SONOMA/MENDOCINO COUNTIES
CITY MANAGERS' AND COUNTY ADMINISTRATORS' ASSOCIATION

TO: LEAGUE OF CALIFORNIA CITIES, CITY MANAGER DEPARTMENT
FROM: CITY/COUNTY MANAGEMENT ASSOCIATION OF SONOMA AND MENDOCINO COUNTIES
DATE: MARCH 12, 2010
SUBJECT: PROPOSAL FOR REGIONAL CITY PENSION STANDARD

Introduction

In July 2009, following the lead of other City Managers' groups in California, the City Managers in the Sonoma/Mendocino County Managers' Association formed a working group to study the pension programs offered to local government employees in California and, in particular, the North Bay. An effective, predictable pension program is an important component in attracting and retaining qualified, professional employees to the public sector. Such employees are crucial to providing consistent services to our communities.

While all are in agreement that these pension programs have worked well to support career local government employees for decades, there is growing recognition that they are no longer financially sustainable in the changed economic climate, and are increasingly politically controversial.

To that end, after reviewing various options, the Association has committed to providing a menu of options that cities may wish to consider when negotiating with their respective employee groups based on their own issues with cost containment. One of these options, the creation of a second tier pension offering, would not affect existing City employees who have vested rights to the current pension program, but would apply to new employees after a date certain and move those cities that choose to pursue that option toward a more sustainable economic model.

Background

For 70 years the State of California and local governments have offered a "defined benefit" retirement plan for employees. This system guarantees annual pension payments based on retirement age, years of service, and salary. Most cities in California are members of the California Public Employees Retirement System (CalPERS).

The main goal of the retirement system is to provide fulltime career municipal employees with pension benefits that provide a reasonable standard of living into retirement. The benefit level is meant to be fair and adequate, but fiscally sustainable for employers and taxpayers. While we recognize that the original defined benefit pension plan worked for decades and should be retained, it is clear that this plan is increasingly rare in the private sector. By comparison, the greater majority of private employers offer "defined contribution" plans where the employer contribution is a fixed dollar amount and the benefits are based on contributions and investment earnings. These plans place the responsibility largely on the employee to amass and manage assets to ensure an adequate pension after retirement. This eliminates the annual pension payment, which is solely based on age, years of service and salary. Such 457 and 401(k) retirement plans have not performed well in recent years due to turmoil in the investment markets. Yet, there is growing sentiment amongst the public and opinion leaders that State and local government workers should be shifted into defined contribution plans, ostensibly to reduce the taxpayer's burden.

We strongly feel this should be reconsidered for several reasons. First and foremost, defined benefit plans have proven to be more efficient than defined contribution plans for delivering pension benefits for both the employer and the employee. Defined benefit plans generally earn greater investment growth than defined contribution plans because they are professionally managed. Defined benefit plans offer lower fees and cover disability retirements, public safety disability requirements and death benefits that are not included in defined contribution plans. Further, defined benefit plans offer a protection for inflation and manage longevity risk better than defined contribution plans by pooling larger numbers of people. On the employer side, moving from a defined benefit plan to a defined contribution plan entails large start-up costs and forces changes in asset allocations that will produce lower investment results in the defined benefit plan that remains for existing employees. Hence, it would likely cost the taxpayers more for many years to force future local government employees into a defined contribution plan.

Additional information in support of the continuation of the defined benefit plan includes:

- The average CalPERS pension is approximately $25,000 per year.
- Half of CalPERS retirees receive less than $16,000 per year or less in benefits

- Unlike the private sector, many CalPERS members do not receive Social Security, making their CalPERS pension their sole source of pension income other than personal savings.
- Only 1% of the nearly half million CalPERS retirees receive annual pensions of $100,000 or more. Many are retired non-unionized or specialized skilled employees of other high wage earners who worked 30 years or more. Many served in high level management positions.

These facts are often under reported or ignored in the public realm conversations and do belie the widespread view that all CalPERS members receive extraordinary benefits.

However, it is true that the defined benefits plans have become more expensive in recent years. In the late 1990's, when CalPERS was earning extraordinary returns on its investment portfolio, the California legislature enacted significant benefit enhancements for public employees in the CalPERS systems that were optional for participating local governments. Because of the positive investment market conditions during that period, this led to increased earnings resulting in a "super funding" of local government pensions. This caused management and labor to seek increased benefit levels to stay competitive in the employment market. It is now common for public safety employees to retire at age 50 or within a few years thereafter with almost a full salary under the 3% at 50 plan and for miscellaneous employees to retire at 55 to 60 years old with 85-100% of full salary. These increased benefits have proven to be unsustainable for several reasons, and need to be addressed and adjusted to the more financially manageable pre-1999 levels.

The costs for these defined benefit plans vary based on two factors: the benefit paid to retirees, and returns earned by investment managers. The pension funds are not immune to stock market declines, and CalPERS has suffered significant losses in its portfolio since mid-2008. While the market is showing some resiliency, it is still performing in a very uneven manner and member agencies will be called upon to pay significantly increased contributions to fund pensions for current employees and make up for the huge losses in '08-'09 over the next 30 years. This will put added pressure on cities at a time when municipal services are stretched to the limit.

Local revenues are depressed at a time when CalPERS rates will be increasing. According to HdL, a professional firm which audits sales tax for the majority of cities and counties in California, a return to 2005 sales tax levels is not anticipated until 2013 or later due to changes in consumer behavior and access to credit. A like opinion is issued by MuniServices, another statewide sales tax audit firm used by cities and counties in California. MuniServices projects that 2009 will be viewed as the "new normal base" for sales tax levels and projections for future growth should therefore be based on 2009 levels. Property tax revenues, long considered the most reliable for steady growth of all municipal revenues, are down significantly in Sonoma and Mendocino Counties this year, and only meager improvement is expected in the coming years. Value reassessments and property tax appeals have reached or are close to historic highs. This will have a multi-year impact on municipal property tax receipts. The CalPERS policy adopted June 16, 2009, spreads the deep losses from FY 2008-09 over the next 30 years, beginning in 2010 and rising through 2013. These increased rates will catch cities while they are still in the throes of fiscal difficulties or just beginning to crawl out of this tenacious global recession. As such, pension costs may soon escalate beyond our ability to manage them while the benefits may exceed what taxpayers themselves can receive and what may be needed to attract qualified employees. The local government pension situation may become untenable unless we proactively implement solutions.

Almost all of the cities in Sonoma and Mendocino counties are members of the Public Employees Retirement System, and the two counties operate their own retirement systems under the 1937 Act. CalPERS Chief Actuary, Ron Seeling, recently stated that due to the significant investment losses to the CalPERS investment pool, and the growth of benefit formulas for public agencies in the State, rates were likely to increase to levels that were not sustainable for most local governments. Rates of 25% of pay for miscellaneous employees and 40 to 50% of pay for safety employees are "unsustainable" and will add financial pressures to cities at a time when local budgets are already in distress.

The Association working group has met on the pension reform subject numerous times since the summer of 2009. The City Managers were interested in convening representatives from local government, labor, tax-payer organizations, and Statewide pension reform organizations for a dialogue on possible reforms to the current pension system. The Association held a pension forum with local labor representatives, the Sonoma County Taxpayers Association, and CalPERS representatives on November 3, 2009. The information shared at the Forum helped all in attendance to recognize the challenges ahead for the retirement system. Most in attendance agreed that it would be better to work together to craft acceptable changes to the system rather than to wait for reform by voter initiative.

There are also a number of efforts by citizens and voter/taxpayer focused groups to qualify initiatives that would implement significant changes to public sector pensions in the State that would drastically alter one of the major benefits of public sector employment. The impacts of these efforts on the ability to recruit and keep high quality public employees could be significant and troublesome. Former State legislator Keith Richman is leading the most prominent of these efforts. Attracting high quality candidates to public sector careers continues to be a challenge in many areas. Recent polls have indicated that there is widespread concern and potential support for changes to the system that would reduce benefits and control costs to taxpayers. While there is much discussion in the media that public employee pay has come into par with private sector employees, that situation is and always has been a result of the cyclical nature of the economy. When the economy was in a significant growth mode, private employment compensation routinely outpaced the public sector. The economic reality that government has to provide a basic level of services regardless of economic conditions requires that the public sector adopts and maintains compensation systems that are steady and predictable. A proactive effort to develop a more sustainable pension program for public agencies has begun to emerge among local agencies on a regional basis. Furthermore, the League of California Cities will be considering pension reform as one of its key goals at a meeting of its Board of Directors early in 2010, and we strongly support this endeavor for Statewide leadership on this issue.

Lastly, the exclusive focus of this paper is regarding the financial impacts of this issue. We recognize that each City has its own CalPERS formulas and internal organization issues, and that each City must in the end weigh the pros and cons of this issue and these options based on their own factors and situation.

<u>Procedural Steps</u>

Discussion of the status of the CalPERS system and 1937 Act programs at the Sonoma City/County Managers' Group:

1. Initial interest expressed by Sonoma City/County Managers' Association to explore reform principles
2. Interest expressed by Mendocino County Managers and Marin County Managers to develop employment market-wide recommendations
3. Sonoma County Sub-Committee on Pension reform created. Nina Regor, Cloverdale, Dan Schwarz; Rohnert Park, Jack Griffin; Sebastopol, and Jeff Kolin, Santa Rosa. With Jeff Kolin's departure, Linda Kelly, Sonoma, was added to the Sub-Committee
4. Briefing scheduled to communicate preliminary recommendations of the Sub-Committee to the City/County Managers' Association on October 12, 2009
5. Establish stakeholder input session with labor, taxpayer groups, and pension reform organizations with the City/County Managers' Association on November 3, 2009
6. Develop recommended principles for sustainable pension reforms on November 9, 2009
7. Present the recommendations to the City/County Managers' Association for preliminary approval of draft principles on November 9, 2009, January 14, 2010, February 8, 2010 and March 8, 2010
8. Each City Manager presents the approved principles to their respective City Councils for each City to discuss.
9. Report to the full Mayor and Councilmember's Association on the completion of the City Manager process
10. Investigate the implementation of the proposed options through the meet and confer process with each bargaining unit as contracts expire in each local jurisdiction
11. Work with the League of California Cities (LOCC) to advocate for Statewide legislation to establish a cohesive pension reform system, including the implementation of a common second tier for new employees

Initial Principles for Reform and Sustainability – Presented to the Sonoma and Mendocino County Managers' Association:

1. Retain the defined benefit retirement format; continue to support the CalPERS model rather than incur start-up costs in a new system
2. Provide a sustainable level of retirement benefits for career public employees
3. Implement changes to the system that share risk and gains equally between employees and employers
4. Define a second tier for new employees that over time will provide for a more sustainable pension system for employers
5. Support Statewide Pension Reform efforts that align with the principles for pension sustainability while maintaining a design that attracts and retains qualified employees in the public sector
6. Support efforts for parity in pension programs, including special districts in the reform efforts
7. Support reforms that eliminate pension spiking

Initial Options for a Second Tier benefit level – Presented to the Sonoma and Mendocino County Managers' Association at their November 2009 meeting:

1. Use a three year average of highest years for final compensation calculation
2. New second tier for Public Safety: CalPERS Formula 2% at 55, 80% Cap on benefits
3. New second tier for Miscellaneous: CalPERS Formula 2% At 60, 90 % Cap on benefits
4. Negotiate increased employee contributions and cost sharing
5. Eliminate Employer Paid Member Contribution (EPMC) provisions in contracts
6. Establish a uniform COLA adjustment in all contracts that is based on the annual SSI increase adjustment

These and any other cost containment mechanisms are subject to the collective bargaining process in each individual city.

Findings

Ideally, responsible and effective pension reform would be addressed at a Statewide level with consistent pension standards for all. Yet, we cannot wait for a statewide solution due to the stalemate in Sacramento. Poorly conceived pension reform by initiative could lead to greater costs for taxpayers and harm local government's ability to attract and retain qualified employees. In the absence of a Statewide reform effort, the concept of regional approaches offers some security in that should all cities, counties or special districts attempt to move forward consistently, that will assist in avoiding having any single city, county or special district be disadvantaged by pension reform. Therefore, the Association supports a modified level of retirement benefits for all new City employees in the Sonoma and Mendocino County region.

In terms of specific recommendations, the Association would urge each city to seriously consider the following when engaging in the collective bargaining process. In making these recommendations, we understand that each city's situation is different and the problem of pension costs may be more acute and urgent in some than in others.

1) Current employees shall participate in the funding of their pensions in all cities. This reform will generate immediate budgetary savings to cities to the extent that existing employees participate in paying for their own retirement. Savings could range from 1 – 9% of payroll annually.
2) Second Tier Retirement Proposal
    - Safety employees – 2% at 55, 80% cap on benefits
    - Miscellaneous employees – 2% at 60, 90% cap on benefits
    - Average of highest three years for final compensation

The second tier proposal will deliver savings over a much longer time period as it only affects new hires after January 2011, or as soon as can be negotiated in each city. When the majority of employees are under the second tier, cities can expect to save approximately 2% of payroll per year. Within 30 years, annual savings of 5% of payroll can be expected. The second tier will also lower each City's volatility index (ratio of assets held for pension payments to payroll), which will help stabilize future rate increases.

These changes can be negotiated and then legislated at the local level. Each City has a responsibility to meet and confer in good faith to reach agreement with its bargaining units. The committee also recommends that Sonoma and Mendocino County cities seek legislative pension reform at the State level. These would include:

1. Establishing a 90% benefit cap for miscellaneous employees and an 80% cap for safety employees
2. EPMC prohibited as PERSable wages
3. Give employers flexibility to determine when part-time employees are entitled to pension benefits
4. Obtain flexibility from PERS to allow employees to move into a lower level tier in the case of two-tier plans if there is some advantage to the individual employee in doing so
5. Provide for reciprocal access to tier 1 benefits for employees who change jobs after the effective date of any State legislative action.
6. Establish additional reserve funding to reduce volatility

7. Retain full disability benefits for those who are injured and cannot work in any capacity, but restrict disability benefits for those who are able to work (in same or similar job) after work-related injury

The League of California Cities (LOCC) North Bay and Redwood Empire Divisions and the Mayors' and Councilmembers' Association of Sonoma County should advocate for these changes to the greater League Board and to our State representatives. These reforms would provide adequate and sustainable pensions for long-term employees in Sonoma and Mendocino County cities.

Next Steps

The Association recommends communicating these ideas to other regional manager groups in the hopes of obtaining wider support for pension reform. San Diego, Los Angeles, Contra Costa, San Mateo, Sacramento, Marin, and Santa Clara area cities have indicated interest, and/or have undertaken their own pension reform efforts. Also, several local water districts have met to discuss similar efforts for pension reform.

The City Managers' Department of the League of California Cities held a panel discussion on this subject at its annual meeting in February 2010. The League has assigned the topic of pension reform to its Employee Relations Policy Committee.

City Managers will discuss these recommendations with their City Councils and seek direction to begin negotiating pension reform as labor agreements expire. In this way, sustainable and defensible pension plans will become the norm over time among Sonoma and Mendocino County cities.

The Association includes Cloverdale, Cotati, Healdsburg, Petaluma, Rohnert Park, Sebastopol, Santa Rosa, Sonoma, Windsor, County of Sonoma, County of Mendocino, Fort Bragg, Ukiah, and Willits. *Note: The County of Sonoma and of Mendocino have their own pension systems.

Respectfully Submitted on behalf of the Sonoma/Mendocino County City Managers Association

Jack Griffin, City Manager, City of Sebastopol
Chairman
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