CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Office of the City Attorney
RICHARD DOYLE, CITY ATTORNEY

FILED
SEP 04 2012
DAVID H. YAMASAKI
Chief Executive Officer/Clerk
Superior Court of CA County of Santa Clara
BY D. ALDYCKI

August 29, 2012

HAND DELIVERED

The Honorable Richard J. Loftus, Jr.
Presiding Judge
Santa Clara County Superior Court
191 North First Street
San Jose, CA 95113

Re: Grand Jury Reports

Dear Judge Loftus:

Pursuant to California Penal Code section 933, et seq., please accept the City's response to the 2011-2012 Santa Clara County Civil Grand Jury Report, "An Analysis of Pensions and other Post Employment Benefits." The City responses approved by the Mayor and the City Council and the Grand Jury's Report are enclosed for your review.

Please feel free to contact me if you have any questions. Thank you for your consideration.

Very truly yours,

RICHARD DOYLE
City Attorney

RD:EJM
Enclosures

cc: Mayor Chuck Reed
Debra Figone, City Manager
Alex Gurza, Deputy City Manager

200 East Santa Clara Street, San José, CA 95113-1905 *tel* (408) 535-1900 *fax* (408) 998-3131

T-24783/894179

COUNCIL AGENDA: 08/28/12
ITEM: 3.3

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Alex Gurza

SUBJECT: SEE BELOW

DATE: August 14, 2012

Approved

Date 8/14/12

SUBJECT: SANTA CLARA COUNTY CIVIL GRAND JURY REPORT – AN ANALYSIS OF PENSION AND OTHER POST EMPLOYMENT BENEFITS

RECOMMENDATION

It is recommended that the Mayor and City Council approve this response to the 2011-2012 Santa Clara County Civil Grand Jury Report entitled "An Analysis of Pension and Other Post-Employment Benefits."

OUTCOME

Approval of this report will satisfy the requirements of Penal Code Section 933(c), which requires the City Council to respond to Civil Grand Jury reports to the presiding judge of the Superior Court.

BACKGROUND

Grand Jury Report

The Santa Clara County Civil Grand Jury conducted an analysis of the Comprehensive Annual Financial Reports of all fifteen (15) cities and town located within Santa Clara County. As such, the Grand Jury provided the City with its final report, including findings and recommendations, entitled "An Analysis of Pension and Other Post Employment Benefits." (Please see Attachment A) According to the report:

> *(T)he Grand Jury sought to answer the following question: "Is the cost of providing pension and other post employment benefits interfering with the delivery of essential City services and is the ultimate cost to the taxpayers a bearable burden"?*

The report contains seven (7) findings with applicable recommendations to all cities in Santa Clara County including specific recommendation made for San Jose. The City has responded to each of those findings and recommendations in accordance with California Penal Code Section 933.05, which states that the responding person or entity shall indicate one of the following with respect to each finding and recommendation:

Finding:

1. The respondent agrees with the finding.

2. The respondent disagrees wholly or partially with the finding, in which case the response shall specify the portion of the finding that is disputed and shall include an explanation of the reasons thereafter.

Recommendation:

1. The recommendation has been implemented, with a summary regarding the implemented action.

2. The recommendation has not yet been implemented, but will be implemented in the future, with a time frame for implementation.

3. The recommendation requires further analysis, with an explanation and the scope and parameters of an analysis or study, and a time frame for the matter to be prepared for discussion by the officer or head of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This timeframe shall not exceed six months from the date of publication of the grand jury report.

4. The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation therefor.

The conclusions of the report indicate "that until significant modifications are enacted, there is no doubt that the escalating cost of providing (employee pensions and other post employment benefits) at the current level is interfering with the delivery of essential City services and the ultimate cost to the taxpayers is an unbearable burden. These costs are already impacting delivery of essential services as demonstrated by San Jose reducing police and fire department staffing levels, closing libraries or not opening those newly built, curtailing hours of community centers, and not repairing pot-hold city streets." The report further concludes that other cities in Santa Clara County "are likely to face similar challenges as long as high cost benefit plans face an underfunding liability."

The focus of the Grand Jury's finding and recommendations includes maintaining an actuarially sound retirement benefit for employees while adjusting the level of benefits offered to newly hired employees. The City of San Jose recognizes the need for reducing retirement costs and recently had a ballot measure before the San Jose voters on June 5, 2012; "The Sustainable Retirement Benefits and Compensation Act," (Measure B). Measure B is intended to provide the City with long-term savings through cost containment strategies related to post-employment benefits, including providing maximums for the retirement benefit for new employees and requiring voter approval for increases in retirement benefits. Further,. a second tier for new employees in the Federated City Employees' Retirement System is currently in the process of being implemented. A second tier for employees in the Police and Fire Department Retirement Plan will be subject to binding interest arbitration.

<u>GRAND JURY FINDINGS, RECOMMENDATIONS AND CITY'S RESPONSE</u>

Grand Jury Finding 1

Public sector employees are eligible for retirement at least 10 years earlier than is common for private sector employees.

<u>City Response to Finding 1</u>

The City agrees with this finding. The City of San Jose is committed to providing its residents and customers with essential services. As a service organization, the vast majority of the City's costs are personnel costs for the employees who provide those services. However, the City's rising personnel expenditures have been significantly affected by the rising costs of pension and other post employment benefits. Despite major sacrifices from both the community the City serves and the City's employees to address these ever escalating costs, significant concerns remain which need to be considered, especially related to escalating retirement costs. To that end, Measure B is intended to provide the City with long-term savings.

Currently, employees in the City's Federated City Employees' Retirement System are generally eligible to retire at age 55 with 5 years of service or at any age with 30 years of service, while sworn employees in the Police & Fire Department Retirement Plan are generally eligible to retire at age 50 with 25 years of service, age 55 with 20 years of service, or at any age with 30 years of service. It is recognized that allowing employees to retire at such an early age significantly adds to the cost of the pension and retiree healthcare benefits.

On June 5, 2012, the citizens of the City who through taxes and fees fund these benefits, voted to approve Measure B by 69.02%. Measure B, among other things, provides for maximums for a new tier of retirement benefits for new employees. This includes language that, within the defined benefit program, the retirement age should be no less than 65 for employees in the Federated City Employees' Retirement System and age 60 in the Police & Fire Department Retirement Plan, thereby raising the eligibility age for retirement. In addition, Measure B creates a Voluntary Election Program (VEP) whereby current employees who are members of the existing retirement programs may choose to enroll in an alternate retirement program with reduced benefits, while maintaining the benefit accrual rate for years of service already rendered. The VEP is subject to IRS approval due to the tax implications of creating an option for retirement benefits. This Voluntary Election Program (VEP) also raises the age at which someone can retire by six (6) months every year, until the retirement age is age 62 for employees in the Federated City Employees' Retirement System and age 57 in the Police and Fire Department Retirement Plan.

Grand Jury Recommendation 1

The Cities should adopt pension plans to extend the retirement age beyond current retirement plan ages.

<u>City Response to Recommendation 1</u>

The City has not yet implemented this recommendation, but it will be implemented in the future. Under the parameters set forth in Measure B, the City will extend the retirement age under the Voluntary Election Program, subject to IRS approval, and the second tier as soon as possible. Specifically, for those current employees who choose to enroll in the Voluntary Election Program, the retirement eligibility will be changed to age 57 for employees in the Police and Fire Department Retirement Plan, and to age 62 for employees in the Federated City Employees' Retirement System over a period of 14 years. Employees in the second tier retirement benefit (Tier 2) in the Federated City Employees' Retirement System will be eligible for retirement at age 65 with at least 5 years of City service. In addition, the eligibility to retire with 30 years of service shall be increased by 6 months annually on July 1 of each year, starting with July 1, 2017. Subject to arbitration, sworn Police and Fire employees would be eligible to retire at age 60 with 10 years of service credit. The second tier for employees in the Federated City Employees' Retirement System is estimated to be in place by the Fall of 2012.

Grand Jury Finding 2

Campbell, Gilroy, Los Altos Hills, Los Gatos, Milpitas and Palo Alto have adopted second tier plans that offer reduced Benefits, which help reduce future costs, but further changes are needed to address today's unfunded liability. Santa Clara County and the cities Cupertino, Los Altos, Monte Sereno, Morgan Hill, Mountain View, San Jose, Santa Clara, Saratoga, and Sunnyvale have not adopted second tier plans.

<u>City Response to Finding 2</u>

The City agrees with this finding. As stated previously, the City plans to implement a second tier retirement benefit for new hires. Voters overwhelmingly approved Measure W in 2010, which allowed the City to create a new retirement benefit tier for newly hired or re-hired employees. As a result, Measure B was designed to provide parameters for a new tier of retirement benefits. The City Council voted to approve a Tier 2 for new non-sworn employees on or about June 12, 2012. The City is currently in the process of implementing this second tier for new employees in the Federated City Employees' Retirement System and it is estimated to be in place by the Fall of 2012. The second tier for new employees in the Police and Fire Department Retirement Plan are subject to binding interest arbitration with the San Jose Police Officers' Association (POA) and San Jose Fire Fighters, IAFF Local 230, (IAFF Local 230).

Grand Jury Recommendation 2A

Santa Clara County and the Cities of Cupertino, Los Altos, Monte Sereno, Morgan Hill, Mountain View, San Jose, Santa Clara, Saratoga, and Sunnyvale should work to implement second tier plans.

<u>City Response to Recommendation 2</u>

The recommendation has not yet been implemented but will be implemented in the future. As noted above, on or about June 12, 2012, the City Council approved a second tier retirement benefit for new, rehired or reinstated non-sworn employees within the parameters set forth in Measure B. The City is currently working on the administrative necessities to put this program in place, including any ordinances, resolutions, etc., that are required to effectuate the second tier retirement benefit for new non-sworn employees. It is expected that this be in place by the Fall of 2012. The City is also pursuing a second tier retirement benefit for new sworn Police and Fire employees consistent with the parameters set forth in Measure B and will be proceeding to binding interest arbitration with the affected unions.

Grand Jury Recommendation 2B

For Gilroy, Los Gatos, Milpitas, and Palo Alto, which have not implemented second tier plans for MISC and Public Safety second tier plans should be implemented for both plans.

<u>City Response to Recommendation 2B</u>

The recommendation will not be implemented because it is not warranted or is not reasonable in that this recommendation appears to address an issue specific to another agency.

Grand Jury Recommendation 2C

All Cities' new tier of plans should close the unfunded liability burden they have pushed to future generations. The new tier should include raising the retirement age, increasing employee contributions, and adopting pension plan caps that ensure pensions do not exceed salary at retirement.

City Response to Recommendation 2C

The recommendation has not yet been implemented but will be implemented in the future. The City recognizes the financial burden placed on current and future taxpayers as a result of the escalating retirement costs and as such determined the necessity to address the unfunded liability. While both the City and its employees will be significantly affected by the financial burden of retirement costs, Measure B is intended to assist the City and its employees manage the financial gap in the years to come As noted above, on or about June 12, 2012, the City Council approved a second tier retirement benefit for new or rehired non-sworn employees within the parameters set forth in Measure B. By implementing Tier 2 for newly hired and re-hired employees, the City expects to realize cost savings over time. It is expected that this be in place by the Fall of 2012.

In addition, the City is also pursuing a second tier retirement benefit for new sworn Police and Fire employees consistent with the parameters set forth in Measure B and the impasse procedures applicable to sworn Police and Fire employees, which is binding interest arbitration.

The second tier parameters in Measure B raise the retirement age, require new employees to pay fifty (50) percent of the total cost of the retirement benefit, and ensure that the retirement benefit payment is based on the highest three consecutive years of earned base pay only.

Grand Jury Finding 3

Retroactive Benefit enhancements were enacted by Cities using overly optimistic ROI and actuarial assumptions without adequate funding in place to pay for them.

City Response to Finding 3

The City agrees with this finding. In 2010, the citizens of the City approved Measure V, which was passed by voters in 2010, prohibits an arbitrator, where applicable, to render a decision or award that retroactively increases or enhances pension and retiree healthcare benefits, or that creates a new or additional unfunded liability the City would be obligated to pay for. It should be noted that whereas arbitrators previously issued decisions in binding interest arbitration granting retroactive benefit enhancements to employees, creating new unfunded liabilities that the City was solely responsible for and that were not previously funded, Measure V prohibits these types of decisions in the future. In addition, the voters also passed Measure W in 2010 allowing for the establishment of a new tier of retirement benefits and that the any such plan must be actuarially sound. In 2012, the voters passed Measure B which takes steps to ensure the actuarial soundness of future retirement benefits and expense decisions.

Grand Jury Recommendation 3

The Cities should adopt policies that do not permit Benefit enhancement unless sufficient monies are deposited, such as in an irrevocable trust, concurrent with enacting the enhancement, to prevent an increase in unfunded liability.

City Response to Recommendation 3

The recommendation has not yet been implemented but will be implemented in the future. The passage of Measure B included language that requires the actuarial soundness of the retirement benefit plans. The language of Measure B also includes language that prevents the Retirement Board from paying a benefit or expense that has not been actuarially funded. In addition, Measure B reserves the right for voters to modify any retirement benefit, including pension and other post employment benefits, and any such increases are subject to future approval by the voters. In addition and as noted above, the voters passed Measure V in 2010 which prohibits an arbitrator, where applicable, to render a decision or award that retroactively increases or enhances pension and retiree healthcare benefits, or that creates a new or additional unfunded liability the City would be obligated to pay for. It should be noted that arbitrators previously issued decisions in binding interest arbitration granting retroactive benefit enhancements to employees, creating new unfunded liabilities that the City was solely responsible for and that were not previously funded; Measure V prohibits these types of decisions in the future.

Grand Jury Finding 4

The Cities are making an overly generous contribution toward the cost of providing benefits.

City Response to Finding 4

The City agrees with this finding. Recognizing the need for a fiscally responsible and actuarially sound pension program, the City acted with the intention of curtailing unsustainable retirement costs by pursuing the changes to retirement benefits in Measure B. Employees who choose to remain in the current retirement benefit tier instead of opting into the Voluntary Election Program will be required to pay for a portion of the unfunded liability costs of the retirement system.

Grand Jury Recommendation 4A

The Cities should require all employees to pay the maximum contribution rate of a given plan.

City Response to Recommendation 4A

The recommendation will not be implemented because it is not warranted or is not reasonable. This recommendation appears to apply to those agencies that are in CalPERS and pick up the employee portion of costs. The City of San Jose operates two (2) independent retirement systems (the Federated City Employees' Retirement System, and the Police & Fire Department Retirement Plan) independent of CalPERS. Under the Sections §1504 and §1505 of the City Charter, the City shares the actuarially defined normal cost of the retirement benefit with active employees in a ratio of 8:3, meaning that for every $8 the City contributes for retirement benefits allocated to an employee's current year of service, that active employee contributes $3. Both the City and its employees currently and will continue to pay their respective contributions under the terms of the City Charter. However, it is worth noting that any unfunded liability associated with pension costs is currently solely funded by the City.

According to the Tier 2 parameters of Measure B, the City and Tier 2 employees are expected to share all costs associated with the Tier 2 plan 50/50. However, Measure B will require employees who choose to remain in the current retirement benefit tier instead of opting into the Voluntary Election Program to pay for a portion of their costs. Furthermore, it is worth noting that the costs associated with retiree medical care are equally borne by both the City and current employees, including any unfunded liability associated with retiree healthcare.

Grand Jury Recommendation 4B

The Cities should require employees to pay some portion of the Past Service Cost associated with the unfunded liability, in proportion to the Benefits being offered.

City Response to Recommendation 4B

The recommendation has not yet been implemented but will be implemented in the future. Under Measure B, active employees who choose to stay in the current level of benefits will be required to contribute additional amounts associated with the unfunded liability of the retirement benefit and thus will share the costs of the unfunded liability with the City. It should be noted that current employees in the Police and Fire Department Retirement Plan currently pay a small portion of the unfunded liability.

Grand Jury Finding 5

The Cities are not fully funding OPEB benefits as evidenced by large unfunded liabilities.

City Response to Finding 5

The City agrees with the finding. The City and employees are currently in a transition phase-in strategy to contribute the full Annual Required Contribution (ARC) for retiree healthcare benefits. As noted previously, active employees currently pay at least fifty percent (50%) of the retiree healthcare cost, which includes normal costs and unfunded liability costs. The transition to contribute the ARC began in 2009 for most bargaining units with a five-year phase in strategy. However, it should be noted that, for employees represented by the POA and IAFF Local 230, the contribution amount cannot exceed an incremental increase of 1.25% of pensionable pay when compared to the previous year. When the retiree healthcare ARC contribution rate exceeds 10% of pensionable pay, the POA and IAFF Local 230 will enter discussions with the City to address the contributions to contribute the full ARC and alternatives to lower retiree healthcare costs.

Grand Jury Recommendation 5

The Cities, should immediately work toward implementing policy changes and adopting measures aimed at making full OPEB ARC payments as soon as possible.

City Response to Recommendation 5

The recommendation has not yet been fully implemented. As noted above, the City has partially implemented the Grand Jury's recommendation to make full OPEB ARC payments. The transition to contribute the full ARC began in 2009 for most bargaining units with a phase in strategy. For employees represented by the POA and IAFF Local 230, both bargaining units will enter discussions with the City to address the contributions to contribute the fully fund the ARC and alternatives to lower retiree healthcare costs, should the retiree healthcare ARC contribution rate exceed 10% of pensionable pay.

Grand Jury Finding 6

The City of San Jose permits the transfer of pension trust fund money, when ROI exceeds expectations, to the SRBR, despite the fact that the pension trust funds are underfunded.

City Response to Finding 6

The City agrees with this finding. The City acknowledged its commitment to fiscal stability by proposing to eliminate the Supplemental Retiree Benefit Reserve (SRBR) in Measure B. The SRBR provided cash payments to retirees, payable under certain circumstances, in addition to their regularly allocated retirement system benefit payments. Accordingly, with the approval of Measure B and once the implementation of Measure B is completed, the assets set aside for the SRBR will be transferred back into the appropriate retirement trust fund. It should be noted that the City Council adopted consecutive resolutions to suspend disbursements from the SRBR in Fiscal Year 2010-2011, and continuing through Fiscal Year 2012-2013, pending the Measure B effective date.

Grand Jury Recommendation 6

The City of San Jose should eliminate the SRBR program or amend the SRBR program to prevent withdrawal of pension trust money whenever the pension-funded ratio is less than 100%.

City Response to Recommendation 6

The recommendation has not yet been implemented but will be implemented in the future. As noted above, the passage of Measure B eliminates the SRBR once implemented. In addition, City Council has previously placed a moratorium on disbursements from the SRBR through Fiscal Year 2012-2013.

Grand Jury Finding 7

The Cities' defined benefit pension plan costs are volatile. Defined contribution plan costs are predictable and therefore manageable by the Cites.

City Response to Finding 7

The City agrees with this finding. While considering the appropriate paths to financial solvency, the City discussed wholly funding Tier 2 employees' retirement benefit through a 401(k)-style defined contribution plan. The parameters set forth in Measure B allowed for a defined contribution plan, however, at this time, the City Council approved a lower defined benefit plan for new employees in the Federated City Employees' Retirement System, and the City anticipates proceeding to binding interest arbitration over a second tier with the POA and IAFF Local 230. Further analysis will be necessary to determine the appropriate defined contribution style plan should the City Council decide to pursue this option in the future.

Grand Jury Recommendation 7

The Cities should transition from defined benefit plans to defined contribution plans as the new tier plans are implemented.

City Response to Recommendation 7

The recommendation requires further analysis. As noted above, the City has not implemented a defined contribution plan but, under Measure B, parameters were set that allowed for a hybrid defined benefit/defined contribution retirement benefit for new hires in Tier 2. Ultimately, the City Council approved a lower defined benefit plan for new employees in the Federated City Employees' Retirement System, and the City anticipates proceeding to binding interest arbitration over a second tier with the POA and IAFF Local 230. Should the City Council decide to pursue this available option in the future, further analysis will be necessary regarding the most viable defined contribution plan option.

PUBLIC OUTREACH/INTEREST

By the very nature of the Grand Jury's report and its release, public outreach requirements have been met. Additionally, upon approval of this memorandum by Council, the City Attorney will submit the memorandum to the presiding judge of the Superior Court, as required under Penal Code Section 933(c).

COORDINATION

This memorandum was coordinated with the City Attorney's Office.

CEQA

Not a project, File No.PP10-069(a) (Staff Reports/Assessments/Annual Reports/Information Memos. City Manager's Office)

Alex Gurza
Deputy City Manager

For additional information on this report, contact Alex Gurza, Deputy City Manager, at 535-8150.