COUNTY EMPLOYMENT RETIREMENT PLAN:
"LET'S MAKE IT CLEAR"

INTRODUCTION

Over time the San Luis Obispo County (County) Employee Retirement Plan (Pension) has grown significantly. As of June 30, 2013, the actuarially[1] accrued asset value was $1.122 billion and the actuarially accrued liability was $1.468 billion. This creates an unfunded pension liability of $0.346 billion. This liability adds to a complex cash flow management burden that must ultimately be solved by our county Board of Supervisors (Board). It must balance the commitment to fulfill contractual obligations to county employees with the need for continuing maintenance of infrastructure and the desire for new programs.

After an interview with a county administrator, the 2013-2014 Grand Jury became aware of a large unfunded pension liability. Because the Grand Jury decided it was an important issue for the county citizenry to recognize and understand, it initiated an investigation.

SUMMARY

San Luis Obispo County citizens may be familiar with media reports about the high cost of pension benefits burdening cities to the point where the only solution is to refinance and/or declare bankruptcy. There has been controversy regarding the viability of maintaining such benefits over time. The county's liabilities for the substantial pension program have grown (*County of San Luis Obispo CAFR* for the fiscal year ended June 30, 2013). This presents a complex situation for the Auditor-Controller-Treasurer and the Board to address in order to avoid a future cash flow burden. It appears that the county has embarked upon a preemptive program with the goal of placing this county on a more fiscally prudent path while still fulfilling

[1] An actuarial valuation is a type of appraisal which requires making economic and demographic assumptions.

contractual obligations to its employees. This perception was validated by Fitch's recent upgrade of the county's credit ratings for general obligation bonds to AAA and pension obligation bonds to AA+.

METHOD

The Grand Jury interviewed the Manager of Human Resources, the Manager of the Payroll Department and the County Auditor-Controller-Treasurer. Based upon those interviews, the Grand Jury reviewed considerable documents, including:

1. The county's audited Comprehensive Annual Financial Report (CAFR) for the fiscal year-end June 30, 2013.
2. The county's audited Pension Trust CAFR for the years ended December 31, 2011, and December 31, 2012.
3. Gabriel Roeder Smith & Company's Actuarial Valuation Report for the year beginning January 1, 2013.

NARRATIVE

This report examines the unfunded liability of the county Pension Plan and the related Pension Obligation Bonds. These unfunded liabilities are recorded in the notes of the financial statements.

Pension Plan

The San Luis Obispo County Employees Retirement Plan is funded by contributions from both the county and its employees. The county has a policy to fully fund the Annual Required Contribution that is determined by the Pension Trust each year. From reviewing the county financial reports noted above, the Grand Jury formed an opinion that the unfunded liability was large and had increased 9 out of the past 10 years, the exception being 2007. For 2012, the actuarial unfunded pension liability increased $25.2 million.[2] While the Pension Trust's *CAFR* for the year-end December 31, 2012, does not clearly identify the variances from actuarial assumptions that caused the increase in the unfunded liability, it does provide details and therefore gives a few clues. For example: Retirees, beneficiaries and disability recipients increased from 1,543 as of January 1, 2007, to 2,040 as of January 1, 2012, a 32% increase for these five years.[3]

- From 2007 to 2011, average annual benefits increased from $18,744 to $25,474, a 36% increase in five years.[4]
- The total actuarial liability increased 39% from $1.057 billion as of December 31, 2007, to $1.468 billion as of December 31, 2012.[5]
- The actuarial value of trust assets increased 35% from $830 million as of December 31, 2007, to $1.122 billion as of December 31, 2012.[6]

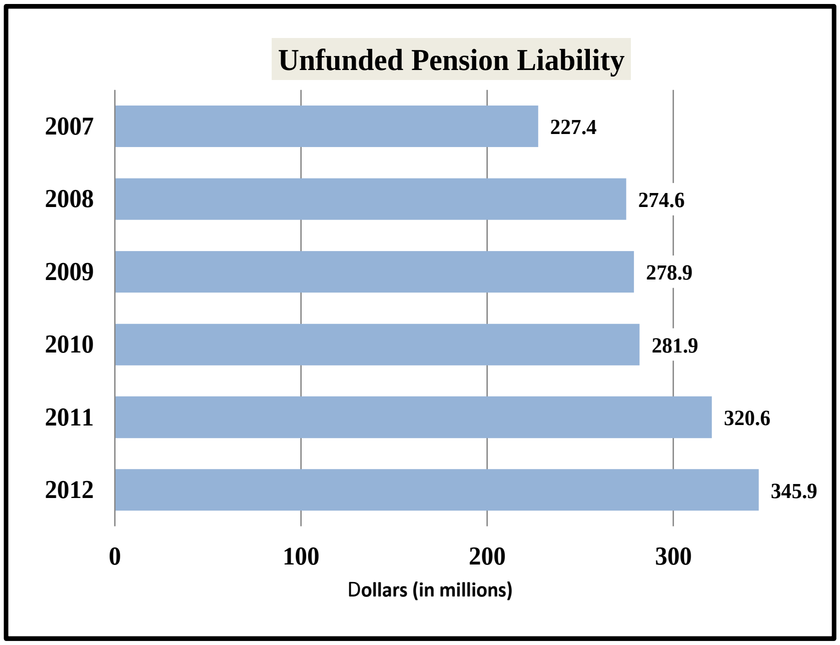
Although the *CAFR* and *San Luis Obispo Pension Trust Actuarial Valuation Report* provide the numbers, they do not provide an understandable explanation of the changes over time.

As of June 30, 2013, the status of the unfunded pension liability was calculated as follows:

Unfunded Pension Liability	
Actuarially accrued liability	$1.468 billion
Fund actuarial value of assets	(1.122 billion)
Unfunded pension liability	**$ 0.346 billion**

[2] *GRS Actuarial Valuation Report for the year beginning January 1, 2013*.
[3] *San Luis Pension County Trust CAFR*, pg. 85.
[4] Ibid.
[5] *San Luis Obispo Pension Trust Actuarial Valuation Report for the Year Beginning January 1, 2013*, pg.14.
[6] Ibid.

The graph below shows the increases in the unfunded pension liability:



An actuarial study by the Pension Trust[7] indicated that, at this time, total annual contributions by both the county and its active employees adequately fund current retiree pensions. Actuarial studies by the Pension Trust[8] indicated a "funded ratio" of approximately 77% as of December 31, 2012. According to county administrators, the 2008 financial crisis negatively affected this funded ratio.

The county has a 30-year plan in place to fund its pension liability. Based on the Pension Trust Actuarial Valuation, unfunded actuarial liabilities will increase in the next 10 years between $452 million to $572 million depending upon a model discount rate (return on investment) of 7.25% and 6.75%, respectively.[9] The county plan uses assumptions that the value of trust assets will increase at a faster rate than the actuarially accrued liability increases to the point where the liability is funded within the remaining 26 years. Part of the plan includes pension tier

[7] *San Luis Obispo County Pension Trust CAFR*, pg. 87.
[8] Ibid.
[9] *San Luis Obispo County Pension Trust CAFR*, pg. 54. Note the discount rate was revised to 7.1% in 2013.

amendments: tier two[10] adopted by the county in 2011 and tier three[11] a statewide measure effective in 2013. Tier two reform, according to the county, was a cost avoidance measure originally instituted to balance the county's budget. The county anticipates that savings from the second tier pension will increase as more employees reside in this level of benefits. Currently, there are 115 new employees with the second tier plans, resulting in annual payroll savings of $782,000. It was also noted that most bargaining units in the county have adopted a pension funding split that will ultimately approximate 50/50.[12]

Pension Obligation Bonds

The effect of issuing Pension Obligation Bonds is to decrease unfunded pension liabilities and increase bond indebtedness. There are three outstanding bond issues totaling $115.6 million in principal. According to county administrators, the unfunded liability that was paid off by these bonds had a 7.75% interest rate. A summary of Pension Obligation Bonds as of June 30, 2013, is as follows:

Pension Obligation Bonds
(as of June 30, 2013)

Name	Maturity	Interest Rate	Original Amount	Principal Outstanding
2003 Series A	2018	1.68-4.54%	$47,995,000	$28,860,000
2003 Series C	2031	5.27-5.75%	$44,199,000	$44,199,000
2009 Series A	2019	7.45%	$42,565,000	$42,565,000
			Total	$115,624,000

Debt service payments are funded as a part of each employee's payroll benefit deduction.

Principal and interest payments for 2014 will be approximately $8.7 million and will increase

[10] Tier two pension reform changed the calculation of final compensation using an average of three consecutive years rather than a single highest year, eliminated the deferred retirement option and changed cost of living adjustment to 2% from 3% with no carry-over, among other changes. http://www.slocounty.ca.gov/Assets/PE/Labor+Relations/MOUs/BU02/Amended+Side+Letter+to+SLOCEA+TCS+July+2011.pdf.

[11] Tier three pension reform includes a 180-day waiting period between retirement and returning to work in any public retirement system, limitations on which tier the retired employee is eligible to reenter, and forfeiture of benefits for felony convictions arising from performance of official duties. http://www.slocounty.ca.gov/Assets/PE/Labor+Relations/PEPRA/PEPRA+Letter+to+All+Staff.pdf

[12] *County of San Luis Obispo CAFR*, June 30, 2013, pg. 9.

annually thereafter. These bonds are not callable and the future interest on this $115.6 million principal will be approximately $124.4 million.

According to county administrators, the rating on these bonds improved from AA to AA+ due to the county's low unfunded liability for Other Post Employee Benefits, the establishment of tier two and tier three employee categories, and a 50/50 split between employees and county for future pension contributions.

CONCLUSIONS

Unfunded pension liabilities increased $25.2 million in 2012. Currently, the unfunded pension liability is $346 million and is predicted to increase over the next 10 years, depending upon actuarial assumptions.[13] Although the liability is presently increasing, the county has an actuarial plan to reduce it to zero over a 30-year planned period (26 years remaining).

Pension Obligation Bonds are used to prefund pension liabilities. Currently, these bond obligations are $115.6 million in principal and future interest payments approximate $124.4 million.

In writing this report, the Grand Jury referred to two CAFRs and a Pension Actuarial Valuation Report. The Grand Jury found the data concerning unfunded pension liability and the associated bonds are available to the public. This information is recorded in the notes of the financial statements which make it difficult to understand the totality of the unfunded obligations. A clearer presentation of the 30-year plan to reduce the unfunded pension liability is lacking. An additional simplified and transparent pension document would be beneficial to the reader.

[13] The January 1, 2013, actuarial report prepared by Gabriel, Roeder Smith & Company forecasts the unfunded liability increasing about the next 10 years and then decreasing to $1 million over the next 17 years.

FINDINGS

F1: Although it is consistent with generally accepted accounting practices, the unfunded liabilities are recorded in the notes of the financial statements which make it difficult to understand the totality of unfunded obligations for San Luis Obispo County.

F2: The county has a 30-year plan to fully fund the pension liability. It is unclear where the county currently stands in this planned recovery.

RECOMMENDATIONS

R1: The Pension Trust administrator and the Auditor-Controller-Treasurer should make available to the Board of Supervisors and the residents of San Luis Obispo County an additional simplified and transparent reporting of the totality of the county's pension obligations.

R2: A balance sheet report should be provided showing year-to-year changes in the actuarial assets and liabilities to assist in tracking the progress of the plan.

REQUIRED RESPONSES

The San Luis Obispo County Auditor-Controller-Treasurer is required to respond to Findings 1 and 2 and Recommendations 1 and 2.

The San Luis Obispo County Board of Supervisors is required to respond to Findings 1 and 2 and Recommendations 1 and 2.

The responses shall be submitted to the Judge Harman, Presiding Judge of the San Luis Obispo County Superior Court. Please provide a paper copy and an electronic version of all responses to the Grand Jury.

Presiding Judge	Grand Jury
Presiding Judge Dodie Harman Superior Court of California 1035 Palm Street Room 355 San Luis Obispo, CA 93408	San Luis Obispo County Grand Jury P.O. Box 4910 San Luis Obispo, CA 93403