Sonoma County Civil Grand Jury

Grand Jury Report

Sonoma County Pension Reform

2014 - 2015

Sonoma County Pension Reform

Summary

Due to a series of events, culminating in the recession of 2008, the County's unfunded pension liabilities have grown from $10.8 million dollars in 2000 to almost a half billion dollars in 2014. The Sonoma County Civil Grand Jury seeks to determine if the County has a long-range plan to reduce its accumulated pension liabilities, to contain costs and to provide the citizens of the County with a consistent, understandable measurement of the County pension system's financial health.

The Sonoma County Board of Supervisors recognized pension obligations were on an unsustainable course. In 2011, they created an Ad Hoc Committee to look into the matter and make recommendations. Because pension funding is a widespread problem, in 2012, the State of California passed legislation reforming how things are done. This law, California Public Employees' Pension Reform Act of 2013 (PEPRA), made some changes for all employees but the biggest impact is with new employees hired after January 1, 2013, requiring a new employee tier with reduced benefits and additional cost savings. Further changes affect retirement age, salary caps, and the compensation pensions are based on. Spiking—the practice of inflating final compensation—was essentially eliminated. As employees retire, their positions are filled by lower pension cost employees. Eventually, the entire workforce will be operating under the new law.

In addition, the County employees, through their unions, agreed to concessions beyond what the new law required, continuing to contribute 3 percent of pay toward the unfunded pension liability. These changes have already saved the County $33 million in pension costs and allowed for a $3.5 million payment toward unfunded liabilities. Many of these reforms put in place by the State 2013 pension reform law are noted by the County's 2015 Pension Reform Update and discussed in this Report.

It is helpful to understand how the system works and which laws govern the pension system. The Grand Jury has provided an overview and a historical perspective, giving greater clarity to those specialized terms that are used by the professionals who control pension decisions, County agencies, and public special interest advocacy groups.

Whether the County can meet its pension obligations in the future seems to be the subject of much debate. No matter what the measurement, it is clear that required pension contributions by the County and its employees are projected annually and the County is paying 100 percent of its required contribution to the pension system. The system gets 40 percent of income from these contributions and 60 percent from investment income. While investment earnings are projected by experts, they have no control over the end result. Any investment losses (and gains) are borne by the County only. The County has a clear goal of reaching full funding of pension liabilities for current and future retirees.

Methodology

In our preliminary investigation of the County's pension system and employment expenses we were struck by the complexity of the issues. There was no lack of scholarly articles, evaluations by public interest groups and extensive information published by the County of Sonoma. The reading list facing the Grand Jury was well over one thousand pages, with over 80 percent dealing with Sonoma County alone.

The Grand Jury examined written materials from inside and outside the County and thereafter interviewed the authors and staff who assembled the materials. The Grand Jury seeks to determine if the County has a long-range plan to reduce its accumulated pension liabilities and contain costs, and to provide the citizens of the County with an understandable and consistent measurement of the financial health of the County's pension system.

Discussion

Sonoma County's Pension Obligations: 2000 - 2012

"Sonoma County's pension obligations are on an unsustainable course. If continued upon, more and more resources will be needed to meet obligations at the expense of community needs." -- Sonoma County Board of Supervisors, Ad Hoc Committee on Pension Reform, 2011

In 2000, the County of Sonoma's pension fund was financially healthy. However, through a series of events including increased benefits because of a tight labor market, baby boomers retiring, legal decisions expanding types of pensionable compensation, the collapse of the housing market and the subsequent economic recession, the amount of unfunded pension liabilities has increased exponentially. In 2000, the unfunded pension liability was $10.8 million. Increased costs coupled with stock market losses and lower than expected investment earnings saw the unfunded pension liability grow to $449 million in 2014.

Recognizing that Sonoma County's pension obligations were on a precarious course, the Sonoma County Board of Supervisors appointed an Ad Hoc Committee on Pension Reform to study the County's pension situation and make recommendations to the Board of Supervisors. In November of 2011, the Ad Hoc Committee issued its report to the Board of Supervisors who then approved the pension reform recommendations. The report identified three goals with suggested strategies to achieve these goals: (1) contain costs, (2) maintain market competitiveness and workforce stability, and (3) increase accountability and transparency. The Grand Jury focused its attention on the first goal, asking the question: Has the County put policies in place to contain pension costs and reduce unfunded liabilities to ensure future funding?

Sonoma County's Retirement System and its Employees

"... to ensure that the County has a set of policies to guide future decisions which reflect the County's needs as a provider of public services, a large employer and an organization that values and respects its workforce." -- Sonoma County Board of Supervisors, Ad Hoc Committee on Pension Reform, 2011

A pension system, in its simplest form, is the manner by which an employer provides a group of its employees with post-retirement financial security through periodic payments after the employee retires. Responsible planning requires that these expenses be funded as they are earned so that the funds will be available when needed.

The County's retirement system is shaped by State legal requirements, various court rulings, and retirement benefits negotiated in good faith between the County and its fourteen employee bargaining units.

The State of California features over sixty public retirement systems, ranging from smaller city and county employee and teacher retirement plans to one of the largest public pension plans in the United States. According to Article XVI of the California State Constitution, counties can provide pensions by establishing an independent system, operating under the provisions of the County Employees Retirement Law of 1937, known as the 1937 Act, or by contracting with the California Public Employee Retirement System, known as CalPers—an agency of the California executive branch.

Of California's fifty-eight counties, twenty counties, including Sonoma, operate under the 1937 Act. This law defines and governs all provisions of the County's retirement compensation benefits, including the retirement formulas, the conditions under which employees are eligible to retire, calculation of service hours, and the level and limit of employee contributions into the retirement system. Changes to the law's provisions require State legislative action.

One must keep in mind two important points. First, Sonoma County's retirement system is governed solely by the California Employees Retirement Law (1937 Act). Most of the other counties and cities in California (for example, the City of Santa Rosa) are part of CalPers: the California Public Employees Retirement System. Second, many of the reports and statements in the public materials do not make this distinction clear.

On September 12, 2012, the Governor signed into law the California Public Employees' Pension Reform Act of 2013, known as PEPRA. The law's stated goal is to create a more sustainable pension system by reducing employer liability and increasing employee contributions toward their pension benefits. This major change in pension law applies to all public employees, in all public retirement systems in the State.

The Sonoma County Employees' Retirement Association (Retirement Association) was established by the County of Sonoma to provide retirement, disability, death, and survivor benefits for its members. The Retirement Association operates under the authority of the 1937 Act and PEPRA and is governed by a nine-member Board. The Board, along with its specialized staff, is responsible for administering the program and investing members' contributed funds. Members of the Board serve in a fiduciary capacity in discharging their duties with respect to the Retirement Association and the pension trust fund.

The 1937 Act authorizes the Board of the Retirement Association with exclusive control over the Trust's investment portfolio. The assets are managed by external professional investment firms. The investment staff and the Board implement investment policies and long-term investment strategies, reflective of variations in the stock market returns on investments over five (13.2 percent), ten (7.2 percent) and twenty (8.0 percent) year periods. For the year 2008, investment return saw a staggering loss of 30 percent. Presently, the Retirement Association maintains a diversified investment portfolio and asset allocation that is structured to meet long-term funding requirements. Examples of asset allocation include: US equities, international equities, global equities, fixed income, and real estate. For the year ended December 31, 2013, the Retirement Association portfolio experienced a return of 19.9 percent.

All County employees are members of the Retirement Association, which is run as an independent defined benefit retirement plan. There are more retirees and beneficiaries currently receiving benefits (4,394) than current active members (3,383). The retired employee receives a set income every month, for the rest of his or her life.

The Retirement Association requires full funding in reserve before granting a cost of living adjustment (COLA) to retirees. Low program reserves and the continuing impact of investment losses have prevented the Board from recommending a COLA. Sonoma County has seen a 13 percent increase in the cost of living since the last COLA in 2008.

As of December 31, 2013, the distribution of payments was:

- Less than $10,000/year: 18.70 percent
- $10,000 to $19,999/year: 23.42 percent
- $20,000 to $49,999/year: 39.41 percent
- $50,000 to $99,999/year: 15.68 percent
- Over $100,000/year: 2.73 percent

Some of the pension benefits are determined by laws in place prior to the employee's retirement and may reflect increases as a result of a statewide class action lawsuit settlement to which the County was a party in early 2000, known as the Ventura Decision.

Funding of the Retirement System

"Sonoma County has not been alone in seeing cost growth." -- Sonoma County Board of Supervisors, Ad Hoc Committee on Pension Reform, 2011

Contribution rates to the retirement system by the employee and employer are set by the Retirement Association within 1937 Act guidelines, and the by-laws and procedures adopted by the Board. The rate is based on the future requirements forecast by actuaries (a group of mathematicians and statisticians). The yearly contribution is based on a number of assumptions. These include payroll growth, mortality rates, expected new retirees and estimated earnings from the trust fund's investments over time, known as the Discount Rate. Sixty percent or more of the Retirement Association's income comes from earnings on the trust fund investments. The forecasts are continuously updated as actual data becomes available and new predictions are made. The actuaries determine the overall cost if everyone retired today. This is the actuarial accrued liability (AAL).

Any shortage to that amount is the unfunded actuarial accrued liability (UAAL). The unfunded liability amount shows any shortage should all earned pension benefits come due and payable immediately. It is important to understand that this event will not actually happen. Throughout their work-life, many employees have earned benefits and will be employed for many years. In addition, the retirement benefits are not paid in a lump sum, but in monthly increments. In the County, as a result of labor negotiations, both the employer and the employees have contributed to reducing the unfunded liability.

Pension bonds were issued in prior years to fund the County's unfunded pension liability. A pension obligation bond, known as a POB, aims to use borrowed funds to generate a higher rate of return than the cost of the debt. The combined outstanding balance of the County's two remaining pension obligation bonds is $459.2 million. The County's financial staff strongly asserts there is no intention to issue any additional pension bonds.

While contribution rates by an employee are set only by the Retirement Association, the County's contribution can be increased by action of the Board of Supervisors. The actuaries use a five year smoothing model to level out the peaks and valleys of investment losses and gains in the Retirement Association's trust fund, stabilizing contribution rates.

The County's portion of funding is called the Annual Required Contribution (ARC), a very sophisticated estimate of the County's yearly pension cost. This required contribution from the County to the Retirement Association adds to the trust fund's assets, with a portion of that contribution designated to reduce the projected shortage described as unfunded liability.

The Retirement Association's evaluation as of December 31, 2013 (the most recent date available) found that the pension trust fund is approximately 82 percent funded. This measuring system is based on the concept that benefits are fully funded when the employee retires, unlike Social Security where today's workers are paying for current retirees' benefits. A 100 percent funding ratio would indicate that there are sufficient funds and revenues to pay all current and future obligations and ensure long term stability and preclude negative impact upon the County budget and services.

Because of the nationwide concern over the difficulties of comparing and assessing pension plans, the Federal Government Accounting Standards Board (GASB) issued new rules for government employers. The new rules (GASB Statements 67 and 68) provide for more transparent disclosure of information to shed light on often severe underfunding of public pension plans and are to be phased in over two years. The County's latest financial statement notes this significant upcoming change to their accounting policies effective for the County's fiscal year ending June 30, 2015, adding, "Management has not determined the effect of this statement." The actual results of the changes will not be available until the 2015 year end statement is completed. However, the County's financial staff preliminarily estimate a positive impact from the changing economy and the new GASB regulations on the real value of pension assets resulting in a corresponding decrease in unfunded pension liabilities.

Changing the Landscape: California's Pension Reform Law of 2013

"A new tier will provide an opportunity to produce long term savings..." -- Sonoma County Board of Supervisors, Ad Hoc Committee on Pension Reform, 2011

The County's 2011 Ad Hoc report outlined strategic goals to contain future pension costs, many of which became law from State legislative action known as PEPRA: the California Public Employee's Pension Reform Act of 2013. PEPRA is intended to make public retirement systems more viable by increasing employee contributions and lowering the employer's costs. This State law created a new, lower benefit formula (tier) to be used for calculating pension benefits for all new employees hired after January 1, 2013. There are currently two employee tiers— Plan A or Legacy employees, and Plan B employees hired after January 2013. The number of active employees in each tier changes frequently with turnover. The savings to pension costs will build slowly but consistently over the coming years as Legacy employees retire and more of the active workforce is covered by the new benefit formula plans.

The Retirement Association set forth policies to implement PEPRA, the new California law. Many of the policies to control and maintain pension costs represent not only changes made by this law, but in addition, good-faith bargaining with County employees. The practice of inflating the final year's compensation to increase pension benefits, commonly called "Spiking" was essentially eliminated. Cash-outs (also called buy-backs) of unused vacation, sick leave, or compensatory time-off are limited to what is earned and payable in one year. Any banked hours above this amount are not included. This change alone accounted for a $33 million savings to the County in Fiscal Year 2013-2014. The new law also capped total compensation for pension calculation to the total of compensation subject to Social Security taxation: $118,500 for 2015.

PEPRA's greatest impact rests with employees newly hired after January 1, 2013, named Plan B members. In general, PEPRA requires reduced benefit formulas for these employees (general employees, with a comparable change for safety employees) of 2 percent per year of service at age sixty-two and 2.5 percent per year of service at age sixty-seven. These pension benefits are based on an average of the final thirty-six months of pensionable salary. This is in dramatic contrast to current Legacy Plan A employees who are eligible for 3 percent per year of service at age sixty (general employees) based on their most recent twelve month pensionable salary.

The County's Pension System in 2015

"There is no simple answer, silver bullet or overnight solution. A solution must be achieved, one based on the County's values, borne through commitment and achieved through collaboration."
-- Sonoma County Board of Supervisors, Ad Hoc Committee on Pension Reform, 2011

The County Administrator's Office issued its first Pension Reform Update (Update) in December 2014 and presented the report to the Board of Supervisors on January 27, 2015. The Update reviews the progress made and recommends next steps in continuing the effort to address the unsustainable course that Sonoma County pension costs had been on throughout the prior decade.

The Update addresses goals and strategies, all previously outlined in the 2011 Ad Hoc Report. Achievements toward meeting the goal of containing pension costs include:

- Two tier retirement benefits
- Elimination of Spiking
- Limiting cash-outs or buy-backs of accrued sick and annual leave
- Final pensionable compensation formulas increased from one year to three
- Total pension compensation caps
- Contribution by all employees toward unfunded pension liability.

No present discussion of the County's pension system is complete without taking into account the cost of post-retirement healthcare. The County is the plan sponsor of a postemployment healthcare plan. The County pays into a trust, accumulating resources to fund future benefit payments in a cost-sharing plan with the retiree. Retirees and the County share the cost of the monthly premium for medical coverage. In 2009 the County began to phase in a contribution maximum paid by the County toward the cost of the plan. That phasing is now complete and capped at a $500 per month maximum contribution, which effectively capped the future liability for these costs.

For the fiscal year ended June 30, 2014, the County contributed $26 million to the health trust. The County's financial report demonstrates an increase to the health fund contribution, with a corresponding increase to future health care obligations, based on actuarial valuations of over $300 million of unfunded liabilities in the health trust.

The discussion of pension reform in 2015 also requires mention of background events that impacted this last decade. In 2002, the County agreed to provide retroactive pension increases. The County's decision, based on a legal settlement and labor negotiations, was made with the understanding that employees would bear the full cost of the enhanced retroactive benefit over the course of twenty years with an additional 3 percent contribution to the pension fund. However, initial estimates, stock market volatility, and accelerated retirements caused an unexpected increased cost to the County as more and more employees started to draw their pensions, instead of contributing to them. In the following years, the County negotiated agreements with bargaining units to partially pay a percentage of this employee contribution.

In the course of recent labor negotiations, the County and its employees agreed to eliminate any County contribution toward the employee's share of retirement costs. In addition, both Legacy Plan A and new Plan B employees agreed to continue a 3 percent pay contribution toward the County's unfunded liability associated with the previous retroactive pension increases.

Additional Strategies to Fund Pension Liabilities by Fiscal Year 2023-2024

"The County is committed to working with labor organizations to seek mutually acceptable solutions to reducing the County's pension costs." -- Sonoma County Board of Supervisors, Ad Hoc Committee on Pension Reform, 2011

Current employees accrue retirement benefits each year. This is the "Normal" or expected cost and is shared by the employee and the County. Unexpected costs are the adjustments to projections and the fluctuations in investment earnings. These costs are borne by the County alone and may add to or reduce (if there is a gain) the unfunded liability. One method to contain costs going forward is to share the risk for unexpected costs. This strategy would require greater contributions from the employees over time and will require coordination with the County Administrator, Human Resources, employee bargaining units and the Retirement Association.

In January of 2015, the Board of Supervisors approved an additional $3.5 million payment to the current projected unfunded pension liability, continuing the County's effort to strengthen fiscal management. This payment, as well as recommended additional payments, is expected to save future financing costs and ultimately pay down the unfunded pension liabilities. In addition, the Board of Supervisors approved a temporary raise in the County's contribution rates to the retirement system for January through June of this year.

The impact of these new County generated policies has been projected by the actuaries to achieve an unfunded liability (UAAL) of zero in the mid 2020's. Management at the Retirement Association believe it will happen somewhat sooner. Both the County and the Retirement Association offer the reminder that projections provide an educated guess at future events. The County must continue to monitor progress and adjustments need to be made in a timely fashion when unexpected factors enter into the pension equation.

Determining the Health of the Pension System

"The County should proceed, based on the commitment to do what is right for all we serve and all who serve." -- Sonoma County Board of Supervisors, Ad Hoc Committee on Pension Reform, 2011

In light of the Ad Hoc report of 2011, the Update this year, and interviews from sources within and without the County, the Grand Jury's inquiry leads to the additional question: what measurement should be used to determine whether the County can meet its pension obligations in the future? That answer seems to be the subject of much debate.

The 2011 Ad Hoc report stated the goal to reduce pension costs to 10 percent of total compensation (salary and benefits) within ten years, with an ultimate target date of Fiscal Year 2023-2024. In 2011, pension costs were 19 percent of total compensation and expected to grow. This year's Update Report altered the previous measurement by adding an additional financial element to the calculation; prior to 2014, the yearly costs associated with payments toward the pension obligation bonds were not included in the ratio.

The County's 2015 update projects pension costs (salary, benefits, and payment to pension bonds) over the next ten years to be about one percent over the previous 10 percent goal. While over the target goal, it is on course to contain and reduce pension costs, rather than increasing costs to further unsustainable levels. While the forecast is encouraging, caution must be exercised until a trend is established.

The County's major cost is employee salaries. While the County can reduce the number of employees, it cannot reduce its contractual obligations such as pension obligations for past services. Making significant reductions in pension costs over time can make more funds available for County services, such as maintaining roads, parks and recreation, health and human services, or cultural activities. No matter what the measurement, it is clear that pension contributions are projected annually by the Retirement Association, the County is paying 100 percent of their actuarially required contribution (ARC), and the County and the Retirement Association policies have a clear goal of reaching full funding of pension liabilities for current and future retirees.

Findings

F1. The information related to pensions is daunting and difficult for the lay person to understand.

F2. The County, its employees, and retirees are well served by the Retirement Association.

F3. Sonoma County, with the assistance of new State laws and good-faith bargaining with employees, has made strides towards reducing unfunded pension liabilities.

F4. Periodic comprehensive update reports on pension reform are valuable tools for gauging the progress of reducing the unfunded liability.

F5. A standard method of measuring performance would help citizens gauge the progress of County's goal of pension reform and funding pension liabilities.

F6. Including annual payments toward the County's pension obligation bonds is a more accurate measurement of the financial health of the pension system.

F7. Actuarial predictions cannot anticipate extreme market volatility, which may result in investment losses and increased unfunded liabilities.

Recommendations

The Sonoma County Civil Grand Jury recommends that:

R1. The Office of the County Administrator publish yearly a Pension Reform Update.

R2. The Office of the County Administrator continue to include the annual payment toward pension obligation bonds in its measurement of the County's ability to meet its future pension obligations.

Request For Responses

Pursuant to Penal Code section 933.05, the Grand Jury requests responses as follows:

From the following governing bodies:

- R1. and R2. - Sonoma County Board of Supervisors

Suggested Reading

The California Employees Retirement Law of 1937

The Public Employees Pension Reform Act of 2013

Sonoma County Board of Supervisors Ad Hoc Commission On Pension Reform Report, November 3, 2011

Sonoma County Board of Supervisors Pension Reform Update, December 2014

The 2014 Pension Reform Update presented to the Board of Supervisors on January 27, 2015 at www.sonomaCounty.ca.gov/Board-of-Supervisors/Meeting-Agendas-Minutes-and-Videos

Agendas, minutes, and resolutions of the Sonoma County Board of Supervisors

Agendas, minutes, and resolutions of the Retirement Board of the Sonoma County Employees Retirement Association

County of Sonoma Citizen's Report, Fiscal Year 2013-14 prepared by the County of Sonoma Auditor-Controller-Treasurer-Tax Collector

Comprehensive Annual Financial Report For the year ended December 31, 2013 prepared by the Sonoma County Employee's Retirement Association, A Pension Trust Fund for the County of Sonoma

Letters and actuarial studies from Segal Consulting (actuaries) to the Sonoma County Employees Retirement Association

Letters and actuarial studies from Bartel Associates, Inc. (actuaries) to the Sonoma County Administrator's Office

Comprehensive Annual Financial Report (CAFR) of the County of Sonoma for the fiscal year ended June 30, 2014

Reports and Articles by Ken Churchill at New Sonoma - www.newsonoma.org

Reports and Articles by the Sonoma County Taxpayer's Association - www.sonomacountytaxpayers.org

Sonoma County Civil Grand Jury Report, "Sonoma County Pension Increases in 2002 - Legal or Not?" dated June 28, 2012

Sonoma County Civil Grand Jury Report 2005-2006, "The Impact of Yesterday's Promises" dated June 26, 2007

Grand Jury Chapter Quotations from Sonoma County Board of Supervisors Ad Hoc Commission On Pension Reform, November 3, 2011

A Full Bibliography is Available at: Sonoma.courts.ca.gov

Reports issued by the Grand Jury do not identify individuals interviewed. Penal Code section 929 requires that reports of the Grand Jury not contain the name of any person or facts leading to the identity of any person who provides information to the Grand Jury.

Consider Becoming a Grand Juror

Grand jury service is a tremendously rewarding experience, providing a meaningful and independent say in local government. Sonoma County grand jurors play a distinct and vitally important role in government. They have broad oversight powers to investigate and influence positive change within the County, its cities, special districts and the many organizations that collectively constitute our local government.

The Civil Grand Jury is made up of a diverse cross section of 19 County residents chosen for a one year term. They decide what to investigate and how to comment on their findings. They are self-starting and self-directed. They are bound by a common interest in promoting transparency and efficiency in government. Special training on grand jury investigative processes is provided to ensure that their work is conducted in a fair and objective manner, consistent with the provisions of the California penal code. The experience provides an enhanced understanding of local government and what it takes to make our community such a desirable place to live.

Examples of past Sonoma County Grand Jury reports can be viewed on-line by clicking the link below. For further information and insight into the role that grand juries provide in California, please see the California Grand Jury Association's web site at **www.cgja.org**

Application forms to become a Sonoma County Civil Grand Juror are available online at Sonoma.courts.ca.gov (click on the Grand Jury tab at the top of the page). You may also obtain an application at the Administrative Office of the Sonoma County Courts, 600 Administration Drive, Room 106, Santa Rosa, CA 95403, phone 707-521-6501. By law, a Grand Juror must be a U.S. citizen 18 years of age or older; a resident of Sonoma County for at least one year; have sufficient knowledge of the English language to participate in meetings, take notes, and write reports; and have no convictions for malfeasance in office, any felony, or any other high crime. In addition to meeting the statutory requirements, a Grand Juror should be able to fulfill the time commitment required to be an effective Grand Juror, be in good health, have the ability to work with others and be tolerant of their views, have a genuine interest in community affairs, and have investigative and computer skills. Applications can be submitted throughout the year. Each spring, judges of the Superior Court interview prospective Grand Jurors from the applicant pool. Several members of the previous year's Grand Jury may be selected to serve a second year in order to provide continuity.

Sonoma.courts.ca.gov