to opt in. It is very difficult to predict how many employees would voluntarily enter into a lower benefit structure. Therefore, employees would be asked to sign an irrevocable waiver without knowing the exact savings that would be achieved.

Cost Savings of Opt In Programs

As noted above, the actual savings of an opt in program will not be known until after the program has been implemented and employees have irrevocably decided to opt in. Although estimates can be developed in order to determine the potential savings of an opt in program, actuaries would need to know the demographics of the employees who have elected to opt in. In addition, the potential cost savings from the opt in program are dependent on the particular design of the opt in program.

<u>Opt In Program Contained in June 22nd Memorandum</u>

The direction from the June 22, 2011 memorandum was as follows:

Negotiations with the bargaining units shall include the following direction that continues with the current Council direction with the additional flexibility to:

1. ***Opt-In Program for Current Employees***
   a. *Negotiate an "opt in" plan and draft related ballot measure language implementing such a plan, such that when combined with the current Council direction, the City's share of retirement costs for FY 12-13 would not exceed the aggregate cost of pension and retiree healthcare costs for FY 10-11*
   b. *Make explicit to all parties that the incentive for employees to choose to "opt in" to this lower tier of benefits by:*
      1) *Enabling these employees to avoid the additional contribution to pay for unfunded liabilities, as described in Paragraph 2, below*
      2) *Reducing the costs of benefits for these employees*

2. ***All Other Current Employees Who Decline to Opt In:***
   a. *Calculate the savings in the City's Annual Required Contribution (ARC) for each plan (Federated, Police and Fire) from the opt-in program described above, again assuming that every employee would choose to "opt-in"*
   b. *Negotiate additional employee contributions in an amount equivalent to the ARC savings from the opt-in program, to pay for benefits and unfunded liabilities.*

Per this direction, the savings needed would be the difference between the City's retirement costs in Fiscal Year 2010-2011 and the projected retirement costs for Fiscal Year 2012-2013, which is approximately $124.5 million in all funds. If $124.5 million was not achieved through the opt in program, then the difference would need to be achieved through additional retirement contributions for employees who did not opt in.

Based on the June 22, 2011, Council memorandum, the following steps would need to be taken:

1. Determine the retirement benefits of an opt in program .

2. Request an IRS approval letter based on the proposed opt in program (will not be able to implement until IRS approval letter is received).

3. Hold an irrevocable election period. Employees would need to understand and sign an irrevocable document that if implemented, they would not be able to opt back into former tier and this form must also be signed by spouse or domestic partner.

4. Once irrevocable election period has been completed, conduct an actuarial valuation to determine the savings.

5. If savings is less than $124.5 million, the difference between what is saved and $124.5 million will be calculated as additional retirement contributions for those employees who did not opt in (must be calculated separately for Police, Fire and Federated).

If no one was to opt into the opt in program, the corresponding increase in employee contribution rates would be approximately 22%[1] in order to achieve $124.5 million. The chart below shows what the employee contribution rates would be if no one opted into the opt in program and all of the savings needed ($124.5 million) was to be achieved through additional retirement contributions.

	Fiscal Year 11-12 Employee Contribution Rate (Pension and Retiree Healthcare)	Contribution Rate with Increase of 22%
Police	17.47%	39.47%
Fire	15.62%	37.62%
Federated	11.20%	33.2%

One challenge in implementing such a program would be that when making a decision whether to opt in, employees would not know how much in additional retirement contributions they would need to pay if they did not opt in. In order to achieve $124.5 million, you would not know the balance needed in additional retirement contributions until <u>after</u> the opt in election period and a valuation is completed.

Another way to structure this opt in program would be to design a retirement benefit that reduces the normal cost by 22% and then also have 22% additional retirement contributions for those that do not opt in. For example, if the normal cost is currently 30%, the new normal cost would need to be 8%. This option would also not be feasible as there is not enough normal cost in our current retirement benefit to have a sufficient enough benefit (or one at all) that reduces the normal cost by 22%.

As noted previously, the June 24th Council direction has been superseded by direction contained in the September 9, 2011, draft proposed ballot measure that has been provided to the bargaining units, which also contains an opt in program (called a Voluntary Election Program or VEP). Because of the issues identified in the City Administration memorandum dated June 23, 2011 and this memorandum, it is unknown exactly what savings this VEP or any other opt in program would generate.

[1] Calculated based on payroll data used by the Department of Retirement Services and is a combined calculation for both plans.

However, it is possible to determine a range of potential savings. In the case of the current draft ballot measure, if no one opted into the opt in program and paid only the 5% in additional retirement contributions for the first year, this would save approximately $21 million (all funds) and if everyone opted into the opt in program this would save approximately $111 million (all funds). Under the current direction, employees would have an estimate of what they would be paying in additional retirement contributions if they did not opt in, which in the proposed ballot measure is 50% of the unfunded liability with each employee's share capped at 25% of the employee's pensionable pay.

ALEX GURZA
DEPUTY CITY MANAGER

Attachments:

A: September 8, 2011, Memorandum from Councilmember Rocha

B: June 22, 2011, Memorandum on Opt In Programs

C: June 23, 2011, Memorandum on Opt In Programs from City Administration

RULES COMMITTEE: 9-14-11
ITEM: H.4

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: RULES AND OPEN GOVERNMENT COMMITTEE

FROM: Councilmember Donald Rocha

SUBJECT: **TRANSPARENCY AND CONSISTENCY IN LABOR NEGOTIATIONS**

DATE: September 8, 2011

Approved Don Rocha Date 9/8/11

RECOMMENDATION

Direct staff to provide an info memo, which would include staff analysis previously only provided in closed session that details the negotiation position of the Council majority adopted at the June 24, 2011 City Council meeting as put forward in the memorandum from Mayor Reed, Vice Mayor Ngyuen, Councilmembers Herrera, Constant, and Liccardo under item #2, entitled "All Other Current Employees Who Decline to Opt-In."

ANALYSIS

On June 24, 2011 the City Council held a Special Meeting which included Item 3.1 under the Strategic Support Services section for action on the Declaration of a Fiscal and Public Safety Emergency and discussion of possible ballot language. A memorandum was submitted by the Mayor, Vice Mayor and three Councilmembers two days prior to the meeting which recommended direction for an Opt-In program for retirement benefits. The direction contained in the memo was adopted by a six-vote majority of the City Council. At the time there was little staff analysis on the direction; we didn't know what the impact would be on future benefit levels and employee compensation should the direction ultimately be implemented.

There was significant debate on the issue by not only the Council but also the public as to what action the Council should take. After months of prior debate and discussion the direction from this meeting defined the Council position for negotiations with our bargaining units. Given the significance of this decision, it is my opinion that in the interest of transparency and consistency, the information regarding this position that was provided to the Council, whether in open or closed session, should also be provided to the public.

The Council has primarily adopted its direction on employee compensation reductions and retirement reform in public. The merits of various proposals were freely discussed in open session. To the extent the Council continues to receive information about the merits of its direction, it should continue to make that information public consistent with past practice.

Releasing this information is also in the interest of good faith negotiations. Information that helps us evaluate the viability of various pension reform alternatives should be shared with our bargaining units because collaborative problem solving is only possible if both sides in the negotiation are working from the same analysis and technical data.

COUNCIL AGENDA 06/24/11
ITEM 3.1

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: City Council

FROM: Mayor Chuck Reed
Vice Mayor Madison Nguyen
Councilmember Rose Herrera
Councilmember Pete Constant
Councilmember Sam Liccardo

SUBJECT: DECLARATION OF FISCAL EMERGENCY AND BALLOT MEASURES

DATE: June 22, 2011

APPROVED: Chuck Reed Pete PC Madison Nguyen N.V. Rose Herrera RH Sam Liccardo 6-22-11

RECOMMENDATION

Negotiations with the bargaining units shall include the following direction that continues with the current Council direction, with the additional flexibility to:

1. **Opt-In Program for Current Employees:**
   a. Negotiate an "opt-in" plan, and draft related ballot language implementing such a plan, such that when combined with the current Council direction, the City's share of retirement costs for FY12-13 would not exceed the aggregate cost of pension and retiree health costs for FY10-11 (approx. $186.0 million for all funds).[1]
   b. Make explicit to all parties that the incentive for employees to choose to "opt-in" to this lower tier of benefits by:
      1) Enabling these employees to avoid the additional contribution to pay for unfunded liabilities, as described in Paragraph 2, below, and
      2) Reducing the costs of benefits for these employees.

2. **All Other Current Employees Who Decline to Opt In:**
   a. Calculate the savings in the City's Annual Required Contribution (ARC) for each plan (Federated, Police and Fire) from the opt-in program described above, again assuming that every employee would choose to "opt-in."
   b. Negotiate additional employee contributions in an amount equivalent to the ARC savings from the opt-in program, to pay for benefits and unfunded liabilities.

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1 For purposes of making the cost calculations described in that paragraphs 1 and 2, the City Manager should assume that every employee would choose to "opt-in" to the new tier of benefits.

According to the City Manager's May 2, 2011 Fiscal Reform Plan, the $186.0 million figure includes the City's pre-payment discount. It also reflects what the City would have paid for retirement benefits had several bargaining units not paid for a portion of their contributions as part of that year's concessions.

c. Provide all employees the ability to avoid paying these additional contributions by choosing to "opt in" to the set of retirement benefits outlined above.

3. **Other Alternatives:** Bargaining units are encouraged to offer other alternatives that achieve equivalent savings under the same assumptions.

BACKGROUND

This recommendation re-affirms Council's basic direction from its approval of the Mayor's Budget Message on March 22, 2011: to propose a set of retirement benefits for current and new employees that would provide sufficient savings to restore the City's services to their levels on January 1, 2011. We recognize that January 2011 levels of service remain inadequate by anyone's standards, particularly as we consider the deep reductions in such basic services as police patrol, library hours, and other basic services. We must also recognize, however, that the task of reducing retirement costs sufficiently to reach even those paltry levels of service will prove challenging to the most committed of negotiators on both sides of the table. Our current direction, for instance, would require that by July 2012, we close a $125 million gap between next year's (FY12-13) and last year's (FY10-11) retirement costs.

Recognizing the work that has already been completed to achieve savings through modifications to the SRBR, retiree COLA, workers compensation and reductions in retiree benefit premium costs, the direction for savings in this memorandum shall be combined with savings achieved by earlier council direction. The $125 million in savings sought by this recommendation approximates the $127 million in 1st Tier retirement savings identified in the City Manager's Fiscal Reform Plan.

Fortunately, the leaders of several of our employee groups -- namely, the Association of Engineers and Architects, City Association of Management Personnel, Association of Maintenance Supervisory Personnel, the Police Officer's Association, and the International Association of Fire Fighters-- recognize the severity of the challenges in front of us, and have stepped forward earnestly to begin negotiating to find a solution. We hope that with the additional direction provided in this memorandum, we will help to open the door for fruitful discussion.

COUNCIL AGENDA: 06/24/11
ITEM: 3.1

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Alex Gurza

SUBJECT: **RETIREMENT BENEFIT OPT IN PROGRAMS**

DATE: June 23, 2011

Approved

Date 6/23/11

RECOMMENDATION

Accept staff report.

BACKGROUND

There has been significant discussion regarding retirement benefit opt in programs in which employees voluntarily choose to opt into a lower retirement benefit design. This first began with a proposal made by the San Jose Fire Fighters, IAFF Local 230 on a retirement benefit opt in program in February 2011. The City and the San Jose Fire Fighters reached an agreement during those contract negotiations that included a side letter to continue discussions on retirement reform that could include an opt in program.

While opt in programs may be one component of an overall solution to the City's retirement costs, there are many aspects of opt in programs that need to be considered and resolved prior to an opt in program, if any, being instituted within the City's retirement plans. As will be discussed in this memorandum, it is very important to note that any type of opt-in program would need Internal Revenue Service (IRS) approval in order to provide it under the auspices of a tax qualified retirement plan.

There are two ways that have been discussed to structure an opt in program. Opt in programs that have been proposed by some bargaining units would be structured so that when an employee chooses to opt into the new program, they leave behind all of their benefits already accrued (except years of service) and their retirement benefit is calculated only based upon the new benefit structure. For example, if the opt in program's benefit is 2% at 60 and the employee has 20 years of service, when they opt in, they will get 2% for all years of service, including the 20 years already accrued.

Another way that has been discussed to structure an opt in program is that an employee's past years of service will be calculated under the prior benefit structure and future years of service will accrue at the new rate. Using the same example above, if an employee gets 3% per year under the current benefit formula, they will opt in with 3% for 20 years already accrued and future service will accrue at 2%. For the purposes of this memorandum, we are discussing opt in programs where all years of service would change for an employee who opts in.

During the May 24, 2011, Council meeting, the Administration was asked to study two different opt in programs developed by Councilmember Rocha and Councilmember Constant. These proposals have been studied and are discussed further in the analysis section of this memorandum.

ANALYSIS

There are many considerations regarding opt in programs. The primary issues are discussed below.

IRS Issues Associated with Opt In Programs

One critical aspect of an opt in program is the need to obtain IRS approval prior to implementation in order to ensure that investment income would be allowed to accumulate on a pre-tax basis and to ensure that employee contributions can be made on a pre-tax basis. It is our understanding that the IRS has not approved any opt in plans since at least 2005 and that there are currently 22 such requests pending with the IRS. Orange County has had their retirement opt in program for current employees on hold waiting on IRS approval.

Implementation of any opt in program would have to be contingent upon receiving IRS approval, as specified in the recent agreement with the San Jose Police Officers' Association. Because of the uncertainty of when and if an opt in program would receive IRS approval, it is difficult to determine when and if any savings could be achieved.

Irrevocable Employee Election Required For Opt In Program

If an opt in program is implemented, employees would be required to irrevocably give up their existing level of retirement benefits and voluntarily choose reduced benefits. Employees would need to sign a legal document that explains that their decision is irrevocable and that they would not be able to change their minds in the future and go back to a more generous benefit structure.

We have been advised that because of community property interests, an employee's spouse would also need to sign the document that irrevocably reduces the employee's retirement benefits. As will be discussed in the following section, any cost savings from an opt in program are dependent upon the number of employees and demographics of those employees that choose to opt in. It is very difficult to predict how many employees would voluntarily enter into a lower benefit structure. Therefore, employees would be asked to sign an irrevocable waiver without knowing the exact savings that would be achieved.

Design of Opt In Program

If the City were to pursue implementation of an opt in program, in addition to tax considerations, it is also important to consider how the benefit design of the opt in program fits in with the pending benefits structure for new employees and the current benefit structure. For example, one goal could be to have an opt in program that matches the benefits structure for new employees that would be designed so that the costs are sustainable and risks are reduced.

Another goal could be that the opt in program does not alter the benefits formula for years of service already worked, but reduces the benefit formula for future years of service. An opt in program could also be designed to achieve a savings goal through the combination of the reduced cost of the opt in program and increased employee contributions for those employees that choose to stay in the existing benefit structure.

Cost Savings of Opt In Programs

As noted above, the actual savings of an opt in program will not be known until after the program has been implemented and employees have irrevocably decided to opt in. Although estimates can be developed in order to determine the actual savings of an opt in program, actuaries would need to know the demographics of the employees who have elected to opt in. In addition, the potential cost savings from the opt in program are dependent on the particular design of the opt in program.

There are potential options to incent employees to opt into a lower level of retirement benefits:

- Potential for a lower employee contribution rate
- Requiring employees who stay in Tier 1 to pay a higher contribution rate
- Higher wages for employees who opt in

The cost savings of the opt in program would also be dependent upon any specific incentives for employees to opt into the lower level of retirement benefit.

Various Opt In Programs

San Jose Fire Fighters, IAFF Local 230 Proposal

In February 2011, in negotiations over a successor Memorandum of Agreement (MOA), the San Jose Fire Fighters made a proposal on a second tier retirement benefit for new employees. This proposal was discussed in an information memo dated April 13, 2011, which is attached to this memorandum as Attachment A. This proposal also included an opt in program where current employees could opt into the second tier, which was as follows:

San Jose Fire Fighters Second Tier Retirement Proposal		
	Current Pension Benefits (FIRE)	**2nd Tier Pension Benefits As Proposed by Local 230 with opt in for current employees**
Eligibility	50 w/25 years of service 55 w/20 years of service 30 years at any age	No change
Vesting	10 year of Service Only if 20 years have lapsed from date of membership	No change
Maximum Benefit[1]	90%	75%
Formula	Years 0-20: 2.5% per year of service At the end of 20 years of service: 3.0% for all years	Years 0-30: 2.5% per year of service
Calculation	Based on Highest 12 Months	Based on Average of the Highest 36 Months
Annual Cost of Living Adjustment	3% Fixed (compounded)	Maximum 2% based on CPI

What is important to note about the San Jose Firefighters' opt in program proposal was that any savings that the City received from the opt in program would be shared equally between the employees and the City. The San Jose Fire Fighters' proposal states that 50% of the actuarial savings would either be paid to the employee or put in a 401(a) type plan for each employee. In addition, this proposal does **<u>not</u>** make any changes to the retirement age, which is one of the factors that contributes the most to the cost of retirement benefits.

The City and the San Jose Fire Fighters have an agreement to continue negotiating pension and retiree healthcare benefits for current and future employees. The San Jose Fire Fighters' proposal would be included in those discussions.

<u>San Jose Police Officers' Association</u>

During successor MOA negotiations, the POA provided the following proposal on an opt in program for current employees:

[1] Includes base pay and any premium pays that are pensionable.

San Jose Police Officers' Association Opt In Program Proposal		
	Current Pension Benefits (POLICE)	**Opt In Program As Proposed by POA**
Eligibility	50 w/25 years of service 55 w/20 years of service 30 years at any age	No change
Vesting	10 year of Service Only if 20 years have lapsed from date of membership	No change
Maximum Benefit[2]	90%	80%
Formula	Years 0-20: 2.5% per year of service 21-30 years of service: 4.0% per year	Years 0-20: 2.5% per year of service 21-30 years of service: 3.0% per year
Calculation	Based on Highest 12 Months	Based on Average of the Highest 36 Months
Annual Cost of Living Adjustment	3% Fixed (compounded)	Maximum 2% based on CPI

One of the most significant issues in the negotiations with the POA over an agreement on a new contract that included a 10% reduction in total compensation was the POA's desire to include an agreement to implement their opt in program. The outcome of those negotiations was an agreement that included a side letter on Retirement Reform, which is included as Attachment B. This side letter stated that in the event the City and the POA do not reach an agreement on the specific design of an opt in program by November 1, 2011, at the POA's option the City will implement the opt in program that was proposed by the POA during contract negotiations, effective December 25, 2011, under two conditions. The first condition was that 40% of the employees represented by the POA sign an irrevocable waiver to elect to go into the opt in program and that the POA decides to continue with the implementation of the opt in program. The second condition was that any implementation of an opt in program is contingent upon receiving an IRS qualification letter. If less than 40% of the employees represented by the POA opt in, the opt in program could proceed if the City and the POA agreed.

The City and the POA will be continuing their discussions on retirement reform, including this opt in program.

Association of Engineers and Architects, IFPTE Local 21, City Association of Management Personnel, IFPTE Local 21, Association of Maintenance and Supervisory Personnel (AEA, CAMP and AMSP)

During successor MOA negotiations, AEA, CAMP and AMSP also provided a second tier retirement benefit proposal that included an opt in program for current employees. This proposal has not been costed, but will be the subject of the upcoming negotiations.

[2] Includes base pay and any premium pays that are pensionable.

Councilmember Constant and Councilmember Rocha's Opt In Programs

In addition, on May 24, 2011, the City Council provided the Administration with direction to cost out and study two different opt in programs. Those are as follows:

	Councilmember Rocha (Predetermined Design)	Councilmember Constant (Design based on 50% of City's normal cost)
Police and Fire	2.33% per year 70% maximum Age- 57 1.5% COLA 3 year final average salary	1.50% per year 45% maximum Age- 57 1.0% COLA 3 year final average salary
Federated	2.00% per year 60% maximum Age- 62 1.5% COLA 3 year final average salary	1.25% per year 37.5% maximum Age- 62 1.0% COLA 3 year final average salary

Estimated Cost Savings

The Department of Retirement Services has completed an analysis of the various opt in programs above (San Jose Fire Fighters, POA, Councilmember Rocha and Councilmember Constant's) and the following summarizes the estimated normal cost of the pension benefits as described above. The normal cost is the cost of funding the retirement benefit for each year of service. It is important to note that the normal cost does not include any of the unfunded liability costs, but using the normal cost allows for a comparison of a particular benefit structure for future years of service.

Although the estimated normal cost below is calculated for a new employee, it can also be assumed that this would be the estimated normal cost if 100% of current employees opted into the second tier. As discussed earlier in this memorandum, it is difficult to estimate the potential savings of an opt in program as there are many factors that are unknown. For example, it is unknown how many employees would elect this option, whether employees with fewer years of service would be more likely to elect this option, or whether employees who are closer to retiring would consider electing this option. These along with many other factors, including the cost sharing for the normal cost and unfunded liability could significantly impact the City and employee costs.

	Current Normal Cost	Police Opt In Proposal	Fire Opt In Proposal	CM Rocha	CM Constant
7.75% (25% Probability) Earnings Assumption	38.50%	30.32%	28.38%	23.27%	N/A
6.75% (50% Probability) Earnings Assumption	48.6%	36.32%	36.65%	29.58%	19.76%

	Federated Current Normal Cost	Federated CM Rocha	Federated CM Constant
7.75% (25% Probability) Earnings Assumption	17.44%	10.85%	N/A
6.75% (50% Probability) Earnings Assumption	22.1%	13.57%	8.93%

In addition, the Department of Retirement Services has provided an estimate of the savings to the City if 100% of employees represented by the San Jose Fire Fighters opted into their opt in program, if 100% of employees represented by the POA opted into the opt in program proposed by the San Jose Fire Fighters and if 100% of both opted into the opt in program. This chart was shown during the presentation to the City Council on May 18, 2011, and is also attached to this memorandum as Attachment C.

EVALUATION AND FOLLOW-UP

Opt in programs will be discussed during the upcoming retirement reform negotiations with the City's bargaining units. Additional information regarding opt in programs and other council direction from May 24, 2011, will be provided during the presentation during the Council meeting on June 24, 2011.

COORDINATION

This memorandum was coordinated with the Department of Retirement Services and the City Attorney's Office.

CEQA

CEQA: Not a Project, File No. PP10-069(b), Personnel Related Decisions.

Alex Gurza
Director of Employee Relations

Attachments:

A: Information Memorandum Dated April 13, 2011

B: Retirement Reform Side Letter with the San Jose Police Officers' Association

C: Opt In Estimated Savings Chart

Attachment A

Distributed on:
APR 14 2011
City Manager's Office

SENT TO COUNCIL:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Alex Gurza

SUBJECT: **Estimated Retirement Pension Benefits Costs - San Jose Fire Fighters, IAFF Local 230 Proposal dated February 28, 2011**

DATE: April 13, 2011

Approved

Date 4/13/11

INFORMATION

On January 25, 2011, the City Council approved direction to the City Manager to negotiate 2nd Tier pension and retiree healthcare benefits for new employees that achieves a normal cost to the City and employees that does not exceed 12.4% of pensionable pay. Further, if a defined benefit plan or hybrid is considered, the following factors should be included: cost sharing – pension unfunded liability, cost of living adjustment (COLA), retirement age, pension formula, determination of final compensation, retirement service credit, minimum service requirements (vesting), joint and survivor benefits, retiree healthcare benefits, retiree dental benefits, retroactive disability retirement applications, Supplemental Retiree Benefit Reserve (SRBR) or "13th Check," and Workers' Compensation offset in the Police and Fire Department Retirement Plan. In addition, the Council direction included exploring options for current employees.

During the negotiations with the San Jose Fire Fighters, IAFF, Local 230, hereafter referred to as "Local 230," Local 230 provided a proposal on 2nd Tier Retirement benefits. The proposal also included an Opt-In Option for current employees. (Please see attached Local 230 proposal dated February 28, 2011)

The City and Local 230 reached an agreement for a successor contract on March 3, 2011. Changes to the retirement benefits were not included in the agreement, however, part of the overall agreement included a side letter to continue negotiations on pension and retiree healthcare benefits for current and future employees.

The agreement was approved by the City Council on March 22, 2011. At the Council Meeting on March 22nd, the City Council made a referral to the City Administration to provide the Normal Cost of Local 230's 2nd Tier proposal. This memorandum is intended to provide a response to the referral made at the City Council meeting on March 22, 2011, on the Local 230 proposal.

Comparison of Current Pension Benefit and 2nd Tier Pension Benefit Proposal

The following chart summarizes the current pension and retiree healthcare benefits provided to employees represented by Local 230, compared to the 2nd Tier proposal made by Local 230 on

February 28, 2011.[1] Local 230 is proposing to roll back the maximum benefit from 90% to 75% of pensionable pay for new employees, as was provided prior to February 1996. In addition, the proposal includes calculating the pension benefit using the average of the highest 36 months and providing a 2% Cost of Living Adjustment (COLA) based on the Consumer Price Index (CPI).

	Current Pension Benefits (FIRE)	2nd Tier Pension Benefits As Proposed by Local 230
Eligibility	50 w/ 25 years of service 55 w/20 years of service 30 years at any age	50 w/ 25 years of service 55 w/20 years of service 30 years at any age
Vesting	10 Years of Service only if 20 years have lapsed from date of membership	10 Years of Service only if 20 years have lapsed from date of membership
Maximum Benefit[2]	90%	75%
Formula	Years 0-20: 2.5% per year of service At the end of 20 years of service: 3.0% per year	Years 0-30: 2.5% per year of service
Calculation	Based on Highest 12 Months	Based on Average of the highest 36 months
Annual Cost of Living Adjustment	3% Fixed (compounded)	Maximum 2% based on CPI

Fiscal Year 2011-2012 Retirement Costs for Fire Employees

The following chart includes the board adopted retirement contribution rates for Fiscal Year 2011-2012 for current Fire employees in the Police and Fire Department Retirement Plan. The Normal Cost is currently split in an 8:3 ratio (City – 73% and Employees 27%). The proposal provided was not proposing to change the cost sharing for the Normal Cost. The City would remain responsible for 100% of the unfunded pension liability. The proposal does not make any changes to the cost sharing for the pension unfunded liability.

Fiscal Year 2011-2012 Retirement Contribution Rates (FIRE)			
Current Benefit	**City**	**Employee**	**Total**
Pension			
Normal Cost	28.53%	10.70%	39.23%
Unfunded Liability/Prior Service Cost	23.01%	0.06%	23.07%
Subtotal	**51.54%**	**10.76%**	**62.30%**
Medical and Dental[3]	**3.92%**	**3.61%**	**7.53%**
Total	**55.46%**	**14.37%**	**69.83%**

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[1] The 2nd Tier Retirement proposal made by Local 230 also includes closing the SRBR program to new employees and changes to the retiree healthcare benefits. For purposes of this memorandum, cost estimates only include the changes to the pension benefit.
[2] Includes base pay and any premium pays that are pensionable.
[3] Medical and Dental rates for the City and Employees are for Fiscal Year 2010-2011. It is anticipated that the Fiscal Year 2011-2012 rates will be available in May.

Normal Cost of 2nd Tier Pension Benefit for New Employees

The Department of Retirement Services completed an analysis of the 2nd Tier retirement (pension only) proposal and the following summarizes the estimated Normal Cost of the pension benefit as described above. It should be noted that during the negotiations, Local 230 indicated that their actuary estimated the Normal Cost for new employees to be approximately 28% of pensionable pay, which is consistent with Retirement Services analysis. As a comparison, the current Normal Cost for the pension benefit is 39.23%.

2nd Tier Pension Benefit as proposed by Local 230 on February 28, 2011				
	Local 230 estimated Cost	City's estimated Cost using current earnings assumption of **7.75%**	City's estimated Cost using earnings assumption of **6.75%**[4]	City's estimated Cost using earnings assumption of **4.00%**[5]
Normal Cost	28%	28.38%	45.6%	89.5%

In preparing the analysis, the Department of Retirement Services used three different earnings assumptions. The earnings assumption (Investment Rate of Return) is the estimated future net rate of return on current and future assets. This rate is used to discount the actuarial liability for each plan, and is one of the most important assumptions.

The Police and Fire Department Retirement Board recently lowered the current earnings assumption (Investment Rate of Return) assumption from 8.0% to 7.75% for the 2010 valuation, which was used to establish the retirement contribution rates for Fiscal Year 2011-2012. The Board is also considering whether to lower the earnings assumption further for the 2011 valuation, which would be used to establish the retirement contribution rates for Fiscal Year 2012-2013.

The earnings assumption actuarial change was made to more closely align expected net rates of return to assumed net investment rates of return. If the investments do not result in earnings that are at least as much as the assumptions set by the retirement boards, it results in an unfunded pension liability that must be entirely paid by the City.

As illustrated in the chart above, if the earnings assumption is lowered, the Normal Cost of the benefit increases. For example, the Department of Retirement Services estimated the Normal Cost to be 89.5% if a 4% earnings assumption were used. This was used to illustrate the impact of using a very conservative and nearly risk-free earnings assumption.

The Unfunded Actuarial Accrued Liability for the Police and Fire Pension Benefits as of June 30, 2010 was $0.65 billion on an actuarial basis and $1.0 billion on a market value basis. If the 2nd Tier proposal were accepted for new employees, it would result in no immediate change to the unfunded liability.

It is important that realistic actuarial assumptions are used to maintain adequate funding. The higher the earnings assumption, the higher the risk and ultimately the higher the costs will be if investment returns do not meet the earnings assumption. Actuarial assumptions do not determine the actual cost of the plan. The actual cost is determined by the benefits paid out,

[4] Includes changes to mortality and merit pay increase assumptions.
[5] Includes changes to mortality and merit pay increase assumptions.

offset by the investment income received. The Boards need to adhere to funding policies that are based on sound actuarial methods to avoid intergenerational transfers of benefit costs.

Opt-In Option for Current Employees

In addition to the 2nd Tier Retirement Proposal for new employees, Local 230 proposed an Opt-In Option for current employees. Under the proposal, current employees would be allowed to opt-in to the 2nd Tier pension plan. Any savings resulting from employees electing to opt-in to the 2nd Tier would be shared equally between the employees and the City. This means that 50% of the actuarial savings would either be paid to the employee or put in a 401(a) type plan for each employee.

At this time it is difficult to determine what the potential savings for this Opt-In Option would be because there are many factors that are unknown. For example, it is unknown how many employees would elect this option, whether employees with fewer years of service would be more likely to elect this option, or whether employees who are closer to retiring would consider electing this option. These along with many other factors, including the cost sharing for the Normal Cost and Unfunded Liability could significantly impact the City and employee costs. If the City Council provides direction on an Opt-In Option, there are many details that would need to be discussed during the negotiation process.

Conclusion

The City and Local 230 have an agreement to continue negotiating pension and retiree healthcare benefits for current and future employees. The Local 230 proposal would be included in those discussions.

Alex Gurza
Director of Employee Relations

Attachment

San Jose Fire Fighters · Local 230
425 E. Santa Clara Street, Suite 300, San Jose, CA 95113 • (408) 286-8718 • FAX (408) 286-2577

SAN JOSE FIRE FIGHTERS LOCAL 230

SECOND TIER RETIREMENT (Plan 2)

For all applicable members initially hired after the effective date of this contract, Local 230 agrees to full pension reform by turning back the clock on pension benefits to the following:

- Maximum retirement benefit 75% of final average salary
- 2.5% per year for years 1 -30
- Final average salary to be calculated as the annual average of the highest 36 months.
- Retiree Annual Cost of Living Adjustment (COLA) calculated to match the CPI Index rate up to a maximum of 2.0%
- Supplemental Retirement Benefit Reserve benefit closed to new members who are hired after effective date of agreement.
- The retiree medical benefit will be defined as the minimum plan amount paid to active members at the time the employee retires without future increases.

VESTED MEMBER
OPT – IN OPTION (Plan 2)

The following pension plan changes shall apply prospectively to any current San Jose Fire Department Employee who at their option select to join the second tier retirement plan (Plan 2). The actuarial savings from a member opting into the second tier retirement plan shall be shared equally between the employee and City at a 1:1 ratio. For the employee the savings can be applied in either of two methodologies:

1. Applied to a new 401(a) account to be dispersed within plan and IRS guidelines upon separation of employment or retirement, OR
2. Paid directly to the employee as compensation on a biweekly basis.

If a current employee selects to join the second tier retirement plan the member shall remain in the second tier retirement plan or, on a one time basis, an employee could re-join the Tier 1 plan but must pay all resultant UAAL attributed to that individual prior to re-joining the first tier plan (Plan 1).

Tentatively Agreed__________
AG_____ JW *JW*

Side Letter Agreement

BETWEEN

THE CITY OF SAN JOSE

and

SAN JOSE POLICE OFFICERS' ASSOCIATION

RETIREMENT REFORM

The City and the San Jose Police Officers' Association agree to continue meeting and conferring on pension and retiree healthcare benefits for current and future employees, including but not limited to healthcare benefits. The negotiations may include modification of healthcare (medical and dental) plans available to current employees, including but not limited to plan design.

Either the City or Union may provide notice to the other of its request to meet and confer. Upon such notice, the parties shall continue these negotiations within ten (10) calendar days after the City or Union receives notice from the other. The City and Union shall meet and confer in good faith in an effort to reach a mutual agreement. If the parties are at impasse and no agreement is reached, the parties shall submit the issues for determination in accordance with the applicable provisions under the Employer-Employee Relations Resolution No. 39367 and/or City Charter Section 1111.

Opt In Program

As part of the negotiations related to retirement reform, the parties will meet and confer regarding an opt in program in which current employees could voluntarily choose to opt out of the current level of pension benefits into a lower level of benefits.

In the event that the City and the POA do not reach an agreement on the specific design of an opt in program by November 1, 2011, at the POA's option the City will implement the opt in program that was proposed by the POA during contract negotiations (2.5% for the first 20 years and 3% after 20 years with an 80% maximum, 2% fixed COLA and 3 year final average salary) effective December 25, 2011, under the following conditions:

1. 40% of the employees represented by the POA sign an irrevocable waiver to elect to go into the opt in program described above. Employees would be required to sign a document indicating that they understand that if the

program is implemented, this is an irrevocable election and that they will not be able to opt back into the former tier of benefits.

AND

2. Any implementation of an opt-in program is contingent upon receiving an IRS qualification letter.

Even if 40% of the employees represented by the POA sign an irrevocable waiver to opt in and IRS approval has been received, the POA will have the option not to proceed with implementation of the opt in program. If less than 40% of the employees represented by the POA sign an irrevocable waiver to opt in and IRS approval has been received, the opt in program may still be implemented by mutual agreement of both the City and the POA.

The parties agree that the dates contained herein regarding the opt in program can be modified by mutual agreement of the parties.

The POA expressly acknowledges that this opt in program is not the solution to the costs of the City's retirement benefits and the unfunded liabilities for both pensions and retiree healthcare. The City has informed the POA that even if the opt in program is implemented, further changes will be required to significantly reduce the costs of pension and retiree healthcare benefits and the unfunded liabilities, which may include a substantially lower cost tier for new employees and reduced benefits and/or increased employee contributions for current employees, including those who may elect the opt in program. Neither party waives any legal rights including the Union's nor any member's right to assert that certain benefits are vested.

This Agreement is tentative and shall become effective only as part of the overall agreement on, and only during the term of, a successor Memorandum of Agreement.

FOR THE CITY:	FOR THE UNION:
6-3-11	6/3/2011
Alex Gurza Date	George Beattie Date
Director of Employee Relations	President, San Jose Police Officers' Association

Attachment C

Opt In Program