

Since that time, WPERP found that the transfers between DWP and City departments had grown out of balance. The Retirement Board requested that the Plan's actuary evaluate the financial impact of the imbalance.⁴¹ The actuary found:

- For the period April 1, 2004 through March 31, 2010, reportedly 1,623 City department employees transferred from City departments to DWP, while only 270 DWP employees transferred to City departments.
- The total increase in the WPERP unfunded actuarial liability due to the transfer of the 1,623 employees amounted to approximately \$183 million which, amortized over 15 years, increases DWP's annual contributions by \$11.7 million or 1.4% of payroll.
- No estimate was made of the offsetting savings to WPERP from the transfer of the 270 DWP employees to City departments so it is likely that the \$183 million in UAAL that was identified for this period is overstated.
- The actuarial analysis was limited to the 6 year period and did not assess the impact from transfers that may have occurred prior to this timeframe. Therefore, the DWP net costs could be even greater.
- The actuarial analysis did not analyze the additional cost or UAAL to DWP for the Disability Insurance, Death Benefits Insurance or Retiree Health Plan benefits granted to the employees after transferring to DWP.

In response, the WPERP Board of Administrators adopted a resolution recommending suspension of the reciprocal agreement. The WPERP Board of Administrators submitted this resolution to the Board of Water Commissioners. The Commissioners approved the resolution and submitted it to the City Council for consideration. The City Council, at its meeting held on October 13, 2010, vetoed the resolution and referred the matter to the City Administrator, WPERP and LACERS for further review. No further action has been taken by the City Council on this matter since that time.

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 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, the CGJ was able to analyze a sampling of 608 retirements which constituted all retirements in the past 3 calendar years. The sampling allowed the CGJ to verify benefit calculations and to identify and support Findings discussed in this Section.

FINDINGS

1. DWP employee relations management staff has not initiated any substantive meet and confer sessions with employee bargaining groups to modify aspects of the retirement benefit package in an effort to reduce costs, despite total annual retirement benefit contributions of approximately \$360 million or 46.9% of pensionable salaries in FY 2009-2010.

⁴¹ August 10, 2010, The Segal Company, *Re: Reciprocity program – Impact of Possible Suspension of Program*

For at least 3 years, the DWP management has chosen to contribute amounts exceeding 250% of the Annual Required Contribution to its Retiree Health Benefits Fund. During this period, they have made \$317,394,370 in excess contributions, while simultaneously requesting utility rate increases and advising City officials that the Department would be unable to pay the full amount of the 8% transfer to the City in FY 2009-2010, because of insufficient cash resources.

The City and LACERS may owe the WPERP \$183 million or more in UAAL for employees who transferred from City employment to DWP employment during the past 6 years, increasing the WPERP contribution requirements by \$11.7 million annually over the next 15 years. The City Council referred this matter to the City Administrator, WPERP and LACERS to refine the analysis on October 13, 2010; but no further action has been taken since that time.

RECOMMENDATIONS

1. The DWP Board of Commissioners give direction to management to evaluate and report back in closed session on alternatives for reducing the Department's cost of employee retirement benefits.
2. The DWP Board of Commissioners advise the new Ratepayer Advocate and the City Council of the decision by the DWP management to accelerate payment of the Retiree Health Benefit Fund ARC in each of the past three fiscal years to ensure that the prepayments are fully considered when the DWP seeks future rate increases or indicates that it is unable to make revenue transfers to the General Fund.
3. Los Angeles City Council, the DWP Board of Commissioners and LACERS Board of Administrators need to expedite reaching an agreement regarding transferring funds to WPERP to cover the cost of an increased UAAL imposed on DWP, estimated by actuaries to equal as much as \$183 million for the 6-year period between 2004 and 2010, due to Los Angeles City employees who have moved from City departments to DWP so that the burden is not imposed on ratepayers.
4. Los Angeles City Council, the DWP Board of Commissioners and LACERS Board of Administrators need to amend the reciprocity agreement between LACERS and WPERP with regard to the transfer of employer pension contributions in order to prevent such inequity in the future.

REQUEST FOR RESPONSE

California Penal Code Sections⁴² §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 Civil Grand Jury 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>
1	City of Los Angeles (Department of Water and Power Board of Commissioners)
2	City of Los Angeles (Department of Water and Power Board of Commissioners) City of Los Angeles (City Council) City of Los Angeles (LACERS Board of Administrators)
3	City of Los Angeles (Department of Water and Power Board of Commissioners) City of Los Angeles (City Council) City of Los Angeles (LACERS Board of Administrators)
4	City of Los Angeles (Department of Water and Power Board of Commissioners) City of Los Angeles (City Council) City of Los Angeles (LACERS Board of Administrators)

⁴² Reference California Penal Code Sections §933(c) and §933.05 at the beginning of this 2010-2011 Civil Grand Jury Report

PHASE II: SECTION 3 PASADENA FIRE AND POLICE RETIREMENT SYSTEM

SUMMARY

The Pasadena Fire and Police Retirement System (FPRS) administers the pension system for certain retired Safety employees of the City of Pasadena. FPRS is a closed plan and does not accept newly hired employees. There are no active employees who are members of the plan. Nonetheless, certain plan attributes, primarily the cost of living adjustment (COLA), make the plan benefits for retirees costly. As a result, the City has chosen to borrow funds by issuing Pension Obligation Bonds (POB) amounting to over \$156 million for both principal and interest as of June 30, 2010 to fund the plan.

All Safety employees hired after 1977 participate in a CalPERS Safety Plan, and all non-Safety employees participate in a CalPERS Miscellaneous Plan. The City also offers retiree health benefits to the employees and retirees of these plans which have an unfunded actuarial accrued liability (UAAL) of nearly \$31 million as of June 30, 2010.

Pasadena's pension obligations, especially those of the FPRS, present a substantial financial challenge for the City. The existing funding source for the debt payments on the bonds that fund FPRS will expire in 2014, leaving the City without a dedicated source to pay the debt service. Without identifying an alternative source of funds, the City will be required to further subsidize the plan from discretionary General Fund resources which will have a direct impact on the City's ability to maintain services to the taxpayers.

As part of its effort to establish long-term funding strategies to address the impending expiration of dedicated funding, in March 2011 the City Council authorized staff to initiate the preparation for the issuance of a third set of POBs in an amount up to \$65 million. In addition, the City should explore opportunities to reduce other pension obligations for its active CalPERS and OPEB plans.

PURPOSE

The City of Pasadena and its Fire and Police Retirement System (FPRS) were chosen by the Civil Grand Jury (CGJ) for in-depth review based on the FPRS' extraordinarily low funded ratio and closed status and the City's substantial POB debt and retiree health benefit unfunded liability.

BACKGROUND

The City of Pasadena offers pension benefits to its current employees through the CalPERS Miscellaneous and Safety plans and to certain former Safety employees through the Pasadena Fire and Police Retirement System (FPRS). Although FPRS was closed to new members in 1977, its obligation to provide retirement benefits for retirees represents a significant liability, the long-term funding for which is undetermined as of the writing of this Report. The City of Pasadena also offers a retiree health benefits program with a liability of \$30.8 million, which is completely unfunded, and has outstanding POB debt totaling approximately \$156 million. The

CGJ chose the City of Pasadena for this review, primarily because of the financial challenges being posed to the City by FPRS. Exhibit 29 shows key attributes of FPRS and other pension obligations for Pasadena excluding the CalPERS plans.

GOVERNANCE

The Pasadena Fire and Police Retirement System (FPRS) was established by Article XV of the Pasadena City Charter. FPRS is governed by a 5 member retirement board of trustees representing the City Council, City residents and FPRS members. Its operations are reported as a Pension Trust Fund in the City's financial statements. The system's asset allocation and investments are reviewed by the Board and by an independent investment consultant, and contract actuaries. The FRPS is staffed by two part-time employees who administer the Plan.

FPRS HISTORY AND FUNDING STRUCTURE

1. Effect of Unlimited COLA

According to City documents, FPRS has had a challenging financial history since around 1960. In that year, City Charter amendments provided an unlimited COLA for the members that was fully adjustable based on changes in the Consumer Price Index (CPI). With inflation in the broader economy during the subsequent years, the plan saw dramatic increases in the COLA and, therefore, in its expenses. In 1977, the system was closed to new members and modified to increase contribution rates for the City and for active members. Additionally, active members were given the option of transferring to the CalPERS plan. However, as one City document stated, "few existing participants elected to join CalPERS and the modifications proved inadequate to address the continuing rise in the COLA benefit."⁴³

The City attempted to roll back the COLA benefit and successfully obtained voter approval in 1981 for a Charter amendment that limited the COLA to 2%. However, the Pasadena Police Officers Association sued successfully, claiming that the amendments impaired the vested rights of its members. An appellate court upheld the ruling and the uncapped COLA was reinstated, paving the way for the system's funding challenges that persist today.

⁴³ "Fire and Police Retirement System Task Force Report," presented to City Manager, Michael J. Beck. April 2010.

Exhibit 29. FPRS and Other Pasadena Pension Benefit Attributes, Excluding CalPERS

MEMBERSHIP		PLAN BENEFITS AND OPTIONS	
Active Members	-	Normal Retirement Age	50
Retired Members	223	Benefit Formula	2% x Sal
Disabled/Retired Members	131	Lump-Sum Death Benefit	60%
Retired Survivors	52	Survivor Benefit	60%
Inactive Members	275	Retiree Health	Defined Benefit
Total Annuitants	275	Deferred Compensation	Yes
ACTUARIAL		FINANCIAL	
<i>Investment/Discount Rate</i>		<i>Pension Fund</i>	
Assumed Actuarial Rate	8.00%	Actuarial Accrued Liability	\$ 166,096,000
One Year Actual Return (FY 2010)	17.90%	Unfunded Actuarial Accrued Liability	\$ 56,356,000
		Funded Status	66.1%
<i>Methods</i>		<i>Retiree Health Fund</i>	
Investment Smoothing	5 Years	Actuarial Accrued Liability	\$ 30,819,908
Investment Corridor	None	Unfunded Actuarial Accrued Liability	\$ 30,819,156
Amortization of Unfunded Liability	28 Years	Funded Status	0.0%
<i>Contributions</i>		<i>Pension Obligation Bonds</i>	
Employer Contribution	N/A	Principal Balance	\$ 111,525,000
Employee Contribution Pick-Up	N/A	Projected Interest Expense	\$ 44,655,524
Total Contribution	N/A	Total Indebtedness	\$ 156,180,524

Sources: City of Pasadena Comprehensive Annual Financial Report Year Ended June 30, 2010; Pasadena Fire and Police Retirement System Report and Audited Financial Statements for the Years Ended June 30, 2010 and 2009; Pasadena Fire and Police Retirement System Actuarial Valuation as of June 30, 2010.

2. "Contribution Agreement" and POBs

In 1999, after the FPRS funded status dropped to approximately 30%, the City and the FPRS negotiated a "Contribution Agreement" whereby the City agreed to issue \$100 million in POBs and transfer proceeds to the FPRS in order to increase the actuarial funding level to 70%. Additionally, the City agreed to make supplemental contributions to the FPRS to ensure that the funding level increased by 1/2% each year for 20 years, in order to reach a funding level of 80% by 2020. Later in this Section, The CGJ examines the magnitude of the supplemental payments and the City's progress toward achieving the annual 1/2% improvement in funding level.

Another \$40 million in POBs was issued by the City in 2004 in order to maintain the contribution levels agreed upon in the 1999 Contribution Agreement. This occurred after a protracted dispute between the City and the FPRS regarding the accounting methodology for treating the investment losses of the early 2000s. The FPRS agreed to allow the actuarial valuation to be conducted without the requirement that the actuarial

value of assets remain within a 20% “corridor” around the actual market value of assets, in exchange for the City providing additional funds through the issuance of the POBs.

As of June 30, 2010, the total outstanding principal on the POBs was \$111.5 million. Combined with the interest payments, the total outstanding POBs debt is \$156.2 million. The final maturity date of the bonds is May 15, 2022.

3. SB 481 and Redevelopment Agency Funding Relationship

In 1987, the City sponsored and secured the passage of special legislation, Senate Bill 481 that established a funding mechanism for the FPRS. SB 481 authorized the City’s Redevelopment Agency to repay prior General Fund advances to the Downtown Project Area for the purpose of funding the FPRS. According to the City, this funding structure has been effective. The revenue from the Redevelopment Agency has been more than sufficient to cover the debt service on the POBs, provide funds for the City to make its supplemental payment required under the Contribution Agreement, and generate a reserve fund to be used for future obligations of the FPRS.

While the repayment of General Fund contributions by the Redevelopment Agency has been effective thus far, the provisions of SB 481 that allowed the funding relationship to exist will expire on December 31, 2014. At that time, unless the City identifies a new funding mechanism, the City will be without a dedicated funding source to cover its debt service on the POBs and make the required supplemental payments to the FPRS.

MEMBERSHIP AND ACTUARIAL VALUATION

As of June, 30, 2010, the date of FPRS’s most recent actuarial valuation, there were a total of 275 members in the system, 223 of whom were retirees and 52 whom were survivors. There are no active members of the system. The last FPRS employee retired in 2009.

The average annual income for the entire set of 272⁴⁴ FPRS retirees as of February 2011 was \$52,761. However, the distribution of annual incomes for all FPRS retirees is represented in Exhibit 30 showing that individual retirements can be much higher.

1. Declining Liabilities, Funded Ratio

As of June 30, 2010, the date of its most recent actuarial valuation, the FPRS’s actuarial accrued liability (AAL) was approximately \$166.1 million; and its Actuarial Value of Assets (AVA) was approximately \$109.7 million, resulting in an UAAL of approximately \$56.4 million and a funded status of 66.1%. As shown in Exhibit 31, over the past 6 fiscal years the total AAL and the funded ratio have declined.

The pattern of declining funded ratio is driven in part by the market losses of recent years and FPRS’s choice to smooth or account for its losses over a relatively short 5 year period. As discussed in Phase I of this report, the implementation of a smoothing period and the length of such a smoothing period may have a significant impact on a plan’s funded status and required contribution rate.

⁴⁴ Three retirees died after the June 30, 2010 actuarial valuation, bringing the total number of retirees, including survivors, to 272 as of February 2011.

Exhibit 30. FPRS Retiree Population by Income Level as of February 2011



Source: Data provided by the Pasadena Fire and Police Retirement System

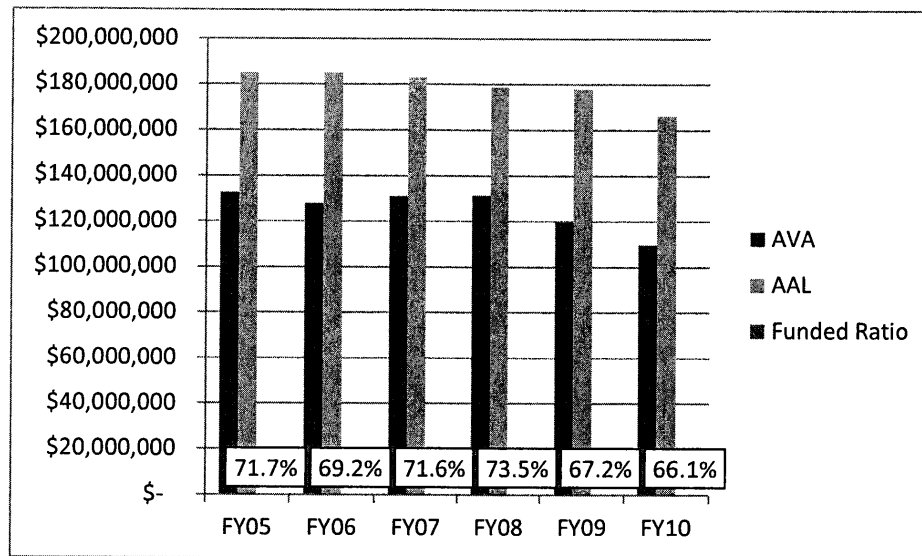
However, FPRS does not have the option of smoothing market fluctuations over a longer time period than its current 5 year term since it is a closed plan with a finite horizon, during which all of its liabilities will come due. If the smoothing period was lengthened, there would be a greater likelihood that the plan could become insolvent during a severe market downturn or that excess assets would accumulate during a market upswing. Therefore, the plan's use of the 5-year (shorter) smoothing horizon to more closely emulate actual movement in the market is appropriate.

2. Assumed Rate of Return Slightly Higher Than 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 will have a significant impact on the actuarial value of assets and, therefore, the funded status. FPRS's assumed rate of return on investments is currently 8.0%, net of all expenses, which is 0.25% of a point higher than the 7.75% rate assumed by CalPERS, LACERA and many other large plans. As reported in City documents⁴⁵, the plan has met the 8.0% target in 5 of the last 10 years. In total, over the last 10 years, its investments have returned only 3.51% overall. Other City fund portfolios with more modest investment growth goals, and therefore more conservative strategies, have achieved higher average returns. According to FPRS and City staff, the plan's actuarial assumptions, including its assumed rate of return on investments, are reviewed regularly by the Board:

⁴⁵ Agenda Report from the City Manager to the Mayor and City Council, March 28, 2011, "Plan to Address Funding Challenges Associated with the Fire and Police Retirement System."

Exhibit 31: Historic Assets, Liabilities, & Funded Ratio for FPRS



Source: City of Pasadena Comprehensive Annual Financial Reports

3. Pasadena's Approach to Issue Resolution

The City of Pasadena recognizes the difficulties it faces as it attempts to keep the FPRS solvent without draining away excess City resources. In a recent analysis conducted by the City Manager's Office and the Finance Department, a number of potential solutions were explored; and a limited set of recommendations came forward to the City Council and the Retirement Board. Some of the more significant of these options are described below:

- a. Initiate preparation for the issuance of new POBs, not to exceed \$65 million, to fund the FPRS. Additionally, approve the concept of refinancing existing POBs in the future. In March 2011, the City Council gave staff the authorization to initiate the preparation for the issuance of a third set of POBs not to exceed \$65 million, which is consistent with City staff's recommendation.
- b. Given the historically weak investment performance and the need to reduce the risk of investment losses, the assumed rate of return used for the estimate of the AVA should be reconsidered and lowered from the current rate of 8%. The impact of such a reduction could be severe, since a projection for lower investment income would cause the funded status of the plan to degrade.
- c. Consider "buy-outs" for current retirees to lower the plan's liabilities. While this may be an alternative that could be pursued by the City, it is the opinion of the task force that examined this alternative that it would be costly to implement; and it did not recommend this option to the City Council.
- d. Implement administrative changes that would lower costs and permit the City to take a more direct role in administering the plan. Specifically, the task force is suggesting that the plan's administrative functions could be consolidated within the City's Finance Department. Further, the FPRS Board should be requested to undertake a new selection process for financial advisor that would be repeated every 3 to 5 years.

- e. Direct the City Manager to seek new dedicated revenue sources to fund the system, while also shielding the General Fund from needing to contribute more discretionary dollars to the plan.

The CGJ believes these recommendations are prudent and will help to move the City toward resolution of the financial difficulties being faced by the City and the plan. The City and the FPRS should work collaboratively on ways to improve cost efficiencies, subject to any applicable legal constraints, including the possible consolidation of the FPRS administrative function with the City's Finance Department.

STATUS OF CALPERS PLANS

The City of Pasadena has 2 CalPERS plans:

- A Miscellaneous Plan, which has 2 tiers, including a 2.0% at 55 and a 2.5% at 55 tiers;
- A Safety plan with a single tier of 3% at 55. As of June 30, 2009, these plans were well funded at 82.9% and 80.5%, respectively

In accordance with contract terms negotiated with the collective bargaining units, the City of Pasadena contributes the full amount of the 8% employee contribution for the Miscellaneous Plan and the 9% employee contribution for the Safety Plan but is partially reimbursed by the employees. Different labor groups have different reimbursement rates ranging from 3.6% to 4.6%. City management notes that the reimbursement rates are planned to increase over time so that employees will eventually cover the complete cost of their contribution.

UNFUNDED RETIREE HEALTH BENEFIT

The City of Pasadena provides retiree health benefits for 1,913 active and 499 retired employees through the CalPERS Health Program. As of June 30, 2010, the most recent valuation, the AAL is \$30.8 million and is completely unfunded. This represents an increase of 30% from the previous valuation in 2008, which was \$23.7 million in unfunded liability.

Pasadena's OPEB benefit is currently a 2-tier program that is in the process of transitioning to a single-tier program. Currently, the 2 tiers provide different levels of subsidy to retirees electing to participate in the CalPERS Health Program. The subsidy amounts are either the minimum required employer contribution under the Public Employees Medical and Hospital Care Act (currently \$105 per month) or a portion of the minimum required employer contribution (currently \$23.50 per month). The members of FPRS currently receive the \$105 subsidy benefit, along with the members of the IBEW, AFSCME, and CalPERS Safety labor groups. All other labor groups receive the \$23.50 subsidy. According to City management, the \$105 subsidy will be phased in for all employees over time. Included in the actuarial valuation is the assumption that the \$23.50 level subsidy will increase to 25% of the minimum contribution in 2011 and 5% per year until it reaches 100% in 2026.

The City funds the plan on a pay-as-you-go basis, contributing only 11.28% of the ARC in FY 2009-2010. This policy has eroded the City's ability to accumulate reserves in this fund and discount the amount of future contributions it will have to make from discretionary resources. As stated by the City's independent auditor in the Comprehensive Annual Financial Report (CAFR) for the year ended June 30, 2010, "If the City should select the 'Prefunding' method, the annual OPEB cost would be reduced."

This unfunded \$30.8 million OPEB liability constitutes a substantial obligation. The high rate of health care cost inflation and the City's move to a single tier benefit, both point to increasing OPEB costs in years to come. Therefore beginning funding health care benefits at the actuarially determined ARC and moving to alternative defined contribution models that would shift a greater portion of the risk to the employee are both viable ways forward, separately or combined.

METHODS AND PROCEDURES

Using information collected for each of the 277 pension plans in Los Angeles County (LAC), the CGJ selected those that exhibited a range of characteristics that suggested 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. Due to the small membership base of the FPRS, the CGJ analyzed a limited set of attribute data for each of the 275 plan members.

FINDINGS

1. The City of Pasadena will be facing a significant financial challenge when it no longer receives funds from the Redevelopment Agency for the payment of Pension Obligation Bond debt presently used to finance the Fire and Police Retirement System. This funding source is due to end in 2014.
2. The City is actively considering solutions to the chronic underfunding of the FPRS which are reasonable and prudent.
3. The City's unfunded retiree health liability of \$30.8 million is a substantial obligation and is expected to grow with planned increases to the subsidy level for FPRS members and the rapidly rising costs of health care. The City has adopted a pay-as-you go policy, which is more costly in the long run because reserve balances are not available to generate investment income that discounts annual required contributions.

RECOMMENDATIONS

1. The City Council endorse the recommendations being made by management staff regarding actuarial assumptions, cost stabilization, administrative restructuring and funding for the FPRS
2. The City Council direct the City Manager to negotiate reductions in the amount of employee contribution picked up by the City for its CalPERS pension plans, up to the full amount of 8% for Miscellaneous and 9% for Safety employees
3. The City Council adopt a policy to fully fund the OPEB actuarially determined Annual Required Contribution each year, to build reserves toward future benefit obligations and earn investment income that can reduce the amount of the ARC in future years

REQUEST FOR RESPONSE

California Penal Code Sections⁴⁶ §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 Civil Grand Jury publishes its Report (filed with the Clerk of the Court).

Respond to:

Presiding Judge
Los Angeles County 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>
1	City of Pasadena
2	City of Pasadena
3	City of Pasadena

⁴⁶ Reference California Penal Code Sections §933(c) and §933.05 at the beginning of this 2010-2011 Civil Grand Jury Report

PHASE II: SECTION 4 MONTEREY PARK RETIREMENT BENEFITS

SUMMARY

The City of Monterey Park had well funded CalPERS plans at the end of FY 2008-2009 at a blended average of 86.4% for its 2 major retirement plans. At the time, few CalPERS plans reported such a strong funded ratio. In fact, in that year the major pool funds administered by CalPERS were generally reporting funded ratios from 60% to 65%.

The City has a long established property tax levy that is dedicated to paying employee retirement costs. In FY 2009-2010, the City projected it would collect approximately \$4.3 million from this levy to pay for CalPERS retirement costs of \$5.1 million. The remaining \$840,000 in CalPERS benefit costs, or 16.3% of total costs in that year, was a general obligation of the City. In the past 2 fiscal years, the City has completely funded this shortfall with a transfer of property tax from the pension tax levy that has historically been allocated to the Redevelopment Agency. The amount of this pass through equals approximately \$800,000 to \$900,000 annually.

Omitted from the CalPERS statements is significant Pension Obligation Bond (POB) debt that lowers the City's overall funded ratio from 86.4% to 75.1% when factored into the calculation. In addition, the CalPERS statements do not reflect significant Unfunded Actuarial Accrued Liability (UAAL) for retiree health benefits of approximately \$49.2 million, or UAAL for a supplemental Massachusetts Mutual Retirement Plan (MMRP) with UAAL of approximately \$6.2 million. When all UAAL and POB debt is totaled for Monterey Park, the unfunded liability and debt for the City reached approximately \$116.6 million in 2009. The City's annual covered payroll in 2010 was \$24.8 million or 21.3% of the total unfunded liability.

The City's current policies for funding retiree health benefits will cause the unfunded liability to grow over the years and create more fiscal distress for the City. Presently, the City's policy is to fund these benefits on a pay-as-you-go basis, contributing only 34.2% and 30.2% of the Annual Required Contribution (ARC) in each of the past 2 fiscal years. The City Council should reevaluate this policy to ensure fiscal solvency of the plan, particularly given its unique position of being allowed to fund its basic retirement costs with a special tax.

Although the city has been successful at negotiating changes to agreements with employee unions to pick up the entire share of the employees' contributions to the CalPERS plans, management reports that the city council recently has not directed staff to take any significant action to curb employee retirement costs. Based on information contained in the FY 2010-2011 adopted budget, previous blue ribbon task force efforts to identify solutions for pension funding shortfalls have centered on mechanisms to generate more revenue instead of reducing costs.

PURPOSE

The City of Monterey Park was chosen by the Civil Grand Jury (CGJ) for in-depth review, based on the high dollar amount of pension and retiree health benefit unfunded liability, coupled with high pension obligation bond debt totaling \$116.6 million.

BACKGROUND

The City of Monterey Park has 2 CalPERS pension plans for its Miscellaneous employees and Safety Fire and Police uniformed employees. As of the last valuation date which was June 30, 2009, Monterey Park's CalPERS pension plans had funded ratios of 83.1% for Miscellaneous employees and 88.2% for Safety employees. The blended funded ratio for the 2 plans was approximately 86.4%, which indicates a good funded status that exceeds the 80% funded ratio cited by public pension experts as an appropriate funding benchmark. In addition to the 2 CalPERS plans, the City funds a closed pension benefit plan through a MMRP, as well as retiree health, or Other Post Employment Benefit (OPEB) plans. Exhibit 32 shows key attributes of the retirement plans for Monterey Park employees.

ANALYSIS OF CALPERS FUNDED RATIO

Analysis of the financial statements for the City of Monterey Park indicates that the City issued \$17.0 million in POB debt in 2004 to prefund a portion of its UAAL with CalPERS. At that time, the amount of the debt plus interest was projected to be over \$38.0 million through the 30-Year funding period ending in FY 2033-2034. During the first 4 years of the borrowing, the City paid interest only amounting to approximately \$1.0 million per year. Beginning in FY 2008-2009, payments began to include both principal and interest; and by FY 2010-2011 annual debt service rose to approximately \$1.5 million per year.

Although not reported in the actuarial statements for pension plans, POB debt represents a general obligation of the jurisdiction and is reported in the financial statements in accordance with Governmental Accounting Standards Board (GASB) requirements. Therefore, when assessing the funded status of pension plans, it is appropriate to also consider POB debt in the analysis. Exhibit 33 suggests that when added to the UAAL reported by CalPERS, the funded ratio declines from 86.4% to approximately 75.1%, which is below the threshold cited by experts as a benchmark for a well funded plan.

Exhibit 32. Monterey Park Retirement Plan Attributes

MEMBERSHIP*		PLAN BENEFITS AND OPTIONS	
Active Members	364	Normal Retirement Age	55 all groups
Retired Members	404	Benefit Formula Miscellaneous	2.7% x Years
Disabled/Retired Members	-	Benefit Formula Safety	3% x Years
Survivor Members	-	Lump-Sum Death Benefit	Yes
Inactive Members	477	Survivor Benefit	Mixed
Total Members	1,245	Retiree Health	Yes
		Deferred Compensation	No
ACTUARIAL		FINANCIAL	
<i>Investment/Discount Rate</i>		<i>Pension Fund*</i>	
Assumed Actuarial Rate	7.75%	Actuarial Accrued Liability	\$ 213,663,012
One Year Actual Return (FY 2009)	-24.00%	Unfunded Actuarial Accrued Liability	\$ 28,977,487
		Funded Status	86.4%
<i>Methods</i>		<i>Retiree Health Fund</i>	
Investment Smoothing	15 Years	Actuarial Accrued Liability	\$ 49,150,000
Investment Corridor	60% to 140% Market	Unfunded Actuarial Accrued Liability	\$ 49,150,000
Amortization of Unfunded Liability	30 Years	Funded Status	0.0%
<i>Contributions*</i>		<i>Pension Obligation Bonds</i>	
Employer Contribution	20.7%	Principal Balance	\$ 16,855,000
Employee Contribution Pick-Up	2.8%	Projected Interest Expense	\$ 15,427,348
Total Contribution	23.5%	Total Indebtedness	\$ 32,282,348

* Calculated for all plans

Source: Monterey Park - 2009 CalPERS actuarial report and CAFR for the year ending June 30, 2009

In addition to the \$61.3 million in UAAL and POB debt shown in Exhibit 33, the City has liability for 2 other retirement benefits offered to its employees⁴⁷: MMRP, which is a defined benefit plan for individuals employed prior to April 1, 1976; and, OPEB or retiree health plan for all City employees retiring with CalPERS pension benefits. The MMRP has been closed to new members since April 1, 1976.

⁴⁷ Excludes the Monterey Park Part-Time Retirement Plan, which is an IRS Section 457 defined contribution plan for part-time and seasonal employees.

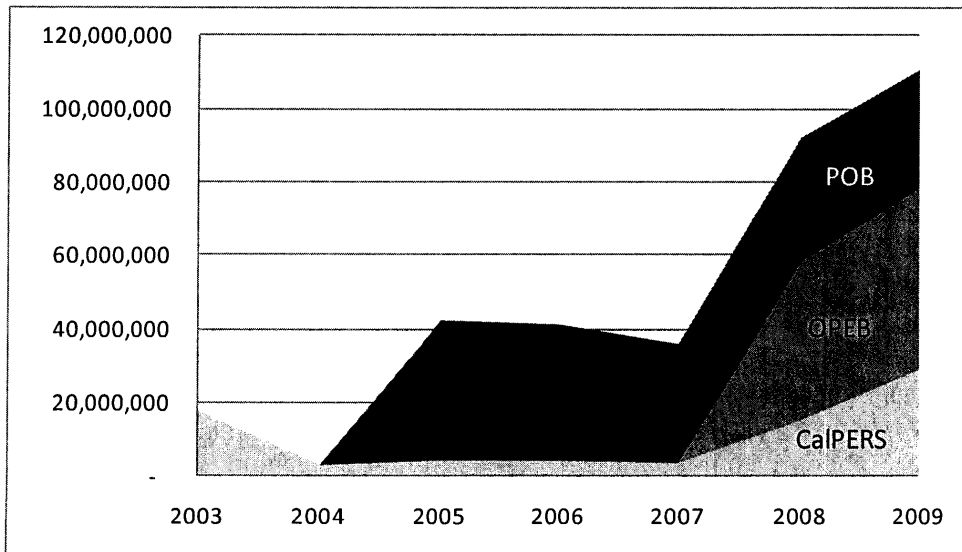
Exhibit 33. Recalculation of funded ratio with POB Debt

UAAL and Debt	AAL/Debt	AVA	UAAL/Debt	Funded Ratio
CalPERS	213,663,012	184,685,525	28,977,487	86.4%
POB Debt (P&I)	32,282,348	-	32,282,348	0.0%
TOTAL	245,945,360	184,685,525	61,259,835	75.1%

Source: Monterey Park - 2009 CalPERS actuarial report and CAFR for the year ending June 30, 2009

The City has continuing liability with the MMRP and significant AAL with the OPEB plan that it has established for employees. The combined UAAL for the City's CalPERS and MMRP pension plans, the retiree health plan and pension debt amounted to nearly \$116.6 million in 2009, which is significant. Exhibit 34 shows the growth in the UAAL and debt for the 3 largest pension liabilities of CalPERS, OPEB and the POBs since 2003. Note that the POB debt was not secured until June 2004 and the City did not report OPEB liabilities until 2008. Exhibit 34 does not include information for the MMRP liability:

Exhibit 34. Growth in UAAL and Debt for Major Retirement Benefit Costs (MMRP not included)



Source: Monterey Park CAFRs for the periods ending June 30, 2004 through June 30, 2010

This escalation in the City's unfunded pension liabilities is significant. In 2009, the CalPERS UAAL and POB debt represented 24.9% and 27.7% of the total unfunded retirement benefit liabilities reported by the City (52.6% of all unfunded retirement benefit liabilities). However, more striking is the portion represented by the OPEB unfunded liability, which was \$49.1 million and over 42.2% of total unfunded retirement obligations in 2009. This analysis is presented in the Exhibit 35.

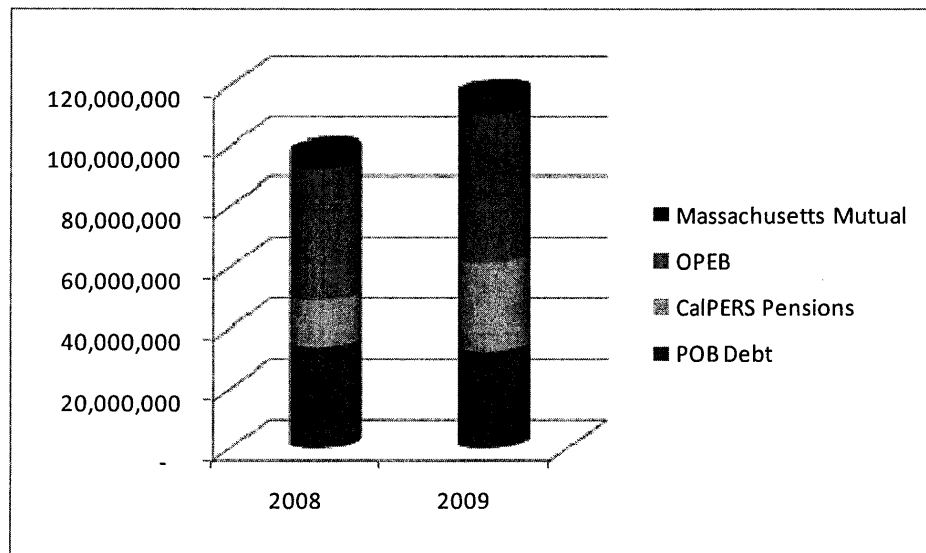
Exhibit 35. Two Year Distribution of Unfunded Retirement Benefit Liabilities

UAAL and Debt	Amount 2008	Percent 2008	Amount 2009	Percent 2009
CalPERS	15,261,000	15.7%	28,977,487	24.9%
POB Debt (P&I)	33,829,061	34.7%	32,282,348	27.7%
OPEB	42,957,000	44.1%	49,150,000	42.2%
Massachusetts Mutual	5,463,000	5.6%	6,154,000	5.3%
TOTAL	97,512,069	100.0%	116,565,844	100.0%

Source: Monterey Park CAFRS for the years ended June 30, 2009 and June 30, 2010

Exhibit 36 shows the total growth in liabilities between 2008 and 2009 has been driven primarily by the change in UAAL for the CalPERS and OPEB plans with the POB debt remaining fairly static. While the MMRP liability has been growing rapidly in the past several years, the relatively small UAAL and the fact that it is a closed plan make this less of a concern for the City:

Exhibit 36. Two Year Distribution and Growth in Unfunded Retirement Benefit Liabilities



Source: Monterey Park CAFRS for the years ended June 30, 2009 and June 30, 2010

The City's UAAL and pension debt provides some perspective on the areas where the City should focus its efforts if it is to begin a strategy to fully fund its retirement benefit obligations. First, it should focus on changes to slow or halt the growth of its OPEB obligations and adopt policies to begin funding its liabilities. Second, it should explore opportunities to reduce its funding obligations for CalPERS, focusing on agreements with employee unions to reduce or eliminate City pick up subsidies for employee contributions.

RETIREMENT BENEFIT FUNDING POLICIES

Because it is a CalPERS member agency, the City of Monterey Park is required to contribute the full amount of its ARC each year. Under the terms of the POB debt instrument, it also must make debt service payments in accordance with the loan agreement.

However, the City has not been making the ARC payments to either the MMRP or the OPEB funds by policy of the City Council. Until 2007, the City was contributing the full amount of the required contribution to the MMRP. However, beginning in FY 2007-2008, the City contributed less than the ARC at a low of 59% in FY 2007-2008 and a high of 96% in FY 2009-2010. Because the FY 2009-2010 required contribution was only \$405,000, this does not present a major annual funding problem for the City. Nonetheless, the City should routinely contribute the ARC to ensure sufficient funds are available to pay benefits to retirees. As of July 1, 2009, the plan had UAAL of approximately \$6,154,000.

More importantly, the City has not been funding the full ARC for its retiree health plan. In each of the last 2 years, the City has contributed less than 35% of the required contribution at 34.2% in FY 2008-2009 and 30.2% in FY 2009-2010. In 2010, this represented a funding shortfall of approximately \$2.7 million. A comparison of the ARC and actual amounts contributed to the OPEB fund for each of the last 2 fiscal years is shown in Exhibit 37:

Exhibit 37. 2-Year History of OPEB Funding

<u>OPEB Funding History</u>	<u>2009</u>	<u>2010</u>
Annual Required Contribution	3,236,000	3,877,000
Actual Amount Contributed	1,108,000	1,171,000
Percent Contributed	34.2%	30.2%

Source: Monterey Park CAFRS for the years ended June 30, 2009 and June 30, 2010

The decision to fund the plan on a pay-as-you-go basis has eroded the City's ability to accumulate reserves in this fund and discount future contributions. Had cash reserves been available in FY 2009-2010, the City could have reasonably expected investment returns that would have reduced its contribution requirements and ensured assets to fund benefits for current and future retirees. At a minimum, the City should begin to fund the ARC in each fiscal year so that it begins to build these reserves and prefund benefit obligations.

PROPERTY TAX LEVY FOR RETIREMENT COSTS

It is important to note that Monterey Park has unique taxing authority because the voters approved special property tax levies in 1946 and 1952 to support employee pension costs in the City. These special property tax levies have been permitted for those jurisdictions that had them in place prior to the passage of Proposition 13, although they are limited by State law to no more than the amount that would be collected by the special property tax rates that were in place when Proposition 13 was passed by California voters.

According to the City's CAFR for the Period ending June 30, 2010, the City collected \$4.1 million in FY 2009-2010 and had a Special Revenue Fund balance of about \$770,000 as of June 30 of that year. For FY 2010-2011, the City Manager projected that the special tax levy

would collect about \$4.2 million, which is consistent with the amounts shown in the financial statements for each of the previous 2 years.

In addition, by resolution of the City Council, the City has begun to pass through the portion of the special property tax levy previously collected by the Monterey Park Redevelopment Agency, to the General Fund. For the 2-year period FY 2008-2009 and FY 2009-2010, the City received \$1.6 million from this pass through; and the City Manager has projected that an additional \$900,000 will be collected in FY 2010-2011. In total, the City is receiving \$4.2 million from the portion of the levy that comes directly to the General Fund and an additional \$900,000 from the Redevelopment pass through for total income of \$5.1 million to support pension costs.

This \$5.1 million is sufficient to pay most of the CalPERS required contributions for both the Miscellaneous and Safety plans, which amounted to \$5,140,000 in FY 2009-2010. Therefore, the CalPERS pension plan cost requires very little, if any, contributions from General Fund discretionary resources. This places Monterey Park in a unique position and should allow enough funding flexibility for the City to fully fund its ARC for both the MMRP and OPEB plans, as well as service the POB debt from discretionary resources. In FY 2009-2010, the full ARC on the MMRP plus the OPEB plans combined with the debt service on the POBs totaled to approximately \$5,830,000. This is only \$690,000 more than the \$5,140,000 CalPERS ARC in FY 2009-2010.

ABSENCE OF POLITICAL WILL

Monterey Park has seen degradation in services over the past several years with data showing that, while basic services are continuing uninterrupted, the City is less able to proactively address other concerns as they arise. As an indicator of this service degradation, based on data from the City's CAFRs, full-time and part-time employees in the City have declined to their lowest levels in more than 10 years. As of June 30, 2001, the City had 403 total employees and as of the same date in 2010, the City had dropped to 373 employees. Public Safety has seen some reductions in recent years, but its FY 2009-2010 staffing levels were close to those that existed in FY 2000-2001 (185 vs. 188). The areas where reductions have been most pronounced have been general government, which includes the overall functioning of the municipal enterprise, culture and recreation, which provide quality of life services to the community, such as parks, youth and senior services and other similar functions.

Nonetheless, it is clear that the City Council has been concerned about the cost of employee pension benefits. According to the FY 2010-11 Adopted Budget:

In 2006, the City formed a community blue ribbon committee to assist the City in addressing the pension-funding shortfall. Last year, the City Council implemented several of the Committee's recommendations including: rounding of utility bills, business annual fire safety inspection, public safety impact fee adjustment, inter-fund cost allocation update, and setting aside 30% of future sales tax from major commercial developments. These items will generate between \$382,000 to \$1.0 million a year (depending on the timing and completion of major commercial developments).

In addition, in FY 2009-2010, the City approved a resolution authorizing the pass through of the special property tax revenue restricted for public employee pension purposes.

None of these recommendations addresses mechanisms for reducing the City's pension costs, although some efforts have been made to reduce the amount of the City's pick up of the employees' pension contribution. The City still pays 5.25% of the 8% contribution for Miscellaneous employees (a net of 2.75% remaining as a payroll deduction for the employee) and pays the full 9% of the required employee contribution for both uniformed Fire and Police

department employees hired prior to July 1, 2010. For employees hired after that date, the City is required to pick up approximately 66% of the 9% of pensionable salaries, or 6% of pensionable salaries, as of July 1, 2010.

During interviews, City personnel were asked whether the City Council had requested initiation of steps to modify pension formulas, retirement pick up, OPEB structure or employee share formulas, or any other retirement benefit changes that would reduce the City's costs. It was indicated that only limited initiatives were being pursued at this time.

Unless the City of Monterey Park pursues pension changes with its employee unions to more aggressively reduce its retirement benefit costs, it will continue to be faced with making budget sacrifices to fully fund the OPEB and MMRP ARC. Without the political will to make such changes, or make the budget sacrifices, the City will find itself in ever deepening financial troubles in the future.

METHODS AND PROCEDURES

Using information obtained for each of the 277 pension plans in Los Angeles County (LAC), the CGJ selected those that exhibited a range of characteristics that suggested 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.

FINDINGS

1. Total CalPERS and retiree health UAAL, including and Pension Obligation Bond debt, equaled \$116.6 million as of June 30, 2009, which is significant.
2. A significant portion of this liability is related to OPEB, or retiree health benefits provided to City employees. As of June 30, 2009, the UAAL for OPEB equaled \$49.1 million, or 42.2% of all unfunded retirement obligations in 2009.
3. OPEB liabilities are growing rapidly. In part, this is because the City has chosen not to fund its Annual Required Contribution at the levels recommended by actuaries. In FY 2008-2009, the City contributed only 34.2% of the requirement; and, in FY 2009-2010, the City contributed only 30.2% of the requirement. In FY 2009-2010, this represented a funding shortfall of approximately \$2.7 million. Since 2007, the City has also not funded the full amount of the ARC for the MMRP closed plan.
4. The policy to fund these benefits on a pay-as-you-go basis is striking because the City has unique pension funding authority authorized by the voters when they approved special property tax levies in 1946 and 1952. Revenue from this levy were sufficient to nearly fund the full cost of the CalPERS Annual Required Contribution in FY 2009-2010. As a result, the City only needs to fund the OPEB, MMRP and POB debt from discretionary resources.
5. With the exception of attempts to reduce the City's pick up of the employees contribution to CalPERS, the City appears to have done very little to reign in the cost of the retirement benefits that it provides. A blue ribbon committee in 2006 recommended revenue solutions to cope with the City's "pension-funding shortfall,"

and subsequent steps by the City Council have involved adopting a resolution to pass through the portion of property tax revenue collected by the Redevelopment Agency from the special property tax levy.

RECOMMENDATIONS

1. Monterey Park's City Council adopt policies to fully fund the ARC for both the MMRP and OPEB retirement benefit plans for employees in order to ensure future funding of benefits and earn investment income which would discount the annual required contributions
2. Monterey Park's City Council direct its City management to explore alternatives for reducing retirement benefit costs, including possible additional revisions to the amount of the employee contribution pick up paid by the City and alternative employee cost sharing arrangements for retiree health benefits.

REQUEST FOR RESPONSE

California Penal Code Sections⁴⁸ §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
Los Angeles County 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>
1	City of Monterey Park
2	City of Monterey Park

⁴⁸ Reference California Penal Code Sections §933(c) and §933.05 at the beginning of this 2010-2011 CGJ Report

PHASE II: SECTION 5 HERMOSA BEACH POLICE SAFETY PLAN

SUMMARY

The Hermosa Beach Police Safety Plan is one of 3 plans the City provides to its employees through CalPERS. In 2009, this plan had the highest contribution rate in the County at approximately 57.9% of salaries for the employer and employee share of pension benefit costs for uniformed personnel. The City also contributed to a defined benefit retiree health plan for these employees at a rate of approximately 5.3% of salaries, for a total retirement contribution rate of 62.2% in that year. Pension contributions are projected by CalPERS to increase by an additional 8.0% by 2012, increasing the total effective rate for uniformed Police Department retirement benefits to 70% of salaries by that year if retiree health rates remain static.

This growth in contributions is also occurring with the Miscellaneous and Fire Safety plans for Hermosa Beach. Also administered for the City by CalPERS, the Miscellaneous employee effective contribution rate was 27.1% of salaries in 2009 and could increase by an additional 2% by 2012. The Fire Safety employee effective contribution rate was 51.9% in 2009, and could increase by an additional 3% by 2012. In total for the 3 plans, CalPERS projects that the City will be required to contribute \$4,149,982 on base salaries of \$12,751,612 in FY 2011-2012, or approximately 32.5% of salaries excluding retiree health benefits.

The City has recognized the significance of the funding difficulties that it faces and has initiated several strategies to reduce costs including proposals to labor unions to modify pension formulas. However, the City is not proposing to reduce or eliminate the City's commitment to pick up the 7% (Miscellaneous) and 9% (Safety) employee contributions for CalPERS pensions at this time. The City is considering the issuance of Pension Obligation Bonds (POBs) to take advantage of current lower interest rates on borrowing. In recent analysis, bond advisors have estimated that POBs would save an estimated \$329,818 over 8 years.

PURPOSE

The Hermosa Beach Police Safety Plan was chosen by the CGJ for in-depth review, based on the high annual required contribution for pension and retiree health benefits, amounting to over 62% of pensionable salaries in 2009, and expected to rise to over 70% of pensionable salaries by 2012.

BACKGROUND

The City of Hermosa Beach offers pension benefits to its employees through CalPERS. CalPERS acts as a common investment and administrative agent for participating public entities within the State of California. Benefit provisions and all other requirements are established by State statute and City ordinance. Hermosa Beach participates in 3 risk pool plans for its Miscellaneous, Fire and Police employees. As of the last valuation, the City had among the highest CalPERS employer contribution rates of any jurisdiction in Los Angeles County (LAC).

The employer contribution rate for its Police Safety Plan was the highest in the County at a reported rate of 48.9% of salaries.

In addition to its employer contribution, the City has agreed to pay the full amount of the employee contribution which amounted to an additional 9% for uniformed Police Department employees. This has a significant effect on the City's costs, creating an effective contribution rate for uniformed police personnel of 57.9% of salaries in FY 2009-2010.

The City also offers its employees retiree health benefits, or Other Post Employment Benefits (OPEB), which had an Annual Required Contribution of \$595,482 in FY 2009-2010. On Citywide pensionable salaries of \$11,229,859, this resulted in an OPEB rate of 5.3% in that year. Added to the effective CalPERS rate described above, the City paid 62.2% of salaries for uniformed Police Department employee retirement benefits in that year. The rate could rise to 70% by 2012. Exhibit 38 shows key attributes of the retirement plan:

Exhibit 38. Hermosa Beach Police Safety Plan Attributes

MEMBERSHIP		PLAN BENEFITS AND OPTIONS	
Active Members	37	Normal Retirement Age	50
Retired Members	68	Benefit Formula	3% x Years
Disabled/Retired Members	Unk	Lump-Sum Death Benefit	Yes
Survivor Members	Unk	Survivor Benefit	Yes
Inactive Members	29	Retiree Health	Yes
Total Members	134	Deferred Compensation	Yes
ACTUARIAL		FINANCIAL	
<i>Investment/Discount Rate</i>		<i>Pension Fund</i>	
Assumed Actuarial Rate	7.75%	Actuarial Accrued Liability	\$ 41,566,800
One Year Actual Return (FY 2009)	-24.00%	Unfunded Actuarial Accrued Liability*	\$ 16,550,608
		Funded Status	60.2%
<i>Methods</i>		<i>Retiree Health Fund**</i>	
Investment Smoothing	15 Years	Actuarial Accrued Liability	\$ 5,830,000
Investment Corridor	60% to 140% Market	Unfunded Actuarial Accrued Liability	\$ 3,192,758
Amortization of Unfunded Liability	30 Years	Funded Status	45.2%
<i>Contributions</i>		<i>Pension Obligation Bonds</i>	
Employer Contribution	48.9%	Principal Balance	\$ -
Employee Contribution Pick-Up	9.0%	Projected Interest Expense	\$ -
Total Contribution	57.9%	Total Indebtedness	\$ -
		* Includes estimates adjusted by Side Fund balance	
		** All City employee cost.	

Source: Hermosa Beach -2009 CalPERS Pooled Plan Actuarial Report and CAFR for year ending June 30, 2009

Because Hermosa Beach has less than 100 employees in each of its plans, it participates in CalPERS pooled fund plans, whereby the assets and liabilities of the City are pooled with those of other similarly sized jurisdictions that have elected the same plans for their employees. As of June 30, 2009, Hermosa Beach was participating in 3 such pooled plans: the Miscellaneous 2% at 55 Plan for non-sworn employees, the Safety 3% at 55 Plan for sworn Fire Department employees, and the Safety 3% at 50 Plan for sworn Police Department employees.

OVERVIEW OF HERMOSA BEACH PLANS

Exhibit 39 shows the low funded status of all 3 Hermosa Beach pooled plans as of June 30, 2009. The City also had an additional negative "Side Fund balance" of \$13.9 million, representing the balance remaining on Unfunded Actuarial Accrued Liability (UAAL) for the plans at the time they joined the various CalPERS pooled funds. The amortization of this negative Side Fund balance significantly increases the City's ARC which is particularly apparent with the Police Safety Plan:

Exhibit 39. Hermosa Beach 3 CalPERS Pooled Plans Funded Status-2009

<u>Hermosa Beach Pension Plan</u>	<u>Funded Status</u>
Miscellaneous: 2% at 55 Plan	64.9%
Safety – Fire: 3% at 55 Plan	61.5%
Safety - Police: 3% at 50 Plan	60.2%

In addition to the unfunded liabilities of its 3 CalPERS pooled plans, Hermosa Beach had nearly \$2.5 million of UAAL in retiree health, or OPEB liability. While the City had not borrowed using POBs as of June 30, 2009, the CGJ was advised during interviews that management was poised to borrow using POBs during the current fiscal year to prefund its UAAL and negative Side Fund balance. The CGJ chose Hermosa Beach for in-depth analysis because it is a CalPERS risk pool plan that has annual contribution rates that are among the highest in the County.

Exhibit 40 shows key attributes of the 3 Hermosa Beach retirement plans. Because these are all pooled plans, the exact amounts for liability and assets for each was not available from CalPERS for this assessment. However, estimates could be made by apportioning the pooled fund actuarial data to Hermosa Beach and then adding specific data for the City's Optional Benefit cost and Side Fund amortization. The results of this analysis indicated that the City's overall CalPERS funded status as of June 30, 2009 was approximately 46.7%, as shown in Exhibit 40. The Police Safety Plan had the lowest funded status of approximately 39.5% and; because it is the largest of the 3 funds, it caused the overall average for the City to skew downward.

Exhibit 40. Estimate of the City of Hermosa Beach Pension Plan Funded Status

Employee Group	Plan	Total Member Count	Estimated AAL	Estimated UAAL	Net Funded Ratio	Side Fund Balance/AAL	UAAL Plus Side Fund	Gross Funded Ratio
Miscellaneous	2% at 55	307	29,602,475	10,396,555	64.9%	2,677,994	13,074,549	55.8%
Safety Fire	3% at 55	77	19,792,157	7,626,696	61.5%	2,590,630	10,217,326	48.4%
Safety Police	3% at 50	134	41,566,800	16,550,608	60.2%	8,609,663	25,160,271	39.5%
TOTAL			90,961,432	34,573,859	62.0%	13,878,287	48,452,146	46.7%

Source: Hermosa Beach and Pooled Fund CalPERS actuarial reports for the year ending June 30, 2009

Exhibit 40 shows the Side Fund balances due as of the valuation date were significant and appear to be a major reason for the overall low funded status for the City even when considered in relation to investment losses. This assessment is borne out by analyzing the components of the City's contribution rate for its Police Safety plan for the current fiscal year as shown in Exhibit 41:

Exhibit 41. Components of the Hermosa Beach 2010-11 Police Safety Contribution Rate

FY 2010-11 Cost Category	Cost	Percent of Payroll
Risk Pool's Net Employer Normal Cost	\$ 653,715	15.707%
Risk Pool's Payment on Amortization Basis	102,800	2.470%
Optional Benefits	112,497	2.703%
Amortization of Side Fund	1,109,691	26.663%
Total Employer Contribution	\$ 1,978,703	47.543%

Source: Hermosa Beach CalPERS actuarial reports for the year ending June 30, 2009

Exhibit 41 shows the amortization of the Side Fund adds 26.663% to the City's Police Safety Plan rate, which represents approximately 56.1% of the total cost of the benefit in that year. According to City management staff, when the City initially joined the CalPERS pooled plans in 2003, it had an existing UAAL that was amortized over a period of 15 years. Each year, the City has paid down the Side Fund balance in amounts required by CalPERS. According to data provided by Hermosa Beach, the Side Fund balances for each of the 3 plans will be fully paid off between FY 2016-2017 and FY 2018-2019. The schedule generally conforms to what the CGJ was told by Hermosa Beach management staff during interviews, who estimated that the Side Fund balances would be completely paid off in 7 to 8 years.

IMPACT ON CITY SERVICES AND LABOR NEGOTIATIONS

The significant costs of retirement benefits for employees, as well as the general revenue losses from the recession, have impacted the City's ability to fully fund historical service levels. In FY 2010-2011, the budget included \$2.4 million in revenue enhancement initiatives; e.g., increase parking lot fees, extend meter enforcement hours, etc., as well as cost reductions; e.g., eliminate funding for 14 positions, eliminate parking attendants and replace with automated attendant machines, reduce contracts for services and supplies, etc. These initiatives equated to budget reductions of approximately 8.2%.

In addition to these recommendations, City management is considering a series of other initiatives to increase revenues and reduce expenditures that could be pursued during the fiscal year. This included a potential option to offer an early retirement program and a commitment to

be “moving to implement a 2-tier retirement system for all new employees.” City management stated that the City would be looking at alternatives for more effectively integrating retiree health care benefits with Medicare.

MODIFICATIONS TO PENSION PLANS

During interviews, the City management stated that these initiatives are being actively pursued. Specifically, as part of active negotiations, the City is offering the changes shown in Exhibit 42 to its 7 employee bargaining groups:

Exhibit 42. Hermosa Beach Pension Change Initiatives Being Pursued with Its 7 Employee Bargaining Groups

Employee Group	Current Formula	Proposed Formula
Miscellaneous	2% at 55	2% at 60
Fire Safety	3% at 55	2% at 50
Police Safety	3% at 50	2% at 50

According to City management, they have received “strong policy direction” from the City Council to reduce the annual pension cost and are confident that the labor unions will work collaboratively with management to establish less costly second tier retirement plans for new employees.

REDUCING OR ELIMINATING EMPLOYEE CONTRIBUTION PICK UP

The City of Hermosa Beach presently picks up the full 7% (Miscellaneous) and 9% (Safety) employee contribution as part of negotiated compensation for City employees. In FY 2010-2011, this equates to approximately \$900,000 on salaries of approximately \$11.2 million. According to the City management, this represents employee compensation that could be reduced or eliminated through the collective bargaining process. However, a proposal to make such changes has not been made to the City’s labor unions at the writing of this Report. Further, because of the way in which CalPERS calculates rates, City management states that impacts of reductions in the contribution pick up would not be realized for approximately 3 years.

The City could receive more immediate budget savings by approaching labor unions to reduce the amount of the pick up for current employees when compared with the timing of eventual savings from establishing a second tier. Typically, savings from establishing second tier benefits occur over a long period as employees receiving the more costly benefits leave employment and are replaced by new employees. This transition often takes 15 to 20 years before substantial savings are realized, particularly in a small jurisdiction where many employees stay for their entire career. Although the CGJ did not analyze the attrition rate in Hermosa Beach, or conduct analysis on projected future savings from the proposed second tier benefit formulas, the CGJ believes immediate budget savings will be minimal unless the City has an older workforce that could be induced to leave employment using early retirement incentives.

The CGJ does recognize that the City could also achieve savings as staffing levels return to levels that existed prior to the recession. In addition to the 14 positions which are included in the budget without funding, City management reported that there were an additional 11 positions

that were funded but unfilled at the time of the interview, for a total of 25 vacancies. To the extent the City hires staff to fill these vacancies after the tiered pension plan is implemented, the budget requirements for retirement benefits will increase at a slower rate.

PENSION OBLIGATION BONDS

At the time of this analysis, the City did not have any POBs but was exploring the possibility of borrowing funds through the California Statewide Community Development Authority to pay down its CalPERS Side Fund balance. An initial analysis by the City's financial advisors indicate that interest savings of as much as \$329,918 could be realized over the funding period by reducing the amount of interest being paid on the debt.⁴⁹ Exhibit 43 summarizes the interest savings projections made by the Hermosa Beach financial advisors on the planned POBs versus the interest charged by CalPERS on the Side Fund balance over the amortization period:

Exhibit 43. Hermosa Beach Bond Advisor Estimate of POB Savings

CalPERS Plan	Term Date	Side Fund Balance Plus Interest Due	Refunding Amount Plus Costs	Estimated Savings
Miscellaneous	7/1/2018	\$ 3,226,028	\$ 3,167,118	\$ 58,910
Fire	7/1/2017	2,963,585	2,903,161	60,423
Police	7/1/2019	10,875,473	10,664,989	210,484
Total		\$ 17,065,086	\$ 16,735,268	\$ 329,818

Source: January 4, 2011, California Statewide Community Development Authority Prepared by Morgan Stanley/BWR

The present value of this savings is estimated to be \$623,100 over the term of borrowing. While the financial analysis supports a decision to borrow POB funds at this time, the City will need to monitor the market and ensure that the savings potential remains since current projections are modest. Should the cost of borrowing funds increase, the ability to realize even these modest savings will be compromised.

In addition, once the Side Fund debt is paid, the City will still be required to contribute significant amounts for pension benefits directly to CalPERS. Except for the arbitrage savings of \$329,918 that is projected to occur over the 8 year debt window (an average of \$41,227 per year), the total outlay for CalPERS and POB debt will approximate the costs that would otherwise be charged by CalPERS.

In addition, as stated elsewhere in this Report, the Government Finance Officers Association of the United States and Canada (GFOA) has issued an advisory on this topic. When discussing practical considerations regarding decisions to issue POBs, the advisory states:

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

⁴⁹ Known as arbitrage, the savings is essentially achieved from the differential between the interest expense on the original debt and the interest expense on the new debt. The amount of savings is highly dependent on market conditions. The financial advisor assumed fixed interest expense of 4.62% through 2016 and 6.20% from 2017 through 2019 on the bonds, compared with 7.75% being charged by CalPERS throughout the debt period. Using the financial advisors assumptions, the present value of the savings would amount to \$623,100.

additional benefits by government employees if plans are fully funded and government's contribution as percentage of payroll has declined relative to neighboring jurisdictions.⁵⁰

Given the relatively modest annual savings to be achieved by issuing the proposed POBs, taking these other considerations into account as it moves toward a decision is advised.

OPEB PREFUNDING AND ANNUAL REQUIRED CONTRIBUTIONS

As part of this assessment, the CGJ analyzed the funded status of OPEB for those jurisdictions that offer retiree health benefits to employees in the County. Only 14 of 70 cities offering such benefits have funded any portion of the AAL for OPEB. The remainder has not been pre-funding these benefits and continues to operate on a pay-as-you-go basis.

The City of Hermosa Beach began to pre fund OPEB benefits in 2007 shortly after it had completed its first actuarial evaluation of retiree health benefits. At that time, the City contributed \$1,401,000 to a trust to begin accumulating a balance that could be invested in high yield investments so that future contributions could be discounted and to establish asset reserves to pay for the future costs of benefits. In addition, the City Council adopted a policy of fully funding the ARC each year in conjunction with the budget action to appropriate funds to the reserve.

As of June 30, 2008,⁵¹ the City reported OPEB AAL of \$5,830,000 and an Actuarial Value of Assets (AVA) of \$2,647,242 resulting in a funded ratio of 45.2%. Although a more recent valuation was not available for this Report, the Hermosa Beach Finance Department reports that the actual market based investment balance for the fund was reported to be \$3,386,296 as of January 31, 2011.

The City has done a notable job in attempting to prefund its OPEB obligations since the initial valuation was prepared, both with the deposit of \$1.4 million in the fund shortly after it was created and with the policy to fully fund the ARC on an annual basis. In addition, costs appear to be well contained with monthly benefits ranging "between \$40 and \$612 per month" at the time of the last valuation and CAFR description. According to the City management, there are currently no plans to modify benefits or increase employee cost sharing.

METHODS AND PROCEDURES

Using information obtained for each of the 277 pension plans in Los Angeles County (LAC), the CGJ selected those that exhibited a range of characteristics that suggested 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.

⁵⁰ GFOA of the US & Canada, *Advisory: Evaluating the Use of Pension Obligation Bonds (1997 and 2005)*

⁵¹ This is the date of the most recent valuation, as reported in the City's *Comprehensive Annual Financial Report for the Period Ended June 30, 2010*.

FINDINGS

1. The City of Hermosa Beach pays among the highest retirement system employer contribution rates in the County and pays the highest employer contribution rate for its CalPERS Police Safety Plan. In addition, the City picks up the full amount of the employees' contribution at 7% of salaries for Miscellaneous employees and 9% for uniformed police and fire employees.
2. These high rates are being driven by unfunded actuarial accrued liability that is reported in a "Side Fund" created after the City moved to its CalPERS Risk Pool plans. Based on the CalPERS rate estimate for the Police Safety Plan in FY 2010-2011, the City is paying over \$1.1 million annually for the amortization of that plan's Side Fund balance, which equates to 56.1% of the total CalPERS employer contribution rate in that year.
3. The high cost of employee retirement benefits plus the impacts from the recession have caused the City to make significant budget reductions in the past years. In FY 2010-2011, City management made budget recommendations to reduce costs by modifying service levels and removing funding for 14 positions. Other positions have been kept vacant to achieve salary savings equating to 25 total vacant positions.
4. The City has taken action to create a second retirement tier for new employees pursuant to strong policy direction from the City Council. However, the City is not pursuing other alternatives that would result in more immediate savings such as reducing or eliminating the pick up of the employee contribution rate.
5. The City is contemplating the issuance of Pension Obligation Bonds which will pay off the Side Fund balance and improve the funded ratio of the pension plan. However, annual savings will be modest based on the most recent analysis conducted by the City's bond analysts.
6. The City has moved forward aggressively to pre fund its OPEB obligations, being one of only 14 out of 70 OPEB cities to do so in the County. While the City's most recent actuarial evaluation from 2008 reported a funded ratio of only 45.2% on \$5.8 million in liabilities, recent finance reports show that the cash balance in the fund has grown substantially to \$3.4 million as of January 31, 2011.

RECOMMENDATIONS

1. Hermosa Beach make proposals for reducing or eliminating the employee retirement pick up during contract negotiations with employee bargaining groups. This pick up does not represent a vested pension benefit for employees, but is considered deferred compensation that could be reduced through the collective bargaining process to achieve more immediate budget savings.
2. Hermosa Beach proceed cautiously with its current initiatives to pay off the CalPERS Side Fund balance by issuing POBs, making certain that the financial benefits are substantial and taking into consideration potential obstacles cited by the GFOA with respect to removing the debt obligation from its pension plans. The City needs to weigh any projected modest savings against other advice from the GFOA for jurisdictions that may be considering POBs as a means of reducing UAAL.

REQUEST FOR RESPONSE

California Penal Code Sections⁵² §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 Civil Grand Jury publishes its Report (filed with the Clerk of the Court).

Respond to:

Presiding Judge
Los Angeles County 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>
1	City of Hermosa Beach
2	City of Hermosa Beach

⁵² Reference California Penal Code Sections §933(c) and §933.05 at the beginning of this 2010-2011 Civil Grand Jury Report