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THE 2015-2016 CONTRA COSTA COUNTY GRAND JURY
725 Court Street
Martinez, California 94553

Report 1603

Pension Reform

If Not Now, When?

APPROVED BY THE GRAND JURY:

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Contra Costa County Grand Jury Report 1603

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TO: BOARD OF SUPERVISORS

SUMMARY

Contra Costa County carries extremely large pension liabilities, which may get worse due to uncertainties in the financial markets. Because of a long-standing California legal precedent, pension benefits to be earned in future periods are not negotiable, while wages and other benefits are subject to negotiation during the collective bargaining process. This grand jury recommends that the County seek a change or clarification of this legal precedent in light of subsequent legislation, thereby clearing the way for fair and sensible pension reform through collective bargaining.

Absent such reform, the County faces serious financial risks, as pension liabilities appear to be on a relentless upward path. The likely consequences of increasing pension costs are service cutbacks and staff layoffs. It is even conceivable, should the pension cost problem reach crisis proportions, that the County would have to consider bankruptcy reorganization, with all the arbitrary and unfair consequences that could flow from such an action. For these reasons this grand jury believes the time to act on pension reform is now.

A Glossary of useful terms for issues discussed in this report can be found in the Appendix. Each term included in the glossary is set in *italics* the first time it appears in this report.

BACKGROUND

Defined benefit pension plans (such as the County's) are financed by means of funds invested on behalf of the individual members of the plans. Both individual members and their employers make contributions to the funds each year, ideally in amounts sufficient to pay for the pension benefits earned during that year. In addition to annual contributions to the pension funds, the funds' *investment returns* are retained and reinvested for the benefit of the members and finance a major portion of the pension benefits. For example, the County's pension fund projects that investment returns on the fund's assets will cover more than 50% of the ultimate costs of the County's pensions. For defined benefit plans to work as designed it is critical that the annual contributions from members and employers plus investment earnings be sufficient to cover the projected future costs of the pensions. When these financial underpinnings to a pension fund fall short, the fund charges the public employer for the amount of the shortfall. These shortfalls, known as *unfunded actuarial accrued liabilities (UAALs)* have become significant debts for public jurisdictions throughout California—including the County--that offer defined benefit pension plans to their employees.

The Stanford Institute for Economic Research estimates that, as of year-end 2013, California public pension systems as a whole were short $281.5 Billion of what they require to assure the pensions will be paid when they fall due. This estimated shortfall amounts to about $22,210 for each household in California, without including the unfunded liabilities of one the largest pension funds, the California State Teachers Retirement System (CALSTRS). Paying down these unfunded pension liabilities is a major reason why pension costs have absorbed increasing percentages of county, city and state budgets over the last 15 years.

The state of California has taken some important steps to address these costs. In 2012, the governor signed into law the *PEPRA* (Public Employees' Pension Reform Act) reform bill, which made significant reductions in pension benefits to be earned by public employees hired after January 1, 2013. However, PEPRA made only modest changes in pension benefits earned by employees hired before that date. That was contrary to the recommendation of the state's Little Hoover Commission, which had warned in a 2011 report that limiting pension reform to new employees was not a sufficient remedy for the pension problem:

> "The problem, however, cannot be solved without addressing the pension liabilities of current employees. The state and local governments need the authority to restructure future, unearned retirement benefits for their employees. The Legislature should pass legislation giving this explicit authority to state and local government agencies. While this legislation may entail the courts having to revisit prior court decisions, failure to seek this authority will prevent the Legislature from having the tools it needs to address the magnitude of the pension shortfall facing state and local governments." (Emphasis added.)

In fact, overall pension costs have continued to rise since the enactment of PEPRA, though at a somewhat lower rate as more employees who were hired after January 1, 2013 enter the system. Thus, pension boards and public employers have continued to deal with rising pension liabilities by means of increasing pension contributions from members and their employers. For example, CALPERS, the state's largest pension plan, has announced plans to increase the contributions required by its members and their employers. The Contra Costa County Employees' Retirement Association

(*CCCERA*), the entity that manages the County's pension fund, effectively increased member and employer contributions in 2014 when it reduced the *assumed investment rate* on its pension fund assets from 7.75% to 7.25%. Member and employer contribution rates increase whenever the assumed rate of return on the pension fund is decreased, because actuaries must then assume that a smaller portion of the required funding for pension obligations will be covered by investment returns.

There are limited options for reducing pension-funding shortfalls:

1. Increasing contributions to the pension fund;
2. Reducing pension benefits;
3. Increasing investment returns on the assets of the pension fund.

The first two options have adverse financial impacts on one or more groups, which explains why pension reform is a difficult and contentious issue. Higher contributions from public employers come at a cost: they must be funded either by higher taxes or reduced public services; e.g., library or park cutbacks, reduced police patrols, longer medical and fire response times. Higher contributions from members mean lower take-home pay. Reductions in pension benefits adversely affect employees who view the pension benefit as an important element of their compensation for services rendered.

It is not surprising, then, that governments and plan members have often turned to higher investment returns as an apparently painless "magic bullet" to close the funding gap. Assuming a high rate of return on fund assets does not come at a cost to any group—at least initially--and does not require any reduction in benefits. However, employers and plan administrators have often made the unwarranted assumption that high investment returns will continue indefinitely. When returns inevitably fall below such unrealistic assumptions, the impact on pension liabilities is severe. In California the public employer (e.g., the County) is solely responsible for making up the shortfall.

The grand jury believes that funding for the pension liabilities the County and other districts have undertaken needs to be addressed realistically, without rosy assumptions about investment returns. Difficult as they may be, these issues must be addressed through adequate contributions to the pension funds, and by negotiations with labor groups over the levels of pension benefits to be earned in the future.

DISCUSSION

The County's Huge Pension Liability

The County has reported in its Recommended Budget for fiscal year 2016-2017 that it carried an unfunded pension liability of $1.155 Billion as of December 31, 2014. This figure also includes the unfunded pension liability of the Contra Costa County Fire Protection District (ConFire), which the County routinely includes in its pension liability reports. The unfunded pension liability is also known as the unfunded actuarial accrued liability or (UAAL). It represents the amount of money the County has yet to set aside in order to cover employee pension benefits already earned that the County will be required to pay in the future. It also represents the amount by which the CCCERA pension fund is not fully funded with respect to the County's pension liabilities.

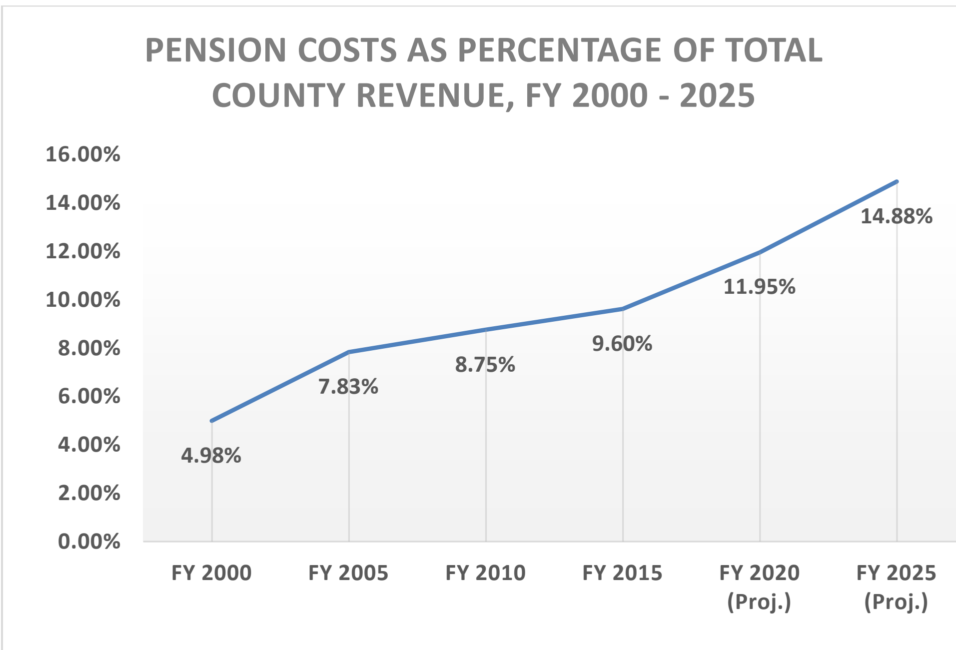
The money the County should set aside today to cover future pension benefit payments is actually much less than what the ultimate payouts will be, since any money contributed to the CCCERA pension fund should increase in value over time from investment returns. By the same token, the contributions held back from the pension fund do not accumulate any investment earnings that could reduce the UAAL. Unless the short-funded CCCERA pension fund can generate investment returns that exceed the 7.25% assumed annual rate, the County will have to make up the UAAL gap in the future by means of increased contributions to the pension fund. The County and ConFire also have outstanding over $329 Million in pension obligation bonds (POBs) that were issued in earlier years for the purpose of raising funds to contribute to CCCERA in order to reduce the County's UAAL obligations. Without the funds raised from the POBs, the County's pension UAAL would be substantially larger.

The $1.155 Billion unfunded liability figure is based on an *assumed investment rate of 7.25%* per year. CCCERA has assumed it will earn this rate of return each year on its pension fund, compounded over the entire period the County's employees are working or receiving pension benefits. However, many financial analysts question whether the 7.25% annual return assumption in today's investment environment is realistic. Private employers typically assume a much lower rate when calculating their liability in a defined benefit pension plan. AT&T, for example, discloses in its 2014 Annual Report that it assumes a compound rate of return on its pension fund assets of 5.75% per year. In CCCERA's own case, its actuary discloses in the latest actuarial report that the CCCERA pension fund has over the ten-year period ended December 31, 2014 earned an average annual return of 6.58%, rather than its currently assumed rate of 7.25%.

The County's comprehensive annual financial report (CAFR) for the fiscal period ended June 30, 2015 contains a vivid illustration of the importance of the assumed investment rate in calculating the size of the County's unfunded pension liability. The CAFR reports its net unfunded pension liability to CCCERA as $925 Million instead of $1.115 Billion, due to certain timing differences. However, the CAFR also discloses that the unfunded pension liability would increase to $1.8 Billion in the event this liability was calculated using an assumed investment rate of 6.25% per year. Thus, in an inherently uncertain financial environment, a change of only one percent per annum in the rate of return would nearly double the size of the County's unfunded pension liability!

The County's $1.155 Billion unfunded pension liability well exceeds the $539 Million it spent on public protection services in its 2015 fiscal year as well as the $445 Million it spent on public assistance during that year. However, the unfunded pension liability is not due immediately. Under the *UAAL amortization policy* adopted by CCCERA, the County is permitted to treat the unfunded liability as a long-term debt payable over a period of 18 years.

The County's annual pension costs consist of its employer contributions to the "*normal costs"* of the pension benefits earned each year plus its amortized payment on the UAAL. The annual pension costs are a large and growing percentage of the County's total budget. During the 15-year period from fiscal year 2000 through fiscal year 2015, the County's revenues grew from $1.347 Billion to $3.217 Billion, a compound annual growth rate of 5.97% per year. By comparison, during this same period the County's pension costs (again, including those of ConFire) grew from $67.06 Million to $308.9 Million, a compound annual growth rate of 10.72% per year. Pension costs now amount to 9.6% of total County Revenues as compared to 4.98% 15 years ago. If these trends continue, pension costs will amount to approximately 11.95% of County revenues in five years, and 14.88% of revenues in 10 years, as illustrated in the chart below.



Another way to see the growth in pension costs is to compare two illustrations the County has prepared in the past five years showing the amount of pension costs incurred for every dollar of salary paid its employees. Here was the breakdown in 2010:

Here is the breakdown today:

for every dollar being spent on permanent salary …

… we spend 53 cents on pension

… and ANOTHER 51 cents on other benefits

These figures and charts show the County already faces an enormous financial challenge in managing its unfunded pension liabilities. Unfortunately, the 2015 declines in the stock markets mean that the challenge is about to get larger. At a special CCCERA Board meeting on February 25, 2016, the Board's advisers reported that the return on the pension fund for the year 2015 was 1.9%, the lowest return since the Great Recession year of 2008. The 1.9% figure is well short of the 7.25% target return by 5.35 percentage points. The latest CCCERA actuarial report advises that for each percentage point the actual return falls below the 7.25% target return, the County will be required to contribute 9.9% of its CCCERA salary base to make up the funding deficit. Based on the County's current payroll of $572 Million included in the CCCERA pension plan, this lower than target investment return for 2015 will likely increase the County's unfunded pension liability by over $300 Million.

CCCERA follows a five-year "*asset smoothing policy"* for recognizing annual investment returns above or below the 7.25% target return. Thus, CCCERA's actuaries will phase in the 2015 investment return shortfall over five years and will offset it against the remaining above-target gains from 2012 and 2013 that are likewise being phased in over five years. Further, because of its UAAL amortization policy CCCERA will allow the County to pay off the 2015 phased-in shortfall over 18 years. Nevertheless, if not offset by above-target gains from other years, the additional annual cost of the 2015 deficit alone to the County could, based on CCCERA's latest actuarial report, amount to over $21 Million per year for 18 years.

This cost estimate makes no allowance for increases in the pension liability that may arise from abnormal pay raises following current contract negotiations between the County and its labor organizations. As recently reported in the press, the County has agreed to pay increases starting July 1, 2016 of 5% per year over the next three years to its deputy sheriffs, with an additional one time 2.5% increase for sheriffs with over five years of service. That rate of increase exceeds the 4.75% assumed rate of salary increase for a safety member with five or more years of service the CCCERA actuaries currently use in calculating future pension costs.

The Peculiar California Pension Rule

Because of the large increases in its pension liabilities that can arise from investment returns falling below the assumed 7.25% annual rate of return, the County is constantly at risk of debt increases that arise for reasons outside its direct control. Further, unlike all other elements of employee compensation, the County cannot manage its pension liabilities by negotiating reduced pension benefits at the collective bargaining table. That means the County is left with layoffs, service cutbacks, cuts in salary or health benefits, or tax increases as the remaining tools available to meet pension liabilities, which the County is legally obligated to pay.

Why is the amount of the pension benefit to be earned excluded from collective bargaining? The reason for this peculiar state of affairs is rooted in a series of legal cases that began before public employees had collective bargaining rights. The first of the cases dealt with an instance of seemingly bad behavior by a city council in Long Beach, California. In the 1947 case of Kern vs. Long Beach, the city council decided to terminate a pension program for its employees just 32 days before one of its employees was due to begin receiving his pension after 20 years of city service. Not surprisingly, the California Supreme Court frowned on such apparently unfair treatment of a long-time city employee. The Court held that once a pension system was in place the employee in question was entitled to a reasonable pension for the time he or she served the city. That might well have ended matters, but the City of Long Beach proved to be a repeat offender when it later sought to impose higher costs and reduced benefits on the members of its pension plan. In the 1955 case of Allen vs. City of Long Beach, the California Supreme Court held that once an employee was enrolled in the city's pension plan, the city was not only barred from terminating pension benefits as an element of compensation for such employees, but was also prohibited from imposing any alterations in its pension plan which result in a disadvantage for employees unless accompanied by "comparable new advantages."

The 1955 decision, while likely reflecting some exasperation by the Court over what appeared to be another instance of bad behavior by the City of Long Beach, resulted in a highly inflexible legal precedent. Known as the "*California Rule"*, it bars a public employer in California from ever reducing the level of pension benefits—even those yet to be earned in future periods—below those that existed on the first day of the employee's term of service.

This precedent has remained part of California law despite numerous important changes protecting the rights of public employees that have occurred in other parts of the California legal framework since 1955. The most important of these changes is the Meyers-Milias-Brown Act of 1968. That Act guarantees the right of public employees to engage in collective bargaining over the terms and conditions of their employment. Public employers have a corresponding obligation to bargain in good faith with their employees. A state agency, the Public Employment Relations Board (PERB), can impose penalties on public employers that engage in unfair labor practices or fail to engage in good faith bargaining.

The California Rule Should be Challenged

The California Rule thus stands as a peculiar exception to the standard practice of negotiating all salary and benefits for public employees at the collective bargaining table. We believe there are two important reasons to challenge the Rule's exclusion of pension benefits from collective bargaining. The first is cost savings. As Report 1503 of the 2014-2015 Grand Jury (Report 1503) pointed out, doing no more than adjusting the amount of the pension benefit all County employees earn in future years to the PEPRA levels earned by employees hired after January 1, 2013 could save the County over $95 Million a year. The second is fairness. Fairness to County employees is a key consideration in any pension reform proposal. Pursuing pension reform at the bargaining table assures employees the following protections:

- Changes in pension benefits would only affect the benefits to be earned in future years. Pension benefits earned in previous pay periods would not be affected.
- Changes would be subject to good faith bargaining obligations on the part of the County and negotiated by labor representatives accountable to the employee groups.
- Changes could be negotiated in a way that pays particular attention to the interests of different groups of employees. For example, pension benefit reductions (and corresponding lower pension contributions deducted from a paycheck) could be limited to tiers of employees with fewer years of service. Such employees may have a greater interest in securing higher take-home pay rather than higher pension benefits that will only be paid many years distant.

<u>The Policy Decision on Pension Reform Rests with the Board of Supervisors</u>

The Board of Supervisors should seriously consider adopting a policy to seek judicial clarification or reform of the California Rule on pensions in light of California law that now guarantees collective bargaining for public employees. The Board is the designated authority within the County to make the required political, financial and value judgments required to go forward with such a policy. We set forth later in this report some specific ideas on how the Board might proceed to mount a legal challenge to the California Rule without putting the County's financial position at risk pending the outcome of the challenge. In its policy deliberations, we believe the Board should review carefully the following questions:

1. Is it right that the California Rule should allow pension costs to crowd out other budget priorities?
2. Is it right that the cost of pension benefits earned by County employees today should be paid by the County over 18 years, thereby assuring that a significant part of those costs will be passed on to taxpayers who are now students in junior and senior high school?
3. Is it right that the cost of pension benefits, already a huge unfunded debt, may at some point so stress the County's resources that a severe and draconian financial restructuring could become necessary, imposing hardships on retirees, employees, and County citizens?

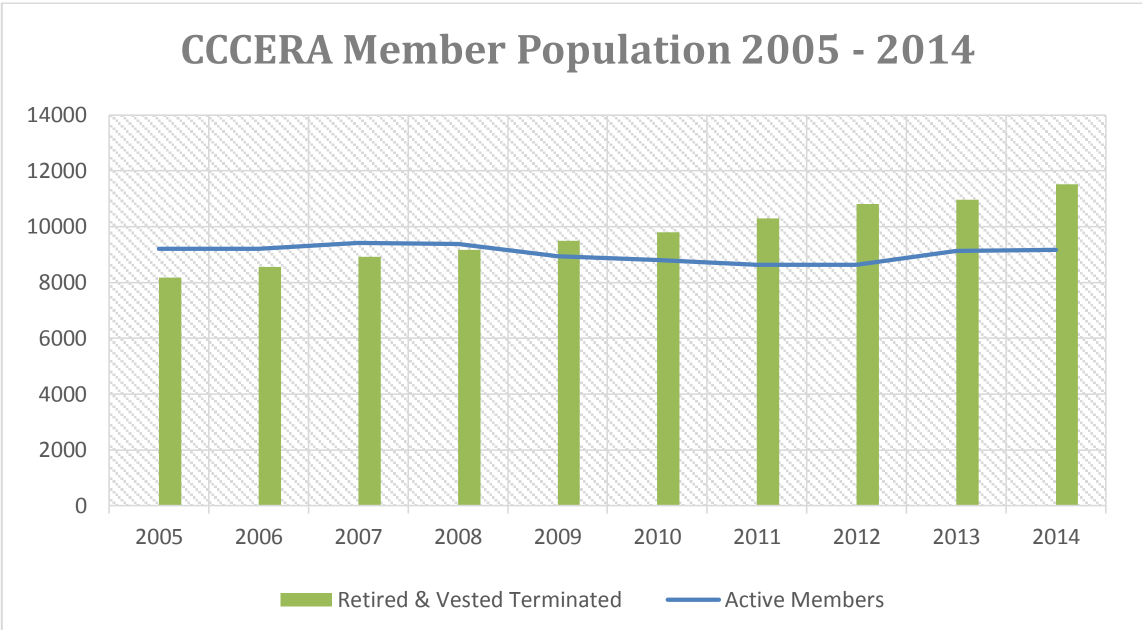
<u>The Crowding-Out Problem</u>. The County faces severe budget constraints. Previous grand jury reports have cited various projects and services that have been deferred or cut back due to budget issues, including maintenance and upkeep of County facilities, plans for an improved and modernized crisis operations center, funding unmet needs in the foster care system, and building facilities for rehabilitation programs in the County jail system. Budget issues also affect employee pay. This year much attention has

focused on the challenges the County faces in retaining an experienced pool of deputy sheriffs to maintain an adequate level of public safety services in the County. Below average pay of the County's deputy sheriffs as compared to neighboring jurisdictions seems to be at the core of the retention problem. In general, the County's employees have only had modest pay raises at best since the onset of the financial crisis in 2008 – 2009. The root of these problems is a shortage of available funds. As noted in Grand Jury Report 1503, a large pool of funds could be made available for all of these purposes (nearly $100 Million annually in that Report's estimate) if the County were able to negotiate the level of future pension benefits to be earned by all employees down to the same level as that for its PEPRA employees.

Passing on Today's Costs to the Next Generation. A large part of the County's annual pension cost is its cost (a) to reduce the UAALs generated by investment return shortfalls in the CCCERA pension fund and (b) to cover payments on long-term pension obligation bonds (POBs) that were issued in earlier years (e.g., 2003 in the case of the longest outstanding POBs) to reduce those UAALs. The UAALs are the funds still needed to cover the County's future pension obligations for services already performed. As noted above, the County is permitted to pay down its UAALs over an amortization period of 18 years.

The 18-year UAAL amortization period, combined with the use of long-term pension obligation bonds to cover unfunded pension liabilities, has troubling consequences. These pension debts cover the costs of services rendered in the past. This means that the taxpayers who pay off these debts for services rendered are not the same taxpayers who received the services. It is as if a homeowner were being asked to pay part of the cost of a gardener who had mowed the lawn ten years ago before the homeowner even bought the house. Put another way, the 18-year amortization of UAAL debt and the long-term final maturity dates for the POBs mean that young children in the County are being tabbed to pay costs for services their parents or grandparents received. That seems unfair as well as unsound, and it is unique in terms of how we generally believe wage and salary payments should be assessed. The costs should be assessed on those who received the benefit and were in a position to review the quality and type of service they received.

Potential Hardships for Employees and Retirees. Most County employees likely do not consider the risk of the County failing to pay their pensions as something to worry about. The common viewpoint is that governmental jurisdictions never go away and they have taxing power to assure that all their obligations can be met. It then becomes convenient to assume high rates of return on the pension fund ("we will earn enough on our investments to cover all the costs") or to treat the unfunded pension liability like a long-term mortgage that can be paid off over many years. However, the pension liability problem cannot be postponed forever. The County has already seen the high cost of its pension obligations crowding out budget allocations for other services and needs, including employee salary levels. Further, as the chart below shows, the membership of CCCERA is now composed of more retirees and vested but non-contributing members than active members, and this ratio has increased every year since 2005.



As CCCERA membership matures, relatively fewer contributing members will be supporting an ever-increasing number of retirees. That means the County will be facing greater risks from changes in the investment returns on the CCCERA pension fund because the total active payroll relative to the pension liabilities will become smaller over time. Furthermore, the County faces the risk of an even sharper drop in the supporting payroll in the event one of the pension reform measures currently being promoted for the 2018 ballot becomes law. Either of those measures (discussed in more detail later in this report) would require voter approval before employees hired after January 1, 2019 could become members of the CCCERA plan under its current terms. If the entry of new employees into CCCERA were cut off, the financial contributions from active members would drop substantially. In that event the County could face substantially higher risks of increased pension costs if investment returns on the pension fund fell below the assumed annual growth rate of 7.25%.

These financial and demographic risks should be weighed carefully in the Board's policy deliberations. Rising pension costs have been a major factor in driving cities into bankruptcy. In California, this has happened to Vallejo, San Bernardino, and Stockton. If the size of the County's pension debt were to become unmanageable, the County could be forced to restructure its debts, including its pension liabilities, through bankruptcy.

The powers of a bankruptcy court are extensive. Its powers extend to restructuring pension benefits in ways that could appear arbitrary and unfair to those affected by the bankruptcy. The court may reduce not only future unearned pension benefits but also already-earned pension benefits. Thus, the legal protection provided to pensions by the California Rule is not absolute even if it were to remain unchanged. In the Stockton Bankruptcy case decision of February, 2015, the judge emphasized that he had the power to alter pension benefits as part of his authority to confirm a fair and just reorganization plan for the city. With specific reference to the California Rule (which he referred to as the "Vested Rights Doctrine"), he had this to say:

> ". . . the Contracts Clauses of the Federal and State Constitutions, as implemented by California's judge-made "Vested Rights Doctrine," do not preclude contract rejection or modification in bankruptcy."

Accordingly, the Board's policy deliberations on seeking reform now of the California Rule through a linkage to collective bargaining should seriously consider the risks to employees and retirees should a bankruptcy filing ever become necessary. A restructuring of pension benefits in bankruptcy could impose far greater hardships on employees than what they would experience from a change to the California Rule that preserved collective bargaining protections.

The grand jury does not see bankruptcy or financial insolvency as a near-term risk for the County at this time. However, we believe the County should so manage its financial obligations that the risk of a bankruptcy, with all of its attendant hardships and inequities, will never have to be considered.

The Pivotal Role of Collective Bargaining Since 1968

Tying pension reform to collective bargaining stands on firm legal ground. Collective bargaining has now become fully embedded in the legal fabric of California as the essential means for negotiating the terms of employment between public employers and their employees. The courts have not, however, yet taken up a case seeking to reconcile the system of collective bargaining with the implied "contract" for pension benefits that was established in the 1955 Allen case. There is, nevertheless, strong evidence to suggest the 1968 Meyers-Milias-Brown Act was intended to cover all items of compensation and benefits to be earned by public employees, including pension benefits. The Act itself states that collective bargaining established for public employees "…shall include all matters relating to employment conditions and employer-employee relations, including, but not limited to, wages, hours, and other terms and conditions of employment."

In a 1998 case, Public Employees Association vs. City of Fontana, a California appellate court explained the strong policy in the law favoring collective bargaining as follows: otherwise, the "employer [would be required] to negotiate over working conditions with any number of employees, thereby defeating the Act's goals of ensuring stability in labor management relations and the right of employees to join and be represented by an employee organization." More recently, a December 29, 2015 ruling by the Public

Employment Relations Board (PERB) found that the City of San Diego had violated the terms of the Meyers-Milias-Brown Act by failing to negotiate with the employee unions over the Mayor's plan to bring a pension reform proposal to San Diego voters by means of a ballot initiative. The PERB decision included this statement:

> "The City does not dispute that pension benefits are generally a negotiable subject and, aside from its argument that the Mayor's pension reform proposal was brought as a citizens' initiative, which we reject, <u>it has offered no other reason why PERB should disregard long-standing private and public-sector precedent treating pension benefits as negotiable</u>." (Emphasis added.)

<u>Preferable Methods to Seek Reform of the California Rule</u>

The California Rule arose originally from a lawsuit filed against a local jurisdiction—the City of Long Beach. Reform of the Rule could likewise arise from a legal challenge filed by a California local jurisdiction, such as the County. Should the Board of Supervisors choose to challenge the California Rule in court, it would no doubt prefer a method that offered both a good prospect of success and that did not subject the County's financial position to substantial risk in the event the challenge was not successful. With those twin objectives in view, here are some legal options the Board might consider with their legal counsel:

1. Advancing the reform argument through amicus curiae legal briefs filed in other pending cases
2. Support for a pension reform initiative or legislation that links pension reform to collective bargaining procedures
3. Bargaining with one or more of its employee unions for changes in future pension benefit rates, subject to the condition that a court first rules that such benefits are covered by the collective bargaining law
4. Moving for a declaratory judgment after any of its labor groups have expressed opposition to negotiating on future pension benefits

<u>Amicus Briefs</u>. An *amicus curiae* or "friend of the court" brief enables an entity not a party to the case to make legal arguments to the court in order to apprise the court of broader public or other interests that may be at stake in the case. The County, as a member of the California State Association of Counties (CSAC), has already participated in one amicus brief relating to pension reform. CSAC filed an amicus brief in a 2014 case supporting a plaintiff's effort to block a pension reform initiative in Ventura County that sought to replace the county's defined benefit pension plan with a *defined contribution plan*. Should an appropriate case arise, the County either on its own initiative or through CSAC, could file an amicus brief urging the court to reform the California Rule so as to recognize the authority of labor organization representatives to negotiate the rates of pension benefits to be earned in future employment periods.

Initiative or Legislative Reform. The initiative process would offer an avenue for reform in the manner recommended in this report if it sought to tie pension reform to the collective bargaining system. There are currently two reform initiatives announced for the 2018 California ballot sponsored by former San Jose Mayor Chuck Reed and former San Diego Councilman Carl DeMaio. However, these initiatives do not include provisions intended to tie pension reform to collective bargaining. Rather, they would require voter approval before any employees hired after January 1, 2019 could be enrolled in a defined benefit pension plan similar to the County's current plans. They would not take any steps on pension reform for employees hired before that date.

Should a local legislator at the County's request sponsor legislation to amend the Meyer-Milias-Brown Act to make explicit that unearned pension benefits are subject to collective bargaining, an avenue could open for a straightforward legal test of the California Rule. The amendment, if passed by the legislature and signed by the governor, would likely be challenged in court by an interested labor group, and the County would have an opportunity to take part in the legal case as an amicus or interested party depending on the circumstance. In either case, the County would be participating simply as a legal participant and would not have its financial position at material risk before the case was decided.

Labor Agreements with Contingent Terms. There is precedent in the County for negotiating a term of a labor agreement related to pension benefits that is contingent on a change in the law. In a number of previous labor agreements, starting with a 2006 memorandum of understanding with the Deputy Sheriffs Association (DSA), the County agreed to a term that would have permitted employees to elect a lower rate of pension benefits to be earned over the course of the agreement. The attraction for the employee would have been a corresponding reduction in his or her required contributions to the pension fund, resulting in higher take-home pay. The term was contingent on certain changes occurring in the law, including state legislation and a private letter ruling from the IRS.

In like fashion, the County could negotiate reductions in the rates of pension benefits to be earned in the future contingent on a court first having ruled that such reductions were proper subjects of collective bargaining. This approach would require two conditions to move forward: agreement by the labor bargaining unit and a legal challenge filed against the agreement by some group or organization seeking to uphold the California Rule.

Declaratory Judgment. Should none of the labor groups choose to cooperate in a challenge to the California Rule, California law provides another alternative for the legal challenge without undue risk to the County. A *declaratory judgment action* is a legal action designed to resolve a legal question before one or both parties to a dispute have taken steps that may have damaging consequences in an uncertain legal situation. The California Code of Civil Procedure provides for such legal actions "… in cases of actual controversy relating to the legal rights and duties of the respective parties …."

To take advantage of the declaratory judgment alternative, the County would have to show that a “case or controversy” exists with one of its labor organizations on the issue whether pension benefit rates are subject to collective bargaining. Such a case could arise if the Board declared a policy or set forth a demand that in an upcoming bargaining session labor representatives should be prepared to negotiate the rates of pension benefits to be earned along with wage rates and other benefits. Should the bargaining unit refuse to negotiate on future pension rates because of the California Rule, an “actual controversy” over legal rights and duties might exist that meets the requirements for a declaratory judgment.

There are likely other opportunities that could arise for the County to seek legal reform of the California Rule by means of an action for a declaratory judgment. The benefit of a declaratory judgment action is the opportunity it presents to mount a challenge to the California Rule without forcing the County to take action that could be very expensive to reverse or undo.

Conclusion

Fair and sensible pension reform remains an urgent priority for the County. The costs of its pension obligations continue to rise despite the PEPRA reforms of 2013. The largest liabilities on the County’s most recent financial statement relate to pensions: its net pension liability of $925 Million and its outstanding pension obligation bonds of $329 Million. Despite the size of this obligation the County has only limited options to manage it. The size of the liability will depend each year on the investment results of the CCCERA pension fund. Because of legal precedent in California that has not yet been challenged, the County has not negotiated with its labor organizations over the rates of future pension benefits to be earned. Such benefits should in our judgment be included in collective bargaining negotiations. To do so, the Board should seriously consider various avenues to challenge the California Rule in court. Such a change would be supported by sound legal arguments and could yield the County, if successful, an important tool to move forward on pension reform through collective bargaining.

FINDINGS

F1. The County's largest outstanding debts relate to its pension liabilities. The unfunded pension liabilities of the County (including ConFire) as calculated by the CCCERA actuaries in September 2015 total $1.155 Billion. In addition to this UAAL figure, the County (again including ConFire) has outstanding $329 Million of long-term pension obligation bonds.

F2. The County's unfunded pension liability will increase in any year in which the rate of return on the CCCERA pension fund does not reach at least 7.25%.

F3. According to the most recent CCCERA actuarial report, for every 1% drop below the CCCERA assumed rate of return of 7.25% the County's unfunded pension liability will increase by a figure equal to 9.9% of the County payroll of employees enrolled in the CCCERA pension plan. Based on its current payroll of over $572 Million that means the reported return of 1.9% achieved by the CCCERA pension fund in 2015 could result in an increased County UAAL of over $300 Million before actuarial five-year smoothing adjustments are made.

F4. Unlike all other elements of compensation that it negotiates with the labor organizations, the County does not negotiate the rate of pension benefits employees will earn in future salary periods.

F5. The reason the County does not negotiate such pension benefits is due to a long-standing legal precedent in California, known as the California Rule, which holds that public employees are covered by an implied contract on their first day of service guaranteeing that the level of pension benefits they earn each year may not be decreased in future years unless replaced by benefits comparable in value for the employee.

F6. The California Rule is based on a case that was decided before public employees had the right to organize and engage in collective bargaining in California.

F7. The County has not taken steps to challenge or seek legal clarification of the California Rule in a California court.

F8. Negotiating the terms of future pension benefits to be earned could result in substantial cost savings for the County if permitted by a court ruling.

F9. There are legal avenues open to the County to seek judicial clarification or reform of the rule without subjecting the County to major financial risks if the challenge proves unsuccessful.

RECOMMENDATIONS

R1. The Board of Supervisors should seriously consider adopting a policy of seeking judicial clarification or reform of the California Rule.

R2. The Supervisors should consider empaneling a task force, a study group, or an internal committee to examine options for challenging the California Rule that would weigh the following considerations:

- Potential cost savings for the County;
- Potential resources to be freed up for other priorities such as service enhancements and other wage and benefit improvements;
- Opportunities to participate as an amicus curiae in existing legal cases;
- Opportunities for challenging the California Rule through legal proceedings such as a declaratory relief action that would not expose the County's financial position to undue risk in the event of an adverse result; and
- Whether the County should undertake the legal challenge alone or in cooperation with other jurisdictions or organizations with a common interest in the issue, such as the California State Association of Counties (CSAC).

R3. The Supervisors should consider issuing a formal statement on their policy toward seeking reform of the California Rule, with an explanation of how they propose to manage their unfunded pension liability in the event no steps are taken to reform or adjust the California Rule.

R4. The Supervisors should consider securing a legal opinion from outside counsel experienced in the field of pension and collective bargaining law on the merits of a legal challenge to the California Rule based on the argument that the Rule should now be modified based on California's collective bargaining system for public employees.

APPENDIX

Glossary of Terms

Actuarial Accrued Liability. This is the total amount of funding the pension fund should have on hand in order to assure that there will be sufficient funds available in the future to pay the pension benefits that have been earned by employees on the date the liability calculation is made. The actuaries calculate this liability based on certain actuarial assumptions about mortality rates, retirement rates, turnover rates, and investment returns the actuaries assume will be earned by the pension fund on a compounded basis over the long term.

Actuarial Value of Assets. This value refers to the market value of assets in the pension fund after adjusting for any investment gains or losses using the fund's asset smoothing policy.

Amicus Curiae. This term (literally translated as friend of the court) refers to an entity or organization that is not a party to a particular lawsuit but that is permitted by the court to advise it in respect to some matter of law that directly affects the case in question.

Asset Smoothing Policy. This policy refers to the practice of stretching out the recognition of annual market gains or losses on a defined benefit pension fund, as compared to the assumed investment return for the fund, over a period of years. CCCERA follows a five-year smoothing policy. For example, if the CCCERA fund falls short of its assumed investment rate of 7.25% by five percentage points, the fund would recognize that loss at a rate of 1% a year over a period of five years.

Asset Volatility Ratio. This ratio is equal to the market value of the assets in the pension fund divided by the total projected payroll used for calculating contributions to the pension fund. In the case of CCCERA that ratio is currently 9.9, meaning that for every percentage point by which its pension fund falls below its assumed investment rate, the UAAL will increase by 9.9% of projected payroll.

Assumed Investment Rate of 7.25%. This is the assumed rate of investment return on its pension fund that CCCERA uses for calculating the *normal cost* of the pension benefits earned by County employees each year. It is also the rate CCCERA uses to discount to present value the future cost of the pension benefits to be paid. The assumed investment rate is a compound annual growth rate, not simply an average annual rate. That is, in order to keep pace, in any year in which CCCERA does not earn its assumed rate of 7.25% it must make up the shortfall in a following year (either through additional earnings or employer contributions) in addition to the assumed annual rate of 7.25% for the following year.

California Rule. This term refers to a legal precedent established by a California Supreme Court decision in 1955. It held that California public employees are subject to an implied pension contract from their first day of employment forward. The pension contract provides that the rate of pension benefits to be earned in future years may never be decreased unless replaced by a benefit comparable in value for the employee. The practical effect of this precedent is that public employers in California do not negotiate pension benefit rates with their employees, in contrast to negotiations that take place over all other wages and benefits to be earned.

CCCERA – the Contra Costa County Employees' Retirement Association. This is the entity that administers pension benefits and runs the pension fund to which the County makes contributions to pay for pension benefits earned by its employees. CCCERA is organized under a law passed in 1937 that authorized California counties to set up defined benefit pension plans for their employees.

COLA – a cost of living adjustment. This is an enhancement to a pension benefit based on increases in the applicable cost of living index, subject to certain caps, usually 2% or 3% per year.

Declaratory Judgment Action. This is a legal action designed to enable parties to resolve a legal dispute before either party has taken steps that may cause or incur a liability that could lead to damages or other remedies awarded by a court.

Defined Benefit Plan. This is a pension plan that provides for a stated benefit to be paid to participants during their retirement years. Generally, the benefit is defined by a formula. For example, 3% of base salary for each year of services, so that an employee with 25 years of service at age 55 could retire under that formula with a beginning pension equal to 75% of his or her base salary. Pension benefits are usually enhanced by cost of living adjustments, also called *COLAs.* Payment of the defined benefit is guaranteed by the employer.

Defined Contribution Plan. This is a retirement plan under which the employer makes defined contributions into a retirement fund for the benefit of its employees. The amount of the ultimate benefits paid out in retirement is dependent on the investment results in the retirement fund and is not guaranteed by the employer.

Investment Return. This is the rate of earnings on the pension fund from dividends, interest, and capital gains, computed as a percentage of the average value of the fund.

Normal Cost. This is the amount of contributions to a defined benefit pension fund required each year to fund the pension benefits earned by employees during that year of service. The figure is calculated by actuaries and is based on certain actuarial assumptions about mortality rates, retirement rates, turnover rates, and investment returns the actuaries assume will be earned by the pension fund on a compounded basis over the long term.

PEPRA – The Public Employee Pension Reform Act. This Act, passed in 2012, established a new level of pension benefits for all state and other public employees in California who were hired on or after January 1, 2013. The new pension benefit levels were lower than those prevailing for existing employees, leading to a two-tiered level of benefits for employees based on their respective dates of hire.

Unfunded Actuarial Accrued Liability (UAAL). This is defined as the extent to which the *Actuarial Accrued Liability* of the pension plan exceeds the *Actuarial Value of the Assets* in the pension fund supporting the plan.

UAAL Amortization Policy. This policy stipulates the amount of the payments that must be made to the pension fund each year by the employer to pay down the UAAL in equal installments. In the case of CCCERA, the UAAL pay down period is 18 years, meaning that 1/18 of each year's net UAAL is charged to the employer each year as an additional pension cost payable to CCCERA.

SOURCES AND REFERENCE MATERIALS

For purposes of this report the Grand Jury interviewed, met with, or sought records from 15 different County, city, special district, state, CCCERA, and employee or research organization officials or representatives who had responsibility for certain aspects of pension benefit issues. We reviewed a number of relevant reports and articles, including the following:

1. The County Comprehensive Annual Financial Report for its fiscal year ended June 30, 2015.
2. The CCCERA Actuarial Valuation and Review as of December 31, 2014, prepared by its actuary, Segal Consulting.
3. Letter dated September 2, 2015 from Segal Consulting to the Deputy Chief Executive Officer of CCCERA setting forth the Unfunded Actuarial Accrued Liability by Employers based on the December 31, 2014 Actuarial Valuation.
4. Agenda for Special Meeting of CCCERA Board Members dated February 25, 2016.
5. Letter dated March 2, 2016 from Segal Consulting to the Chief Executive Officer of CCCERA setting forth the actuary's latest five-year projection of Employer Contribution Rate Changes Based on Estimated 2.4% Gross Market Value Investment Return for 2015.
6. Little Hoover Commission, report entitled Public Pensions for Retirement Security, published in February, 2011.
7. The online materials regarding unfunded pension liabilities provided by The Stanford Institute for Economic Research. The relevant materials can be found at pensiontracker.org.
8. The Annual Report of AT&T for calendar year 2014, pages 65-67.

We also reviewed a number of California reported legal cases on pension or employee benefit issues, including those cited in the text of our report. These are the full case citations for the cases mentioned in our report:

1. Kern vs. City of Long Beach, 29 Cal.2d 848 (1947).
2. Allen vs. City of Long Beach, 45 Cal.2d 128 (1955).
3. San Bernardino Public Employees Association v. City of Fontana, 67 Cal. App. 4th 1215 (1998). The quotation included in the text is found at page 1220 of the reported case decision.
4. In re City of Stockton, California, Debtor; US Bankruptcy Court, Eastern District of California; 526 B.R. 35 (Bankr E.D. Cal. 2015). The quotation in the text is from page 39 of the reported decision.
5. City of San Diego (2015) PERB Decision No. 2464-M.
6. The chart on page 11 of the Report is compiled from data found on page one of the CCCERA Actuarial Report prepared by Segal Consulting and referred to above.

The text of the Meyers-Milias-Brown Act can be found at California Government Code, sections 3500 – 3511.

California Code of Civil Procedure Section 1060 provides the statutory authority for declaratory judgment actions in California.

REQUIRED RESPONSES

	Findings	Recommendations
Board of Supervisors	1 - 9	1 - 4

These responses must be provided in the format and by the date set forth in the cover letter that accompanies this report. An electronic copy of these responses in the form of a Word document should be sent by e-mail to epant@contracosta.courts.ca.gov and a hard (paper) copy should be sent to:

Civil Grand Jury – Foreperson

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