

The GFOA advises public agencies to proceed with caution when contemplating borrowing with POBs. In a GFOA Advisory on the topic:

The Government Finance Officers Association (GFOA) recommends that State and local governments use caution when issuing pension obligation bonds. If a government chooses to issue pension obligation bonds, they should ensure they are legally authorized to issue these bonds and that other legal or statutory requirements governing the pension fund are not violated. Furthermore, the issuance of the pension obligation bonds should not become a substitution for prudent funding of pension plans . . . .

Even if the analysis indicates that financial benefits appear to outweigh the risks, governments should evaluate other issues that may arise if the bonds are issued, such as the loss of flexibility in difficult economic times because of the need to make timely payments of principal and interest in order not to default on the bonds, potential misunderstanding by policy makers regarding the possibility that an unfunded liability may reappear in the future, and potential pressures for additional benefits by government employees if plans are fully funded and government's contribution as a percentage of payroll has declined relative to neighboring jurisdictions.

The GFOA further suggests that there are certain other considerations, including making sure that the structure of the bond does not defer any principal payments, understanding the implications on the jurisdictions' debt rating, and impacts on cash flow as debt obligations become due.<sup>25</sup> Other professional organizations, such as the Center for State & Local Government Excellence, issue similar cautions and makes the further observation that, "governments are more likely to issue POBs if they are in financial stress and already have substantial debt outstanding and the plan represents a substantial obligation to the government . . . In short, the data shows that the governments that could issue a POB generally have not, while those that should not issue a POB have done so."<sup>26</sup>

## METHODS AND PROCEDURES

This Report provides a review of current literature and commentary on public pensions conducted in conjunction with plan-specific data analysis and field work. Phase I, the results of which are summarized in this Section, involved the collection of pension plan information for each of the public sector jurisdictions within LAC. Typically, this involved obtaining 2 key documents: the Comprehensive Annual Financial Report (CAFR) for the jurisdiction; and, the financial statements, actuarial valuation or annual report for each of the plans. A set of matrices (included as Appendices C.1 to C.9) present the data that was available for the 277 identified plans, and summary Exhibits included in this section tabulate an overview of the basic attributes. Appendix D presents an alphabetical list of all jurisdictions with the C matrices on which their respective pension(s) attributes are cataloged.

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<sup>25</sup> GFOA of the US & Canada, *Advisory: Evaluating the Use of Pension Obligation Bonds (1997 and 2005)*

<sup>26</sup> January 2010, Center for State & Local Government Excellence, *Issue Brief, Pension Obligation Bonds: Financial Crisis Exposes Risks*

## FINDINGS

1. Many of the Little Hoover Commission recommendations related to modifications to pension benefit formulas, establishing hybrid defined benefit and defined contribution models, capping maximum salaries for determining final average salary or amounts of pensions that can be earned have merit.
2. Although several recommendations made by the Stanford Institute for Public Policy Research have merit, the central theme of reducing the assumed investment rate of return to “risk free” levels is overly conservative and could expose taxpayers to unnecessary additional costs.
3. Recommendations made by the Public Employee Post-Employment Benefits Commission are generally sound, particularly those related to establishing strong prefunding policies, requiring minimum employer contribution levels, and establishing “tax-advantaged” supplemental savings plans; e.g., defined contribution plans, in lieu of enhanced benefits.
4. Agreements for employers to pick up the employee contribution to retirement or OPEB plans are not considered vested retirement benefits and can be modified without violating the pension guarantees protected by contract law. For the jurisdictions in LA County whose pension plans are administered through CalPERS, employee contributions are set at 7% and 9% of salaries for Miscellaneous and Safety Members, respectively. For 84% of CalPERS member agencies in LAC, employers pick up some or all of this employee contribution. Eliminating this pick up by transfer of responsibility for employee contributions back to the employee could save jurisdictions between 7% and 9% of salaries. This change could be implemented within a 3-year time period.
5. Longer term savings could be achieved by modifying some pension benefit provisions for new employees. These include: changing the basic benefit formulas to levels that existed prior to 2001 and restricting or eliminating service credit enhancement provisions, such as sick leave and “air time” service credit.
6. Regular review of actuarial assumptions facilitates keeping pension plans focused on prevailing investment climates, actuarial trends and other factors that influence pension assets, liabilities and sustainability. For example, the pension plan administrators of both CalPERS and LACERA review actuarial assumptions annually with their respective governing boards and evaluate them more rigorously on at least a triennial basis.
7. The risk of “pension spiking” could be reduced substantially by converting to a 36-month or longer basis for calculating Final Average Salary for at least 85% of CalPERS member agencies in LAC.
8. Besides regular salary, some jurisdictions allow other categories of compensation to be included in the calculation of pensionable salaries, including sick leave buy-back and certain categories of special pay and bonuses. This results in higher pension benefits and costs.
9. Hybrid defined benefit and defined contribution pension plans would more equitably share the risk of investment losses between the employer and employee. A jurisdiction’s ability to modify pension provisions for retirees, existing employees or future employees varies by group and may be controlled by statute and case law.

10. A small percentage of LAC CalPERS member agencies (13.2%) have decided to adopt post retirement COLA provisions that have a potential to increase pension system costs at rates that exceed inflation, effectively increasing the present value of retiree compensation over time.
11. The actuarial assumed rate of return using both the 10-year and a 15-year smoothing methodologies cause swings in actual investment gains and losses to moderate actuarial investment performance, and thus the actuarial value of assets. These methodologies ensure that jurisdictions contribute an amount each year that is closer to the normal contribution rate.
12. The overwhelming majority of jurisdictions in LAC are not prefunding retiree health benefits or contributing the Annual Required Contribution determined by actuaries, deciding instead to fund these benefits on a pay-as-you-go basis. This practice is inconsistent with recommendations by actuaries and the Government Finance Officers Association. In addition, this is a costly policy that reduces the jurisdictions' capacity to discount contribution rates and, instead, passes full costs onto the taxpayer.
13. Opportunities may exist for some jurisdictions to cap benefit amounts, require copayments from retirees or implement other changes that would reduce costs for jurisdictions providing retiree health benefits to current retirees in the short term. However, each instance would need to be assessed by the jurisdictions' legal counsel to ensure that such modifications would not be a violation of contract law.
14. It is unlikely that retiree health benefits can be modified for current retirees and employees. However, jurisdictions could change the benefit offered to new hires by establishing benefit caps or defined contribution components, establishing improved cost sharing agreements with employees and modifying plan design to more effectively couple retiree health benefits with Medicare. Such change may involve negotiations with collective bargaining groups.
15. Pension Obligation Bonds are not used extensively by Los Angeles County jurisdictions. However, there are indications that some jurisdictions are considering POBs to fund UAAL that developed during the recent economic downturn. The GFOA and other experts recommend that jurisdictions proceed cautiously when considering POB borrowings by:
  - a. Thoroughly evaluating financial benefits and risks
  - b. Fully recognizing "other issues" that may arise if the bonds are issued such as:
    - i. The loss of flexibility in difficult economic times because of the need to make timely payments of principal and interest in order to not default on the bonds
    - ii. Potential misunderstanding by policy makers regarding the possibility that an unfunded liability may recur in the future
    - iii. Potential pressures for additional benefits by government employees if plans are fully funded and government's contribution as a percentage of payroll has declined relative to neighboring jurisdictions

## **PHASE II: SECTION 1**

### **LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION**

#### **SUMMARY**

The Los Angeles County Employees Retirement Association (LACERA) administers the pension system for the County of Los Angeles, acts as the trustee of contributions that have been made by the County and plan members, and invests assets in a manner that attempts to moderate risk and maximize returns. LACERA provides advice and counsel to County managers on the financial impact of proposed changes to the County's retirement system, and are partners with the County on benefit design, funding strategy and other aspects of pension system management.

Overall, LACERA is well run and effective at fulfilling its responsibilities, and the County has done a good job at moderating pension costs. However, LACERA could explore the benefits of changes to actuarial methodologies used to smooth investment returns and the County could, with input from LACERA, focus on discussions with employee bargaining groups to redesign benefits, including exploring benefit caps and establishing defined contribution alternatives; examining opportunities for cost reductions from modifying certain provisions that create opportunities for pension spiking; and consider policy changes to ensure the pre-funding of OPEB benefits by increasing annual contributions and narrowing the allowed uses of the County Contribution Credit Reserve.

#### **PURPOSE**

The Los Angeles County (LAC) and LACERA were chosen by the Civil Grand Jury (CGJ) for in-depth review based on its status as the largest plan in the region and relatively high dollar amount of liability. LACERA also has a better than average funded ratio and multiple plan tiers, as well as the County's substantial pension obligation bond debt and retiree health benefit unfunded liability.

#### **BACKGROUND**

LAC offers pension benefits to its employees through the LACERA. In addition, LACERA administers a retiree health benefits program for eligible retirees. As measured by total assets, LACERA is the fourth largest public pension plan in California behind CalPERS, the California State Teachers' Retirement System and the University of California Retirement Plan, and is the largest county retirement system in the United States. The combined LACERA funds hold assets of \$39 billion and serve more than 160,000 members.

Exhibit 12 provides a summary profile of the Plan membership, benefit structure, actuarial assumptions and financial status, as of the time of this Report. Because of the multiple tiers offered under the LACERA Plan a more complete profile of pension benefits provided to active LAC employees is included in Exhibit 21 (located at the end of this section).

## GOVERNANCE

LACERA was established on January 1, 1938 in accordance with the enactment of the California state law known as the County Employees Retirement Law of 1937 (CERL), which set forth the policies and regulations governing County retirement systems. LACERA is governed by the California Constitution, the CERL, and the bylaws, procedures, and policies adopted by LACERA's Boards of Retirement and Investments. The LAC Board of Supervisors may also adopt resolutions as permitted by CERL, which may affect the benefits of LACERA members.

The Board of Retirement is responsible for the administration of the retirement system, the retiree health care program, and the review and processing of disability retirement applications. The Board of Investments is responsible for establishing LACERA's investment policy and objectives as well as exercising authority and control over the investment management of the fund. Each board is composed of 9 members who are selected by a combination of appointment by the Board of Supervisors and election by plan members.<sup>27</sup>

## MEMBERSHIP AND ACTUARIAL VALUATION

As of June, 30, 2010, the date of LACERA's most recent actuarial valuation, there were a total of 160,604 members in the system, 54,196 of whom were retired. LACERA's membership includes both "General" and "Safety" employees. Safety membership includes law enforcement (Sheriff uniformed staff and District Attorney investigators), firefighter, forester, and lifeguard classifications. General membership is applicable to all other occupational classifications. Of the 160,604 members, 136,469 are General members; and 24,135 are Safety members. Exhibit 12 and Exhibit 13 show the distribution of the system's membership by the broad categories of Active, Retired and Deferred.<sup>28</sup>

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<sup>27</sup> The County Treasurer and Tax Collector are required by law to serve on both boards as ex-officio members. The Retirement Board also includes two alternates, one of which is elected by the active Safety membership and the other by the Retired membership.

<sup>28</sup> Deferred are vested employees who have left employment with the County but have not yet retired.

Exhibit 12. LACERA Profile<sup>29</sup>

MEMBERSHIP		PLAN BENEFITS AND OPTIONS	
Active Members	94,410	(See Detailed Comparison of Plan Provisions Within)	
Retired Members	54,196	Normal Retirement Age	Varies by Plan
Disabled/Retired Members	8,990	Benefit Formula	(Sal x Yrs)/ Plan Fraction
Beneficiaries	7,808	Lump-Sum Death Benefit	Varies by Plan
Inactive Members	11,998	Survivor Benefit	Varies by Plan
Total Annuitants <sup>†</sup>	160,604	Retiree Health	Defined Benefit
		Deferred Compensation	No
ACTUARIAL		FINANCIAL	
<i>Investment/Discount Rate</i>		<i>Pension Fund</i>	
Assumed Actuarial Rate	7.75%	Actuarial Accrued Liability	\$ 46,646,838,000
One Year Actual Return (FY 2010)	11.60%	Unfunded Actuarial Accrued Liability	\$ 7,807,446,000
		Funded Status	83.3%
<i>Methods</i>		<i>Retiree Health Fund</i>	
Investment Smoothing	5 Years	Actuarial Accrued Liability	\$ 24,031,000
Investment Corridor	None	Unfunded Actuarial Accrued Liability	\$ 24,031,000
Amortization of Unfunded Liability	30	Funded Status	0.0%
<i>Contributions</i>		<i>Pension Obligation Bonds</i>	
Employer Contribution	12.9%	Principal Balance	\$ 345,913,000
Employee Contribution Pick-Up	No	Projected Interest Expense	\$ 253,644,000
Total Contribution	12.9%	Total Indebtedness	\$ 599,557,000

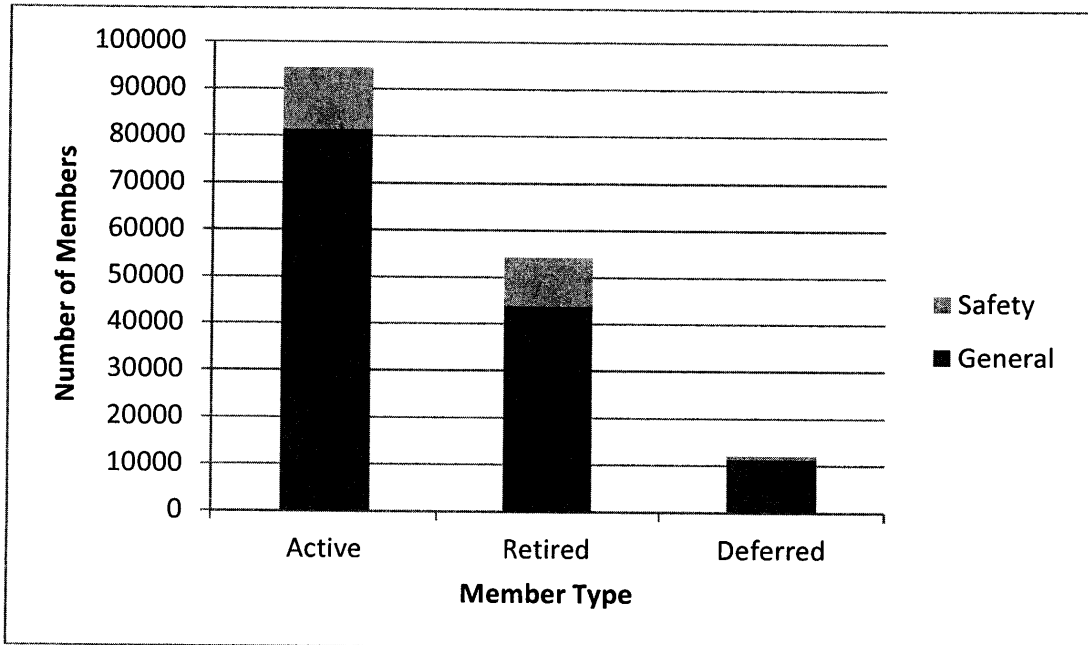
SOURCE: LAC COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE YEAR ENDED JUNE 30, 2010 AND THE LAC EMPLOYEES RETIREMENT ASSOCIATION ANNUAL REPORT FOR THE YEAR ENDED JUNE 30, 2010.

1. Declining Yet Above Average Funded Ratio

As of June 30, 2010, the date of LACERA's most recent actuarial valuation, the plan's actuarial accrued liability (AAL) was approximately \$46.7 billion; and its actuarial value of assets (AVA) was approximately \$38.8 billion, resulting in an unfunded actuarial accrued liability (UAAL) of approximately \$7.8 billion and a funded status of 83.3%. As shown in Exhibit 14, over the past 3 fiscal years, both the total AAL and the UAAL have grown, resulting in a pattern of declining funded ratio:

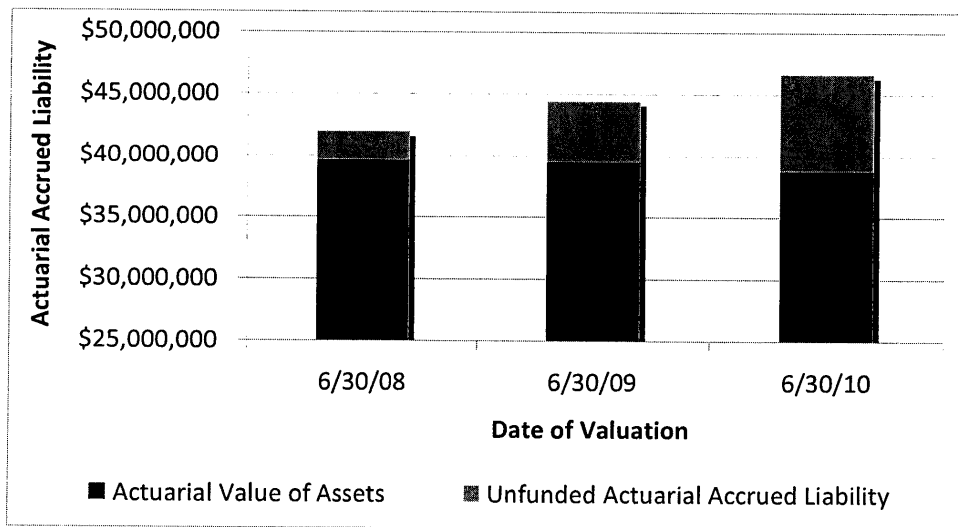
<sup>29</sup> In addition to serving LAC, LACERA provides retirement benefit services to the LAC Superior Court and to four outside agencies: Little Lake Cemetery District, Local Agency Formation Commission, LAC Office of Education, and South Coast Air Quality Management District.

Exhibit 13. LACERA Membership by Type as of June 30, 2010



Source: LAC Employees Retirement Association Annual Report for the Year Ended June 30, 2010.

Exhibit 14. LACERA Actuarial Accrued Liability 3-Year Trend



Source: LAC Employees Retirement Association Annual Report for the Year Ended June 30, 2010.

The pattern of declining funded ratio is driven in part by the market losses of recent years and, as discussed in the actuarial assumptions section, LACERA's choice to smooth, or account for, its losses over a relatively short 5-year period. In 2009, the Board of Investments adopted a new funding policy which, among other things, changed

the investment smoothing period from 3 to 5 years effective June 30, 2009. As discussed in Section 1, smoothing policies have a significant effect on funded status and the annual required contribution rate. In this case, LACERA's move from a 3-year to a 5-year smoothing period had the effect of moderating the change in asset losses in the year of the loss and amortizing, or spreading, the effect of that loss over a longer period of time. Additionally, the corresponding increase in the required employer contribution rate established to compensate for the unfunded liability has now been spread over a longer period of time.

Even though the loss of assets and increase in required contribution rate "fell" in a single year under the 5-year policy, it is less than under the previous 3-year policy LACERA is still recognizing the losses across a much shorter period of time than some other public pension plans, principally CalPERS. For the purposes of comparing funded ratios, contribution rates and other factors, it is important to understand LACERA's situation in the context of the assumptions made by other pension systems. CalPERS, for example, uses a 15-year smoothing period, which has the effect of reducing the appearance of loss when compared against systems like LACERA which use a shorter smoothing period. Conversely, as the recovery occurs, LACERA's funded status will improve at a much faster rate than CalPERS (1/5 recognition of actual asset gains for LACERA vs. 1/15 recognition of asset gains by CalPERS).

However, given LACERA's shorter smoothing period, its funded ratio is higher than the average of the CalPERS plans in LAC. As of June 30, 2009, the date of the most recent CalPERS valuation, the average funded ratio for all non-risk pooled CalPERS plans was 85.7%. LACERA's funded ratio as of that date was 88.9%, even though the shorter smoothing period tends to exaggerate losses and gains.

## 2. Assumed Rate of Return is on Par with Most Plans

As discussed in Section 1 of this Report, it is important to evaluate a plan's assumed rate of return on its investments when considering its funded status. In particular, a plan's assumed rate of return is critical in interpreting its funded status since even minor changes in the assumed rate can have a significant effect on the actuarial value of assets and, therefore, the funded status. As of the writing of this report, LACERA's assumed rate of return on investments was 7.75%, net of all expenses, which is consistent with the rate assumed by CalPERS and many other large plans.

According to LACERA staff, the plan's actuarial assumptions, including its assumed rate of return on investments, are reviewed regularly by the Board of Investments. Every 3 years, the actuarial valuation includes a more intensive review of the plan's assumptions, using forecasting prepared by external investment auditors and assessed by the Plan's actuaries. The most recent "triennial valuation year" was 2010. According to LACERA management, the current 7.75% assumed rate of return was analyzed and discussed extensively; and the Board of Investments decided to leave the assumption unchanged.

## PRUDENT "TIERING" OF PLAN BENEFITS

LACERA's stronger than average financial condition reflects, in part, prudent efforts by the County to manage pension costs through benefit design. Since 1977, the LAC has consistently demonstrated efforts toward controlling pension costs. In addition to financial management



approaches described in this Report, strategies have aimed to reduce benefit costs and to increase the proportion of costs shared by employees. By establishing benefit tiers in 1977, the County began to exhibit a collective bargaining culture that many other public jurisdictions have only recently begun to embrace.

Retirement benefits offered by LACERA are “tiered” and based on the date of LACERA membership. In total, since its inception, the County has designed 7 different plans for General and Safety employees: Plans A, B, C, D, and E for General members and Plans A and B for Safety members. Both Plans A/General and A/Safety are now closed to new members, as are Plans B/General and C/General. New General employees have the option of joining either Tier D or Tier E which are distinguished by the contribution requirements for employees. New Safety members are eligible only for B/Safety. The status of each of the plans, including the time period when each plan was open to new members, is shown in Exhibit 15:

Exhibit 15. Status of LACERA Plans

General Plans			Safety Plans		
	Status of Plan	Years Open		Status of Plan	Years Open
A	Closed	1938 – 1977	A	Closed	1938 – 1977
B	Closed	1977	B	Open	1977 – present
C	Closed	1978			
D	Open	1979 – present			
E	Open	1982 – present			

Source: Interviews with LACERA management.

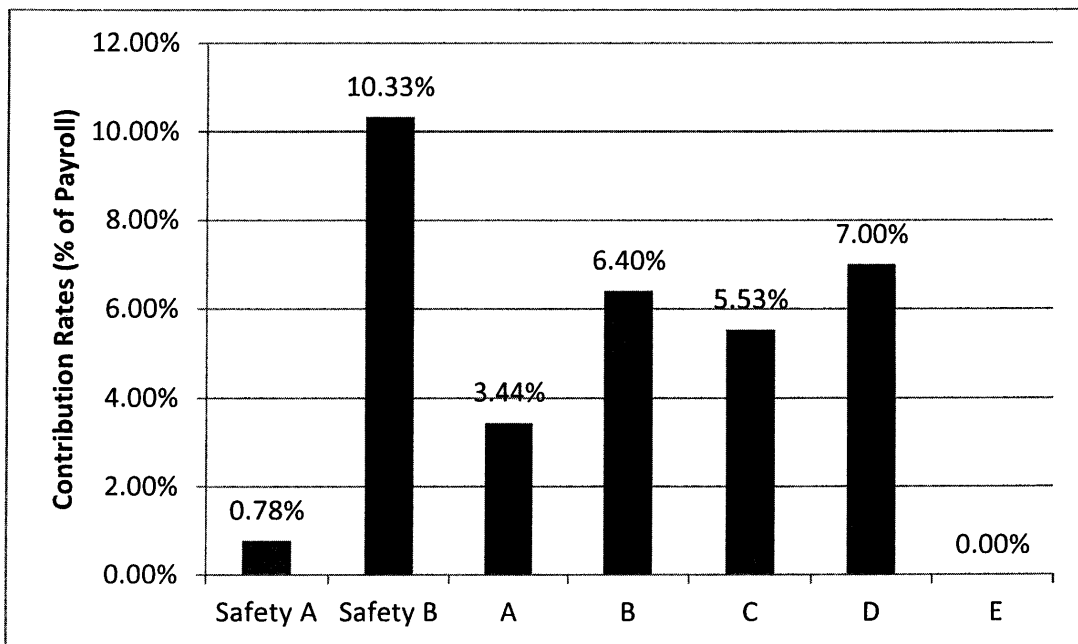
The benefits offered by each new plan have generally been less generous than the benefits offered by previous plans. As described by executive management of both LACERA and County Employee Relations, the movement toward less generous retirement packages has reflected a deliberate effort toward pension reform and controlling pension costs. The provisions of the plans currently available to new employees, Plans D and E for General employees and Plan B for Safety employees, are summarized in Exhibit 21 located at the end of this section.

#### 1. Employee Contribution Rates

While many jurisdictions have agreed to pay the employee’s retirement contribution as part of the collective bargaining process, the LAC continues to require employees to make their own contribution from payroll deductions. Plan E is the only “non-contributory” plan, meaning that the employee does not make contributions to the plan during his or her term of employment. However, upon retirement, Plan E members are entitled to a lower defined benefit, not to exceed 80% of Final Average Salary (FAS). In plans other than Plan E, benefits are capped at 100% of FAS.

The member contribution rates are set at each “triennial valuation.” Since the 2010 actuarial valuation was a triennial valuation, new member contribution rates were determined by the actuary and adopted by the Board. As of June 30, 2010, the average employee contribution rate for all members was 5.75% of payroll. Exhibit 16 shows the rate breakdown by plan.

Exhibit 16. Employee Contribution Rates by Plan as of June 30, 2010



Source: LACERA plan summary documents.

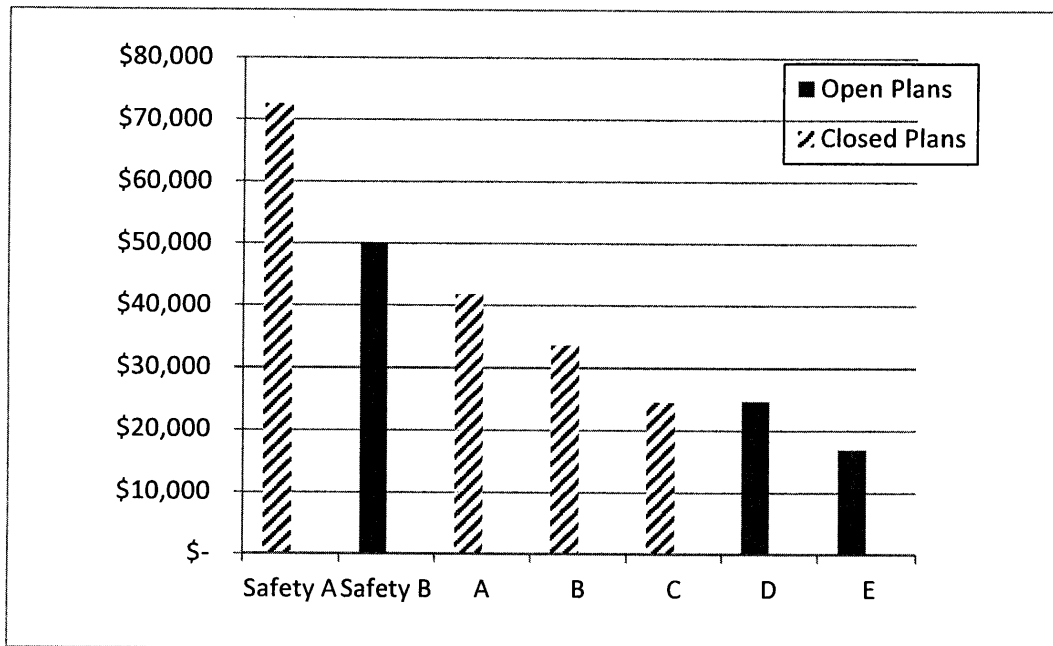
For the General members who choose the contributory plan (Plan D), the contribution rate (7%) is equivalent to that for most Miscellaneous CalPERS plan members. However, as previously noted, most LAC employers who are members of CalPERS contribute the 7% on behalf of their employees in addition to their own employer cost. In that regard, LAC stands out as adhering to a philosophy of shared responsibility to fund pension benefits with the employee.

The County's total required contribution rate is set by the Board of Investments each year based on the recommendations of an actuarial valuation. The total contribution rate is comprised of 2 sub-rates: the normal contribution rate and the rate representing the payment of the amortized unfunded actuarial accrued liability (UAAL). As of June 30, 2010, the normal contribution rate was determined to be 9.84% of payroll, and the payment toward the UAAL was determined to be 6.47% of payroll; yielding a total contribution rate of 16.31%. This represented an increase from the previous fiscal year when the County's rate was determined to be 14.22% of payroll. According to the actuarial report, the 2.09 percentage point increase was primarily due to the recognition of deferred investment losses.

## 2. Pattern of Decreasing Average Annual Retirement Income by Plan

As a result of the County's success at establishing progressively less costly benefit tiers, the average annual retirement income varies among plans. Exhibit 17 shows the average annual retirement income of all 54,196 LACERA retirees as of June 30, 2010. As Exhibit 17 shows, members of the earlier plans, which are now closed, earn a significantly higher retirement income than their counterparts in the more recent plans. In particular, Plan A Safety retirees earned an average of \$72,466 in FY 2010, which was 127% higher than the combined average of the other plans at \$31,902.

Exhibit 17. Average Annual Retirement Income by Plan for Retired LACERA Members

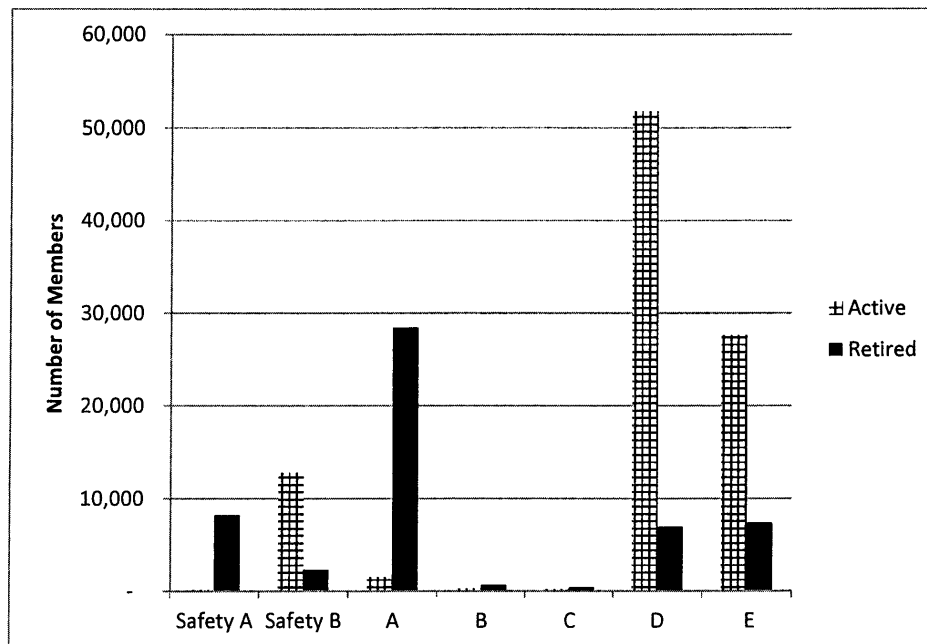


Source: LACERA member database as of June 2010.

While the average retirement incomes for Safety members are higher than the average incomes of members of the General plans, the number of Safety retirees is much smaller than the number of General retirees as shown in Exhibit 18.

Exhibit 18 also shows the distribution of active and retired members by plan, highlighting the fact that the high-cost Plan A Safety members constitute a small portion of active members. The remaining 159 active Plan A Safety members, whose average age is 56, constituted 0.17% of the total active membership.

Exhibit 18. Distribution of All LACERA Members by Plan



Source: LACERA member database as of June 2010.

### 3. Cost of Living Adjustment and Supplemental Targeted Adjustment for Retirees

Cost of living adjustments (COLA) are applied to all retirement allowances (service and disability), optional death allowances, and annual death allowances effective each April 1<sup>st</sup>, based on changes in the Consumer Price Index (CPI). COLAs are capped at either 2% or 3%, even if the CPI exceeds these caps. The various COLA benefits are broken out by plan in Exhibit 19:

Exhibit 19. Cost of Living Adjustments by Plan

Plan	COLA Benefit
A	Maximum 3% increase; Eligible for COLA Accumulation
B, C, D, E	Maximum 2% increase <sup>30</sup> ; Eligible for COLA Accumulation

Source: LACERA plan summary documents.

As shown, plans A through E offer a “COLA Accumulation” provision which allows members to maintain an accumulation of credits for years in which the CPI either

<sup>30</sup> The 2% for Plan E is pro-rated based on service earned after June 4, 2002. “Elective COLA” increases for service earned prior to June 4, 2002 may be purchased by the member.

exceeds 2% or 3% (depending on plan). Those credits may be used in future years to provide COLA increases when the CPI falls below 2% or 3%.

Additionally, the Supplemental Targeted Adjustment for Retirees (STAR) program allows for members (except for Plan E members) who have an accumulation of COLA credits that exceed 20% age point credits to receive a supplemental adjustment to restore retirement allowances to 80% of the purchasing power held by retirees at the time of retirement. Any such adjustments are subject to the availability of STAR's reserve funds. As of June 30, 2010, the reserve amounted to \$614 million. STAR reserve funds may only be spent on STAR program benefits.

In its 2009 funding policy, the Board of Investments chose to include the STAR reserve in the Valuation of Assets, as permitted by the plan's funding policy, even though there is no corresponding liability for future STAR benefits. This accounting method understates the plan's potential liability and, therefore, overstates the strength of its financial position. Since 100% of the STAR reserve must be spent on STAR program liability, except in extreme circumstances, a \$614 million STAR liability should be booked against the full \$614 million STAR asset reserve. According to the actuarial valuation, if the reserve were to be excluded from the Valuation of Assets, or have a liability booked against the full amount of the asset reserve, the unfunded actuarial accrued liability would increase, the 2010 required employer contribution rate would increase by 0.52 percentage points to 16.83%, and the Funded Ratio would decrease by 1.4 percentage points to 81.9%.

#### 4. Computation of Final Average Salary

Because current employees are vested in the pension benefits in place during their period of employment, there is no opportunity to change key benefit methodological provisions for existing personnel. However, collective bargaining agreements could be changed for new employees, which was the approach that the County took in the past when it created the multiple plans for General and Safety employees over the years.

One provision that can affect the amount of pension that employees receive is the basis for computing the FAS upon which the pension will be based. When it is based on a shorter period of 12 months, employees can receive a lifetime of pension benefits that are based on a very short period of time during their careers. To prevent "pension spiking" from occurring, some jurisdictions establish a 36-month timeframe for calculating the FAS, which reduces the opportunity for spiking to occur.

Of the 3 open plans in the County, Safety Plan B and General Plan D base the FAS on the final 12 months of employment. General Plan E, which is the non-contributory plan that caps retirements at 80% of final salary, is based on a 36 month FAS period. A recent memo from the LAC Chief Executive Officer to the Board of Supervisors estimates that implementing a 36 month period for these 2 plans could potentially save the County over \$100 million annually as the newly hired employees retire, and eventually reduce the County's pension obligation by \$2.3 billion<sup>31</sup>. Because this is a long-term strategy, the County would not realize significant savings for many years. However, such a change is consistent with the County's approach to managing its pension system costs during the past 2 decades.

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<sup>31</sup> "Report on Options to Reform the County Pension System," from William T. Fujioka, Chief Executive Officer, to the Members of the Board of Supervisors, September 17, 2010.

In addition, some other jurisdictions in LAC also cap pensions. For instance, some employee groups in the City of Los Angeles have pensionable salaries capped at a percentage of an employee's FAS, as does the County with employees who elect General Plan E. An alternative would be to cap the amount of pension that a retiree can earn at or below the level set by the Internal Revenue Service (IRS), which limits pensions at \$195,000 for qualified plans, which are the types of plan provided to most County employees.<sup>32</sup>

However, the County has established a second plan, the Los Angeles County Replacement Benefit (RB) Plan, enabling retirees to earn benefits in excess of the \$195,000 limit set by the IRS. In these instances, LACERA will pay the amount up to the IRS limit and additional pension amounts will be paid from the Replacement Benefit Plan. According to LACERA, "Retirees impacted by Section 415(b) will receive two separate checks (or direct deposits) each month; one from LACERA and one from the RB Plan. . . . The total gross amount of the retiree's benefit remains the same." CalPERS member agencies have a similar program.

As it evaluates mechanisms for further reducing pension costs, such as modifying benefit formulas, the County may also wish to evaluate the time period for computing FAS, the effect of the RB program for highly compensated employees, and placing caps on pension amounts that are less than or correspond with IRS limits for qualified plans, such as most plans provided by LACERA.

## MILESTONES IN EMPLOYEE RELATIONS

The retirement benefits available to LACERA members are driven in large part by the results of negotiations between the employee labor organizations and the County. In addition to establishing plan tiers, beginning in the late 1970's, a number of other key milestones have shaped the design of benefits and the County's declining liability trajectory.

### 1. Landscape of Employee Organizations

All but 3 of the County's 60 bargaining units receive fringe benefits from 1 of 2 Fringe Benefits Agreements. The 2 agreements, one for the Service Employees International Union Local 721 and 1 for the Coalition of County Unions, are essentially identical. As of the writing of this Report, the other 3 bargaining units had undetermined benefit packages<sup>33</sup>. Non-represented employees, who constitute approximately 10% of the County workforce, receive a separate package of fringe benefits. This group includes executive management.

Despite the existence of multiple fringe benefit packages, all County employees are subject to the same restrictions in retirement plan participation as described earlier. The differences in retirement related provisions between employee groups manifest in 1 broad area, pensionable earnings.

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<sup>32</sup> Internal Revenue Code Section 415(b); applies to employees who entered employment with the County after "January 1, 1990. These limits are established for "qualified" plans, which receive favorable tax treatment.

<sup>33</sup> Bargaining Units with undetermined fringe benefits packages were Probation Directors, Supervising Child Support Officers, and District Attorneys.

## 2. Changes in Pensionable Earnings

In the early 1990s, County employees had several categories of compensation counted in the calculation of their FAS. Included were contributions made by the County to the employees' "Cafeteria Benefit Plan," as well as County contributions to the LACERA retirement fund. In 1996, State law modified the amount of Cafeteria Plan benefits that could be counted toward pensionable salaries, based on percentages of the total County contribution.

In 1997, case law defined in the "Ventura Case"<sup>34</sup> redefined pensionable income to include everything that is paid to an employee in cash. For CERL systems, like LACERA, other forms of compensation such as uniform allowance, vehicle allowance, skill-based differentials and other miscellaneous categories of pay were also included. However, sick leave and accrued vacation buy-back pay is pensionable in LAC, subject to Administrative Policy. These administrative policies could be reversed, lowering the amount that employees can apply toward service credit or pensionable salaries when the FAS is computed.

As pension investment income rose at the end of the decade, employee bargaining groups in the County began to bargain for enhanced pension benefit formulas. However, this was resisted strongly by the County. In exchange, the County offered longevity and wellness bonuses to Safety and other employee groups, which allowed pensionable income to be raised by as much as 11% during the final years of employment (for example, 4% at 20 years, 4% at 25 years and 3% at 30 years for police Safety, compounded). As the County explores alternatives for reducing its overall pension cost, these 2 special categories of pay could be reduced or eliminated through the collective bargaining process as a mechanism for reducing pensionable salaries in the final years of employment.

In addition, LACERA, like CalPERS, allows employees to purchase at full cost "Additional Retirement Credit," or ARC (also known as "Air Time") for up to 5 years of service credit. Under this optional benefit, employees are permitted to purchase 1 to 5 years of service credit at cost, as determined using actuarial methods. Although LACERA states that this is an expensive option for most employees, some employees take advantage of the opportunity to raise their annual pension amount when short of major years of service thresholds.

A review of what is and is not defined as pensionable income is worth including in the evaluation when the County next decides to modify pension benefits. However, any changes to defining certain categories of compensation as pensionable versus non-pensionable income must be considered within the constraints of existing case law.

## LONG TERM FUNDING STRATEGIES & INVESTMENTS

### 1. Pension Obligation Bonds and County Contribution Credit Reserve

During FY 1994-1995, the County issued approximately \$2 billion in pension obligation bonds (POB) as a result of the Retirement Association Funding Agreement, which established a mechanism to fund the UAAL. As of June 30, 2010, the total outstanding

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<sup>34</sup> The final decision in the Ventura Case was issued in 2002.

principal on the bonds was \$345,913,000. By June 30, 2011, the County reports that it will pay the last principal and interest payment on this POB debt.

The 1994-1995 Agreement also allowed surplus earnings on LACERA's assets for the period July 1, 1994 through June 30, 1998 to be split between a County controlled reserve account (75%) and the STAR program (25%), which provides the supplemental cost of living adjustment. Those excess earnings were used to create the County Contribution Credit Reserve, which may be used by the County to meet its required contribution requirement without adding new cash deposits to the fund. In each year since the establishment of the reserve, except 2010, a significant yet declining portion of the County's contributions have been met using these reserve funds. No funds were spent from the reserve in FY 2010. The balance of the County Contribution Credit Reserve as of June 30, 2010 was \$470.7 million.

Rather than keeping it in reserve, some or all of the \$470.7 million County Contribution Credit Reserve could be put toward funding the retiree health trust. This would be a step toward accumulating reserves for OPEB benefits which is currently 0% funded.

## 2. Effective Investment Management

LACERA's Board of Investments (BOI) and its investments division have been recognized for strong financial stewardship. The independent fiduciary services firm that conducted LACERA's most recent fiduciary review wrote, in summary:

We were favorably impressed by the dedication and insight of the BOI, caliber of staff, the level of sophistication in operations, and the obvious focus on maintaining excellence in the areas covered by this fiduciary review. We did not discover any material shortcomings, and the LACERA BOI and staff should be proud of their investment program's many accomplishments.

In comparison to other large public pension funds and to the market as a whole, LACERA's fund assets performed relatively well during the financial crisis of 2008-2009. LACERA's return on investment for the year ending June 30, 2009 was negative 18.2%, while CalPERS had a negative 24.8% return for the same period.

### UNFUNDED RETIREE HEALTH BENEFIT

LACERA also administers a retiree health benefit program for eligible retirees. also referred to as OPEB. Every 2 years, the LACERA Board commissions an actuarial valuation of the plan to determine its liability. As of July 1, 2010, the most recent valuation, the actuarial accrued liability for the retiree health program was \$24.03 billion and was completely unfunded. This represents an increase of 9.9% from the previous valuation in 2008, which was \$21.86 billion in unfunded liability.

The current retiree health benefit is defined by the "1982 Agreement" between LACERA and the County, wherein LACERA would administer the program and the County would fund the program. The current benefit provides retirees between 40% and 100% of the cost of retiree health insurance, depending on years of service. At 10 years of service, the County covers 40% of the cost of the benefit for the employee; and that rate increases by 4% per year of service up to 100% coverage at 25 years of service.

The County's OPEB liability will continue to compound at increasingly higher rates due to pressure from high rate of health care cost inflation, coupled with increasing retirement rates.



As described in Phase I of this Report, many jurisdictions operate OPEB programs on a “pay-as-you-go” basis. However, this unfunded liability is significant and growing in the LAC; and the County should develop and adhere to a plan for funding the benefit.

**RESULTS OF SAMPLING**

In order to analyze certain attributes of recent retirees and understand general trends in the LACERA population, the CGJ drew a sample comprised of all employees who entered retirement during the 3 most recent fiscal years (July 1, 2007 through June 30, 2010). First, statistical analysis was conducted on the entire 3-year population, which totaled 6,979 retirees. The results of this analysis are summarized in Exhibit 20. Plan E members comprised the largest group of retirees during the 3-year period at 31.7% of all retirees; Plan D members comprised 28.7% of the population, and Plan A members comprised 22.7%.

When considering all plan retirements during this 3-year period, the average number of years of service credit was 25.2 years; and the average annual retirement income was \$45,948. As Exhibit 20 shows, there is a large variance in average annual retirement income between the plans, ranging from a low (Plan E) of \$23,670 to a high (Plan A/Safety) of \$117,047.

This sampling helped CGJ identify and support the findings delineated in this Section.

Exhibit 20. Summary of All Employees Entering LACERA Retirement During 3 Most Recent Fiscal Years (July 1, 2007 through June 30, 2010)

<b>Plan</b>	<b>Number of Retirements</b>	<b>Average Total Service Credit (yrs)</b>	<b>Average Benefit Percentage</b>	<b>Average Annual Benefit</b>
A/G	1585	32.5	79.2%	\$68,920
A/S	388	31.6	84.3%	\$117,047
B/G	120	28.9	66.6%	\$59,620
B/S	618	24.3	62.1%	\$74,040
C/G	51	25.8	58.3%	\$43,891
D/G	2006	17.6	38.2%	\$29,182
E/G	2211	25.7	38.6%	\$23,670
<b>Grand Total</b>	<b>6979</b>	<b>25.2</b>	<b>52.9%</b>	<b>\$45,948</b>

Source: LACERA retirement records.

**METHODS AND PROCEDURES**

Using information collected for each of the 277 pension plans in LAC, the CGJ selected those that exhibited a range of characteristics that suggested an in-depth research and analysis would be appropriate. Once the plans were selected, meetings were held with officials, various documents were obtained and analyzed; and Findings and Recommendations were developed. In addition to various documents, LACERA was able to provide the CGJ a sample of nearly 7,000 LACERA retirements for analyses and benefit calculation verification. These analyses identified and provided support for several of the Findings discussed in this Section.

## **FINDINGS**

LAC management, with advice and counsel from LACERA, has taken relatively prudent measures in the last 30 years to control and fund pension costs for LAC.

LACERA manages a County Contribution Credit Reserve that has been used in past years to offset a portion of the Annual Required Contribution for pension benefits. As of June 30, 2010, this reserve had a balance of \$470.7 million.

The legal requirement to count certain categories of compensation as fully pensionable, such as uniform allowances, vehicle allowances, and skill-based pay differentials, has the effect of inflating salaries. However, vacation and sick leave “buy-back” categories of pay have also been designated as pensionable salaries by administrative policy of the County.

The use of a 12-month period for determining final average salary and, ultimately, the amount of the retirement benefit in all plans except Plan E, may provide an opportunity for “pension spiking.” Plan E and other plans administered by CalPERS set the FAS period at 36 months, which reduces the opportunity for pension spiking.

Certain provisions of the LACERA plan and County agreements, such as agreements that permit certain classifications of employees to earn “longevity pay,” may increase overall pension costs. However, these options were often agreed to by the County as alternatives to salary increases or pension formula enhancements that were being negotiated with employee labor unions at the time.

The lack of caps on retirement income and the use of the LAC Replacement Benefit Plan allows high-income, long-term employees to earn pensions that are higher than those allowed by Internal Revenue Code 415(b), which is \$195,000 in 2011.

The County’s unfunded retiree health liability of \$24.03 billion should be a significant concern for the County, especially when considering the rising costs of health care.

The LACERA Board of Investments’ choice to book the \$614 million STAR reserve as a Valuation Asset without booking a corresponding liability overstates the financial strength of the plan.

## **RECOMMENDATIONS**

1. Eliminate Administrative policies that permit employees to spike their final average salary in the final years of employment. When the County next decides to modify pension benefits, include in the modification scope an examination of the efficacy of:
  - a. Changing the period used to determine FAS from 12 months to 36 months for most plans
  - b. Eliminating all pensionable pay categories that are not mandatory, such as vacation and sick leave buy-back pay
2. Through the collective bargaining process, the County could also reduce or eliminate automatic pay increases given to employees as they approach retirement, such as longevity and wellness pay, which contribute to pension spiking.
3. The County to consider changes to pension plans for new employees, capping pensionable salaries or placing a cap on the maximum value of pension allowed, including changes to the Replacement Benefit Plan for highly compensated employees.

4. The County to consider negotiating changes in the Retiree Health Benefit Plan with labor organizations, to reduce the County's net cost for the retiree health benefit, by either modifying benefit levels or increasing the member's share in the cost of retiree health insurance.
5. The County to consider applying the full amount of the \$470.7 million County Contribution Credit Reserve to the retiree health trust as a first step toward accumulating reserves for OPEB benefits.
6. The County begin contributing the full annual required contribution for retiree health benefits in an attempt to build reserves and apply investment income as discounts toward the cost of benefits.
7. LACERA Board of Retirement to wholly offset the County STAR asset reserve, valued at \$614 million in 2010, by a corresponding liability since funds may only be expended for STAR benefits. .

## REQUEST FOR RESPONSE

California Penal Code Sections<sup>35</sup> §933(c) and §933.05 requires a written response to all Recommendations contained in this Report which shall be made no later than ninety (90) days after the CGJ publishes its Report (filed with the Clerk of the Court).

Respond to:

Presiding Judge  
LAC Superior Court  
Clara Shortridge Foltz Criminal Justice Center  
210 West Temple Street,  
Eleventh Floor, Room 11-506  
Los Angeles, CA 90012

All responses for the 2010 - 2011 CGJ Report's Recommendations must be submitted to the above address on or before the end of business **September 30, 2011**.

Responses are required from:

<u>Recommendation Number(s)</u>	<u>Responding Agency</u>
1a	LAC (Board of Supervisors)
1b	LAC (Board of Supervisors)
2	LAC (Board of Supervisors)
3	LAC (Board of Supervisors)
4	LAC (Board of Supervisors)
5	LAC (Board of Supervisors)
6	LAC (Board of Supervisors)
7	LAC (LACERA Board of Retirement)

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<sup>35</sup> Reference California Penal Code Sections §933(c) and §933.05 at the beginning of this 2010-2011 CGJ Report

Exhibit 21

**Provisions of Open LACERA Plans (Unmodified)**

Provision	Plan D (General)	Plan E (General)	Plan B (Safety)
<b>Member Contributes to Plan</b>	Yes	No	Yes
<b>Vested<sup>36</sup></b>	5 Yrs	10 Yrs	5 Yrs
<b>Eligible Age to Receive Retirement Allowance</b>	<ul style="list-style-type: none"> <li>· Age 50 with 10 yrs svc</li> <li>· 30 yrs svc, any age</li> <li>· Age 70, any svc</li> </ul>	<ul style="list-style-type: none"> <li>· Age 55 if vested</li> <li>· Age 70, any svc</li> </ul>	<ul style="list-style-type: none"> <li>· Age 50 with 10 yrs svc</li> <li>· 20 yrs svc, any age</li> </ul>
<b>Maximum percentage of Final Compensation Member Can Receive as a Retirement Allowance</b>	100%	80%	100%
<b>Disability Retirement</b>	Yes	No	Yes
<b>Pre-Retirement Death Benefit</b>	Yes	No	Yes
<b>Pre-Retirement Survivor Benefits</b>	Yes	No	Yes
<b>Retiree Health Insurance Subsidy</b>	Yes	Yes	Yes
<b>Post-Retirement Survivor Benefits</b>	Yes	Yes	Yes
<b>COLA Increases after Retirement</b>	Yes	Yes	Yes
<b>Eligible Former Members May Be Reinstated to Prior Contributory Plan</b>	Yes	No	Yes
<b>May Purchase Service Credit for Eligible Government Service Prior to LACERA</b>	Yes	No	Yes

<sup>36</sup> Years of County Service Credit.

## **PHASE II: SECTION 2**

### **CITY OF LOS ANGELES DEPARTMENT OF WATER AND POWER EMPLOYEE RETIREMENT PLAN**

#### **SUMMARY**

The City of Los Angeles Department of Water and Power Employee Retirement Plan (WPERP) administers the pension plans established for Department of Water and Power (DWP) employees. The WPERP invests assets for the DWP Retiree Health Benefits plans. The WPERP acts as the trustee of assets held for all elements of the pension plans.

DWP contributions are made in amounts based on the recommendations of actuaries for the Retirement and Retiree Health Benefits plans. While the Retirement Fund exceeded the 80% funded ratio threshold cited by experts for a well funded plan in 2010, other trust funds are at lower funded ratios. While DWP has been accelerating payments to the Retirement Health Benefit Fund in recent years to build asset reserves by contributing in excess of 250% of Annual Required Contributions (ARCs) in each of the past 3 years, the WPERP reports a 2010 Funded Ratio of only 60.5% for the Retiree Health Benefits fund.

In FY 2009-2010, the most recent year for which actual data is available, the combined Department contributions paid to the Retirement Fund, Retirement Health Benefits Fund, the Death Benefits Insurance Fund and the Disability Benefits Insurance Fund was \$360,447,428 on payroll of \$767,912,436 (a contribution rate of 46.9%). Yet, DWP employee relations personnel state that the Department is not currently contemplating any changes to employee bargaining agreements in an effort to reduce pension benefit costs. This contrasts sharply with efforts being made by the City to reduce retirement costs for non-DWP employees who receive benefits through Los Angeles City Retirement System (LACERS).

The WPERP also has a reciprocal agreement with the LACERS, which provides benefit portability for employees who transfer between City and DWP jobs. However, actuaries have determined that approximately \$183 million in WPERP unfunded liability is attributable to weaknesses in this agreement stemming from the absence of a provision requiring the plans to transfer assets representing employer contributions between LACERS and WPERP when employees move between plans. The actuary modeled this \$183 million underfunding by amortizing it over 15 years and determined that the WPERP contribution rate would need to increase by a factor of 1.4% of current payroll or approximately \$11.7 million per year. This should be a City cost and not a responsibility of DWP ratepayers.

To ensure DWP ratepayers are not subsidizing City services, the Los Angeles City Council and DWP Board of Commissioners should work diligently to resolve the funding discrepancy that has resulted from the reciprocity agreement. In addition, DWP should work collaboratively with employee bargaining groups to evaluate alternatives for lowering the cost of benefits provided to DWP personnel.

#### **PURPOSE**

The City of Los Angeles Department of Water and Power Employee Retirement Plan (WPERP) was chosen by the Civil Grand Jury (CGJ) for in-depth review because as a public utility

business-type enterprise, employer borne pension costs are passed through to the ratepayer. With a solid funded ratio and a recent history of accelerated payment of OPEB liabilities, the CGJ's initial review suggested that the plan was not undergoing the same financial difficulties as other LAC Public Pension Plans.

## **BACKGROUND**

The DWP offers pension benefits to its employees through its WPERP. In addition, DWP provides Retiree Health Benefits to its employees through a separate plan that is jointly administered by the Department and the WPERP. The City has not issued any Pension Obligation Bonds (POBs) to prefund any portion of DWP's pension liabilities, but has been aggressively accelerating contributions to the Retiree Health Benefits Fund to improve that plan's funded ratio in recent years. Exhibit 22 shows key attributes of the retirement plan.

## **GOVERNANCE**

The WPERP is established in the Los Angeles City Charter<sup>37</sup> which also establishes the Board of Administrators and defines its powers, duties and authorities related to Department of Water and Power (DWP) retirement fund administration. Article XI, Part 2, §1180 through §1190 of the Charter define the benefit parameters and administrative requirements of the WPERP, including the Board's authority to modify the plan and the assignment to DWP of its responsibility to pay retirement benefits "as a general obligation of the Department." The WPERP Board of Administrators is exempt from §245 of the City Charter, which allows the City Council to veto decisions of other boards established in the City Charter.

It is important to note that the Retiree Health Benefits Fund is not overseen by the WPERP Board of Administrators. According to the combined financial statements for all retiree benefits, the "Board of Water and Power Commissioners approved the creation of the Retiree Health Benefits Fund (RHBF) in September 2006 to defray current and future retiree health benefit liabilities and related costs incurred by the fund. The Retirement Board has the fiduciary responsibility for investing the assets of the Health Fund and administering payments from it, while the DWP Board of Water and Power Commissioners continues to have the responsibility to set the funding policy and the funding level of the RHBF."

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<sup>37</sup> Article XI, Section 1102 (b)

**Exhibit 22. WPERP Profile**

<b>MEMBERSHIP</b>		<b>PLAN BENEFITS AND OPTIONS</b>	
Active Members	9,295	Normal Retirement Age	60
Retired Members	6,358	Benefit Formula	2.3% x Years
Disabled/Retired Members	-	Lump-Sum Death Benefit	Option
Survivor Members	2,110	Survivor Benefit	50% of pension
Inactive Members	1,739	Retiree Health	Defined Benefit
Total Members	19,502	Deferred Compensation	No
<b>ACTUARIAL</b>		<b>FINANCIAL</b>	
<i>Investment/Discount Rate</i>		<i>Pension Fund</i>	
Assumed Actuarial Rate	8.00%	Actuarial Accrued Liability	\$ 8,893,618,433
One Year Actual Return (FY 2010)	11.96%	Unfunded Actuarial Accrued Liability	\$ 1,649,188,744
		Funded Status	81.5%
<i>Methods</i>		<i>Retiree Health Fund</i>	
Investment Smoothing	5 Years	Actuarial Accrued Liability	\$ 1,631,916,204
Investment Corridor	None	Unfunded Actuarial Accrued Liability	\$ 644,440,228
Amortization of Unfunded Liability	15 Years	Funded Status	60.5%
<i>Contributions</i>		<i>Pension Obligation Bonds</i>	
Employer Contribution	38.5%	Principal Balance	\$ -
Employee Contribution Pick-Up	0.0%	Projected Interest Expense	\$ -
Total Contribution	38.5%	Total Indebtedness	\$ -

Source: The Segal Group, Inc., *Water and Power Employee Retirement Plan Actuarial Valuation and Review as of July 1, 2010* and Simpson & Simpson, Certified Public Accountants, *City of Los Angeles Water and Power Employees' Retirement, Disability, and Death Benefit Insurance Plan Financial Statements and Supplemental Information for the Years Ended June 30, 2010 and 2009 Water and Power Employees Retiree Health Benefits Fund Financial Statements and Supplementary Information for the Year Ended June 30, 2010 and 2009*

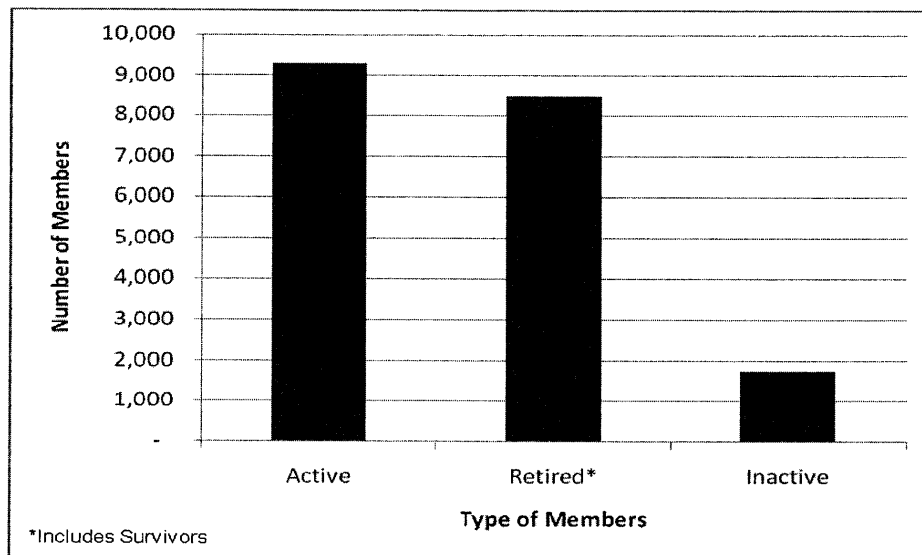
A more complete profile of pension benefits provided to DWP employees is included in Appendix C of this Report.

**MEMBERSHIP AND ACTUARIAL EVALUATION**

As of June 30, 2010 there were 19,502 members in the WPERP, of which 6,358 were retired. Per the City Charter which establishes WPERP as a single employer plan, only those employees who work for DWP are members. However, the WPERP has a reciprocal agreement with the LACERS, which provides benefit portability between plans when individuals move from employment between other City departments and the DWP. Exhibit 23 shows WPERP membership by broad type:



Exhibit 23. WPERP Membership by Type as of June 30, 2010



Source: The Segal Group, Inc., *Water and Power Employee Retirement Plan Actuarial Valuation and Review as of July 1, 2010*

In the past 3 years, between 2007 and 2010, there were 608 retirements at the DWP. On average, these individuals received a full pension allowance of \$65,040 per year, which was 71.3% of the final average compensation used to calculate their pensions at the time of retirement. Of the 608 retirees, there are 68, or 11.2%, who are receiving pensions over \$100,000 per year. The average pension for these 68 individuals equaled approximately \$125,970 per year.

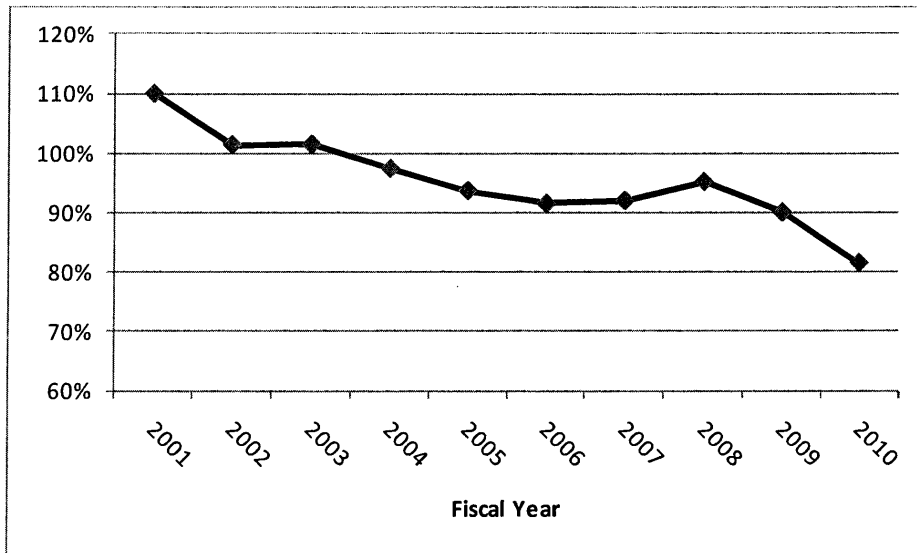
It is important to note that these pensions are derived from both employer and employee contributions over the employee's career. With an average of 30 years employment at the DWP, these pensions can sometimes appear high. For example, when conducting the sample, the CGJ found one individual with approximately \$585,000 in his employee contributory account. Because this individual was elderly when he retired and because of the balance in his contributory account, he would have been able to retire with a monthly pension that would have exceeded 160% of his final average compensation. Instead, he decided to name a beneficiary who would receive a percentage of his salary upon his death.

#### Although Funded Ratio Remains Strong, Contribution Requirements Have Escalated

As of the last valuation date of July 1, 2010, the WPERP Retirement Fund has Actuarial Accrued Liability (AAL) of \$8,893,618,433. The Unfunded AAL (UAAL) for the Retirement Fund was \$1,649,188,744, resulting in a funded ratio of 81.5%. Although this Funded Ratio is within the range considered sufficient by experts, it follows a 10 year pattern of declining performance by the fund from a high of approximately 110.0% Funded Status in 2001. This deterioration has correspondingly increased the Annual Required Contributions (ARC) from the DWP as shown in Exhibit 24 and Exhibit 25 adapted from the WPERP's most recent actuarial report.<sup>38</sup>

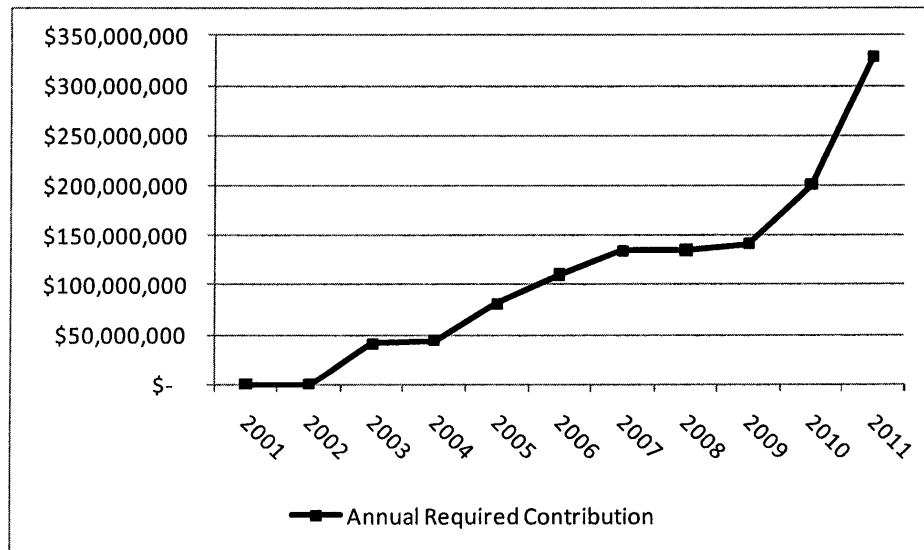
<sup>38</sup> The Segal Group, Inc., *Water and Power Employee Retirement Plan Actuarial Valuation and Review as of July 1, 2010*, Page 14

Exhibit 24. FY 2001 through FY 2011 History of WPERF Funded Ratio



Source: Adapted from The Segal Group, Inc., *Water and Power Employee Retirement Plan Actuarial Valuation and Review as of July 1, 2010*, Chart 16

Exhibit 25. FY 2001 through FY 2011 History of WPERP Annual Required Contributions



Source: Adapted from The Segal Group, Inc., *Water and Power Employee Retirement Plan Actuarial Valuation and Review as of July 1, 2010*, Chart 15

As shown by Exhibits 24 and 25, as the funded status of the Retirement Fund has declined, the ARC has grown dramatically. In FY 2000-2001 and FY 2001-2002, the Department was not required to contribute anything to the Fund because the funded ratio was over 100%. In the next

8 years by FY 2010-2011, the DWP's projected ARC climbed to \$329,178,234, which is 38.45% of the projected payroll of \$856,089,559.<sup>39</sup>

In addition, the ARC for the WPERP does not include additional contribution amounts for the Retiree Health, Disability Insurance or Death Benefits Insurance plans provided to employees and retirees. An analysis of the ARC and actual contributions for all categories of DWP retirement benefits in FY 2009-2010 shows that the additional costs are significant, as shown in Exhibit 26:

Exhibit 26. FY 2009-2010 Contributions for Major Categories of DWP Retirement Benefits

Fund	ARC	Actual	Difference	% of ARC
Retirement	\$ 200,578,278	\$ 201,034,807	\$ 456,529	100.2%
Retiree Health	\$ 58,502,789	\$ 159,412,621	\$ 100,909,832	272.5%
Total	\$ 259,081,067	\$ 360,447,428	\$ 101,366,361	139.1%

Source: Simpson & Simpson, Certified Public Accountants, *City of Los Angeles Water and Power Employees' Retirement, Disability, and Death Benefit Insurance Plan Financial Statements and Supplemental Information for the Years Ended June 30, 2010 and 2009 Water and Power Employees Retiree Health Benefits Fund Financial Statements and Supplementary Information for the Year Ended June 30, 2010 and 2009*

The actual contributions for all categories of DWP retirement benefits in FY 2009-2010 amounted to \$360,447,428. This equates to approximately 46.9% of actual pensionable salaries of \$767,912,436 in that year.

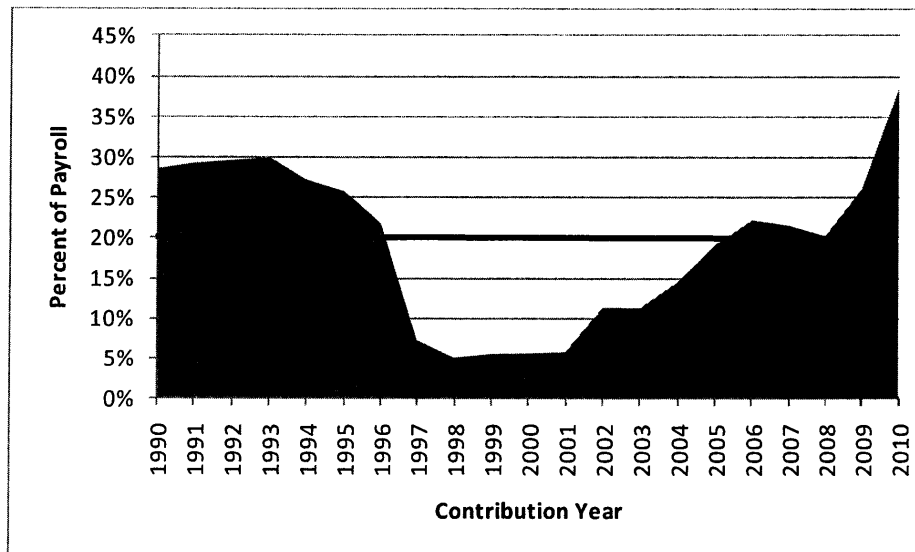
Two important factors are to be considered when viewing this data:

1. The ARC for the Retirement Plan was calculated to be 26.12% in FY 2009 on a smaller base of pensionable salaries amounting to \$767,912,436. In FY 2010-2011, the ARC is projected to be 38.45% of a higher base of pensionable salaries of \$856,089,559. The difference in cost for DWP from this change will therefore amount to an additional \$128,588,157 in FY 2010-2011. This does not include additional costs which may be necessary to fund the ARC for the Retiree Health Plan.
2. Despite the steep increase in these costs, DWP has chosen to accelerate the prefunding of the UAAL for its Retiree Health Benefit Fund, amounting to additional contributions of \$100,909,832 in FY 2009-2010. This equates to 272.5% of the actuarially determined ARC in that year and followed two years (FY 2007-2008 and FY 2008-2009) when the actual contribution exceeded the ARC by 391.98% and 261.43%, respectively.

It is also important to recognize that in 12 of the past 20 years, the base contribution rate for the WPERP has exceeded 20% of DWP employee salaries (60% of the time period), excluding contributions for Retiree Health Insurance. Although DWP employees are exempt from Social Security, DWP saves the 6.2% payroll tax on the first \$106,800 in employee earnings. This percentage contribution is significant. Exhibit 27 shows the pattern of contributions made to the WPERP over a 20-year period between 1990 and 2010:

<sup>39</sup> The Segal Group, Inc., *Water and Power Employee Retirement Plan Actuarial Valuation and Review as of July 1, 2010*, "Summary of Key Valuation Results", Page iv

Exhibit 27. 1990 to 2010 WPERP Contributions Compared to a 20% Benchmark



Source: Department Contribution Rate as a Percentage of Pay, schedule prepared by WPERP management for this assessment.

As part of this assessment, a meeting was held with the employee relations managers at DWP. During this meeting, managers were asked whether management intends to meet and discuss with DWP employee bargaining groups potential modifications of aspects of the retirement benefit package in an effort to reduce costs. The response was that they were not aware of any such initiatives, which contrasts sharply with public statements made by the Mayor and other elected officials for City employee groups whose members are served by LACERS.

To the extent that costs are not reduced through the collective bargaining process, the DWP ratepayers will continue to subsidize retirement benefits provided to DWP employees at historically high levels. In addition, DWP's ability to make the required annual transfer to the City's General Fund could be compromised.

#### OTHER POST EMPLOYMENT BENEFITS

DWP provides Other Post Employment Benefits (OPEB) to its employees through the Retiree Health Benefits Fund, which is a defined benefit plan that subsidizes health insurance for employees after retirement. Although investments are managed by the WPERP, by agreement with the Department, authority for policy and funding decisions is held by the DWP Board of Commissioners and has not been assigned to the WPERP Board of Administrators.

Governmental Accounting Standards Board (GASB) Statement No. 27 describes the standards for reporting pension obligations by State and local governments. For governmental funds, such as the General Fund of a jurisdiction, the amount of the Net Pension Obligation (NPO) is recognized on a modified accrual basis and reported in the general long-term debt group. In contrast, for Proprietary or Enterprise funds the NPO is recognized on an accrual basis and is reported as a liability against the fund assets. Hence, the standard for an enterprise operation's Proprietary, or Enterprise funds, such as the DWP, differ from the standard for the General Fund of a jurisdiction. These standards apply to all categories of retirement obligations, including OPEB.

These differences affect the reporting of fund balance (Governmental Funds) and net fund assets (Proprietary Funds) on the balance sheet for the 2 categories of funds. Because only the current portion of the NPO is recognized for governmental funds using the modified accrual basis, a General Fund balance sheet does not show long-term obligations. Instead, the long-term obligations are reported in subsidiary schedules shown as an adjustment for purposes of presenting the combined governmental funds statement and are only recognized as a liability on the fund balance sheet when it becomes due.<sup>40</sup> However, the reporting of the full amount of the NPO on an accrual basis for an enterprise operation, such as the DWP, directly impacts the reporting of net fund assets on the balance sheet. For example, the City's Comprehensive Annual Financial Report (CAFR) for the year ended June 30, 2009 held \$784,749,000 in non-current assets in its Water and Power Enterprise Funds that were restricted to pay for the funds' net pension obligations, effectively reducing the amount of unrestricted net fund assets by the same amount.

As a result, accelerating payment to the OPEB trust fund does not affect the amount of available net fund assets. Discussions with DWP management indicate that the decision to accelerate OPEB funding has been made by the General Manager in each of the past 3 fiscal years, based on cash balances available in the Water and Power Enterprise Funds. According to management, approximately 32% of the contributions are made by the Water Enterprise and 68% of the contributions are made by the Power Enterprise. There has neither been a specific DWP Board of Commissioners action nor a stated Citywide policy or DWP policy to accelerate funding of the OPEB UAAL above levels required by GASB. The CGJ was advised that this pattern of accelerated payment is likely to continue again in FY 2011-2012 at the slightly reduced level of approximately \$75 million.

The degree of acceleration has been significant. During the past 3 years, the DWP management has chosen to contribute in excess of 250% of the ARC to its RHBF. The accelerated contributions are unnecessary, and payments could be reduced substantially by DWP. The Governmental Accounting Standards Board (GASB) Statement No. 45's plain language publication states that:

The process for determining how much should be set aside now in order to provide for future benefits in a defined benefit plan utilizes actuarial methods and assumptions . . . . The actuarial calculations are required to take into account not only benefits *expected to be earned* by employees in the future (future normal costs), but also those benefits the employees *have already earned*. . . . The portion of the actuarial present value allocated to prior years of employment--and thus not provided for by future normal costs--is called the *actuarial accrued liability (AAL)*. . . . The excess of the AAL over the actuarial value of assets is the *unfunded actuarial accrued liability (UAAL or unfunded liability)*. **The unfunded liability would be amortized (spread) over a period of up to 30 years. . . . The normal cost and the portion of the UAAL to be amortized in the current period together make up the annual required contribution (ARC).** (Bold and underlined emphasis added).

When the DWP actuaries prepared their analysis according to GASB rules, they isolated and spread the unfunded liability over a period that would allow the plan to fully fund employee benefits over time before expenses become due and payable. However, DWP chose to follow a funding plan that differed from the actuary's minimum requirements and chose to accelerate payments to levels substantially above these requirements as shown in Exhibit 28:

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<sup>40</sup> The City of Los Angeles CAFR reflects this reporting standard and states, "long-term liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the (individual) funds."

Exhibit 28. Three Year History of DWP Contributions for Retiree Health Benefits

Year	Annual Required Contribution (ARC)	Actual Contribution	Over (Under) ARC	Percentage Contributed
2008	40,144,629	157,359,628	117,214,999	391.98%
2009	60,976,358	159,412,621	98,436,263	261.43%
2010	58,502,789	160,236,897	101,734,108	273.90%

Source: Simpson & Simpson, Certified Public Accountants, *City of Los Angeles Water and Power Employees' Retirement, Disability, and Death Benefit Insurance Plan Financial Statements and Supplemental Information for the Years Ended June 30, 2010 and 2009 Water and Power Employees Retiree Health Benefits Fund Financial Statements and Supplementary Information for the Year Ended June 30, 2010 and 2009*

As discussed in Phase I of this Report, most jurisdictions that offer OPEB benefits to their employees have not funded future benefits and continue to operate on a “pay-as-you-go” basis. This is inconsistent with GASB standards; and as the CGJ recommended in Phase I, these jurisdictions should end this practice and develop strategies to fully fund the ARC.

However, DWP has been funding this liability at levels far greater than the amount determined using GASB accounting standards, while at the same time requesting an electric rate increase in the Spring of 2010; and advising the City Council that it would be unable to pay the full amount of the 8% electric utility transfer to the City in FY 2009-2010, because of insufficient cash resources. The unpaid portion would have amounted to \$73.5 million which is less than the \$101,734,108 of accelerated funding paid to the RHBF.

Although the CGJ did not examine the specifics of this controversy as part of this assessment, the CGJ recommends that the new Ratepayer Advocate and the City Council, through the powers overwhelmingly granted by the voters with Propositions I and Proposition J on March 8, 2011, be advised of the decision by the DWP Board of Commissioners to accelerate payment of the RHBF ARC in each of the past 3 fiscal years. Had these payments not been accelerated, \$317,394,370 in additional resources would have been available in the Water and Power Funds during this 3-year period. Although the CGJ does not have information on the portion of these payments that were made from the Water and Power Enterprises, respectively, it is likely that all or a substantial portion of the delinquent payment could have been made from that fund.

RECIPROCAL AGREEMENT

On February 1, 1980, a reciprocal agreement was entered into by the WPERP and LACERS to provide benefit portability to DWP and City employees when they moved employment between City departments and the DWP. Under the agreement, employee contributions are transferred between the retirement funds, the employees' service credit is transferred between the benefit programs, and any contracts the employees may have for the purchase of retirement service credits are transferred between departments.

Based on the CGJ's review and according to the Los Angeles Chief Legislative Analyst (CLA), the reciprocal agreement does not include provisions for the transfer of employer contributions between plans. According to the CLA, this occurred because, “Actuarial reports conducted at the time it was established indicated the cost of the program would be similar in both pension plans.” It was thought that the WPERP cost of providing benefits to employees transferring from City departments to DWP would be essentially offset by the LACERS cost of providing benefits to employees transferring from DPW to City departments.