

The Looming Crisis of Yolo County City Pension and Retirement Medical Costs

SUMMARY

California cities are experiencing an alarming fiscal burden due to increasing expenses and liabilities related to retiree pensions and health insurance. Yolo County’s four cities (Davis, West Sacramento, Winters, and Woodland) are no exception to this retiree cost crisis. However, information about this looming fiscal crisis is not commonly known to many city residents, nor easily discovered. The 2017-2018 Yolo County Grand Jury (Grand Jury) investigated potential impacts on cities with primary focus on:

- Unfunded retiree cost liabilities
- Annual retiree expense management
- Best practices collaboration
- Transparency to city residents

The Grand Jury found that current and future retiree benefits are putting extreme pressure on other city service priorities (road maintenance and improvements, public works, parks and recreation, public safety, etc.) and revenue sources. The retirement benefit costs (pensions and health insurance) are consuming increasing portions of local city budgets.

The California Public Employee Retirement System (CalPERS), which manages all city plans within Yolo County, is in the midst of a planned multi-year escalation in employer contribution rates. This is due to changes CalPERS has made in calculating payments in order to build assets to pay for future pension payments. CalPERS has been gradually ramping up its requirements for “unfunded accrued liability” payments (see Glossary) statewide, which total \$8.9 billion more than anticipated out of governmental entity coffers in only three years (FY2017-18 through FY2019-20).

Yolo County’s four cities are contributing varying portions of their fair share of these “catch-up” costs (see Glossary) to ensure their retirement programs can cover future liabilities (payments to retirees). Some cities in the County are projecting that their “catch-up” payments will double for all pension funds over the next six years. Retiree medical insurance payments by cities add to this financial challenge. All of these increases are large relative to available budgets and are growing faster than projected current revenue sources.

When looking at total (“normal” and “catch-up”) pension costs over the next seven years (Fiscal Year 2017-18 through Fiscal Year 2024-25), CalPERS anticipates staggering increases for Yolo County cities:

▪ Davis	\$8.7 million	87% increase
▪ West Sacramento	\$6.9 million	90% increase
▪ Winters	\$0.4 million	67% increase
▪ Woodland	\$6.3 million	78% increase

The Grand Jury recommends that Yolo County city councils become more transparent to taxpayers concerning growth of retirement costs and the negative impact of this growth on city priorities and fiscal health. Cities should consider creating a simple statistical template, such as that created by the Grand Jury for city managers (see Appendix), showing historic and projected budget impact of retirement costs. The Grand Jury also recommends that cities consider more sustainable alternatives to the existing retiree benefit programs managed by CalPERS. Finally,

collaboration should increase among cities, where allowed by law, to share best practices for managing these cost increases.

BACKGROUND

Public pensions and retiree medical insurance have always been important benefits for city and county government employees. However, when considering pension and medical benefit burdens on California cities and counties, two perennial questions are: (1) How much are the costs going to increase? (2) What degree of stress are those increases going to place on other services expected to be provided by city governments? CalPERS, the nation's biggest pension system, and individual cities have completed studies (see Bibliography items 1, 2, 6) that address these questions. Yet this growing fiscal crisis is unknown to, or misunderstood by many taxpayers in Yolo County cities.

The Grand Jury chose to investigate several aspects of the growing budgetary crisis caused by pensions and retiree medical insurance costs in each of Yolo County's cities. The investigation focused on the impact of current levels of payments for these benefits on other city service priorities (such as public safety, parks and recreation, public works, street maintenance and improvements), the unfunded liabilities for future retiree payments, and the lack of transparency about these issues with citizens of each city.

APPROACH

During the investigation, the Grand Jury interviewed the City Managers in Yolo County and obtained information from some of the city finance departments. In addition to the interviews and follow-up conversations with the City Managers, the Grand Jury reviewed numerous documents and sources:

- Yolo County Cities Finance Department-provided pension and Other Post Employment Benefit statistics (OPEB)
- Yolo County Cities Comprehensive Annual Financial Reports
- Yolo County Cities Annual Fiscal Adopted Budgets
- CalPERS Annual Valuation Reports for Police, Fire, and Miscellaneous Employee Programs
- California Public Employees' Pension Reform Act of 2013 (PEPRA)
- California Public Employees' Pension Reform Act of 2018 proposal – Senate Bill 32
- CalPensions State Bulletins (CalPERS, CalSTRS and other government pensions)
- "How Much More Will Cities and Counties Pay CalPERS?" California Policy Center Study
- City of Monrovia pension case study related to balancing increasing CalPERS payments with payments for other city services.
- City of Vallejo, California pension case study related to bankruptcy
- Information and news concerning city and general retiree pension and medical insurance costs from multiple sources cited in the bibliography

- California legal codes and definitions cited in the bibliography and glossary

DISCUSSION

The Grand Jury identified and investigated several areas of concern in Yolo County's four cities related to the growing pension and retiree medical insurance payments and liabilities. Although this report only focuses on the four cities, the same factors and concerns exist in Yolo County itself and other government entities within this county. The alarming increase in the rate of projected expenses and unfunded liabilities is neither easily found nor understood by many Yolo County city residents, which means that city governments can do more to be transparent.

Lack of Transparency

City officials are accountable for being transparent and forthcoming with the public about local government finances.

- Council members have a fiduciary role that includes financial oversight, sound policies and awareness of the fiscal and service impacts of the decisions they make, according to training curriculum provided to them by the League of California Cities (see Bibliography item 13).
- In California, the people's right to know what their government is doing has been enshrined as a fundamental right in the state Constitution. "The people have the right of access to information concerning the conduct of the people's business, and, therefore the meetings of public bodies and the writings of public officials and agencies shall be open to public scrutiny" (CA Constitution article 1, section 3, subd. (b)).
- "Without a duty of accountability [by government officials], the public's ability to monitor the behavior of public fiduciaries would be severely limited. From the duty of accountability flow the duty of transparency and the concepts of disclosure, open meetings, and accessibility of public records" (see Bibliography item 10).

However, communication with the public about the growing burden on city finances of retiree costs has not been very transparent.

- The most common sources of publicly available pension and retiree medical insurance statistical information can be found only in city Comprehensive Annual Financial Reports, city Annual Fiscal Adopted Budgets, and CalPERS Annual Valuation Reports. Once found, the information can be difficult for city residents to understand, especially with respect to its effects on other city service priorities.
- The City of Davis provided a recent example of a missed opportunity to educate its taxpayers in a spring 2018 utility bill insert, "Expenditures – Where does the money go?" This summary did not mention anything about pensions or retiree benefits (see Bibliography item 12).

Pension and Retiree Annual Costs – "Normal" and "Catch-up" Costs

- The *employer* contribution to the pension programs is a combination of "normal cost" (see Glossary), calculated as a percentage of employee payroll, and "catch-up" (see Glossary) dollar payments required to cover "unfunded accrued liabilities" (see Glossary). These liabilities have been increasing at an alarming rate when considered in relation to CalPERS investment returns, which have not been meeting projections,

according to CalPERS Annual Valuation Reports and city financial documents. The “normal” employer cost as a percentage of payroll has been more stable and predictable. The employer pension contribution includes “catch-up” costs that fluctuate based on CalPERS investment returns and the amount of unfunded pension accrued liabilities. This is a subject of growing concern for most cities.

- The *employer* contribution shown in CalPERS required annual payment calculations, seen in its Annual Valuation statements, does not explain that the “normal cost” will decline over time as new employees are hired into pension plans under the Public Employee Pension Reform Act (PEPRA) pension contribution cost sharing criteria.
- The *employee* pension contribution varies among Yolo County cities and is typically determined through collective bargaining with various employee unions that represent police, fire, and other miscellaneous employee groups. This contribution remains constant from year-to-year as evidenced in CalPERS Annual Valuation Reports and PEPRA limitations (see Bibliography item 3). The percentage of payroll contributed by employees in Yolo County cities range from 6.9% to 9.0%.
- According to CalPERS projections and Grand Jury interviews, the four Yolo County cities’ payments to CalPERS for pensions rise sharply from current levels in the next seven years, ranging from approximately 67% for Winters to a 90% for West Sacramento. In dollars, these increases are projected to range from \$0.4 million for Winters to \$8.7 million for Davis. The following Figure 1 and 2 information provides additional four-city facts.

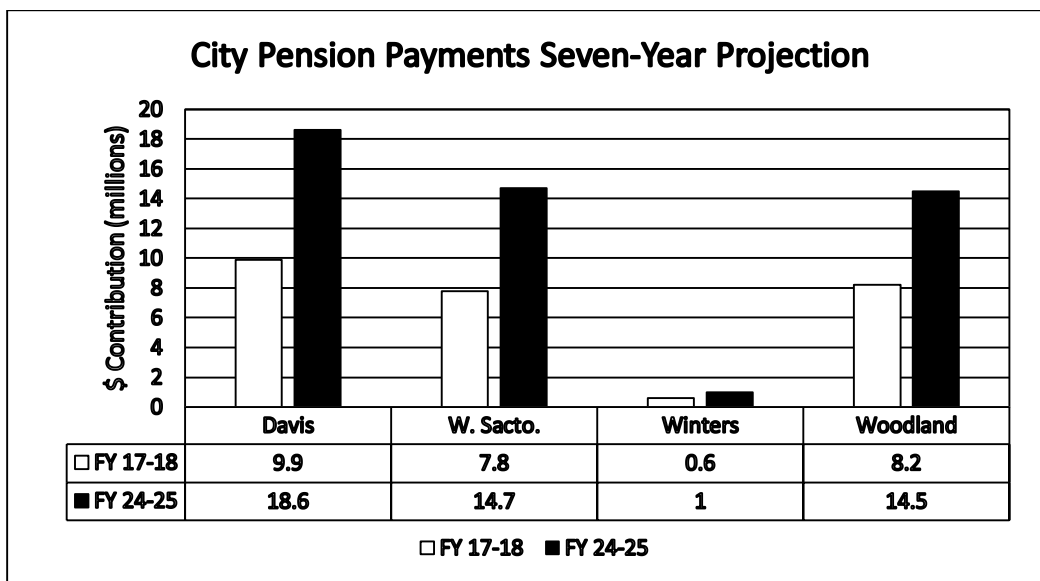


Figure 1 – City Pension Liability Currently and in Seven Years

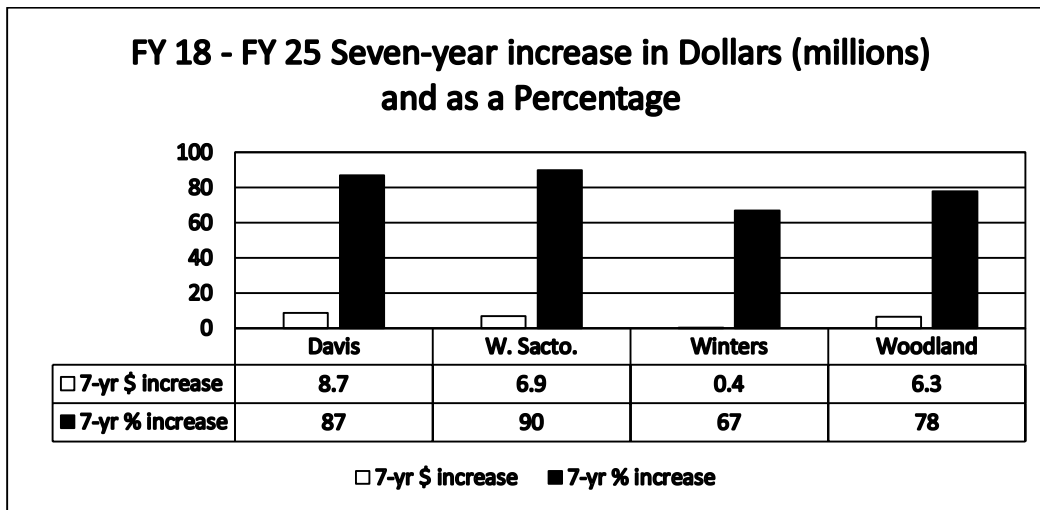


Figure 2 – Pension increase over the next seven years shown in dollars and percent.

- According to a February 13, 2018, Sacramento Bee editorial (see Bibliography item 14), the League of California Cities has determined that statewide pension payments are about 11% of General Fund budgets, on average. These are expected to become about 16% of General Fund budgets in the next seven years. Showing retirement expenses as a percentage of the General Fund is an effective way of educating the public about the importance of retirement costs competing with other city service priorities.
- According to information obtained from city financial reports and forecast statistics, Davis is contributing about 19% of the city’s general fund budget to pensions and retiree health benefits, a share that will rise to approximately 26% by 2025. West Sacramento can expect its pension and retiree benefits to increase from 16% of its general fund budget this year to approximately 17% by 2025. Winters will see that share jump from 12% to 16% and in Woodland, it will climb from 14% to 18%.
- City Adopted Budgets and Annual Financial Reports, and accompanying notes, show that City Councils have found it very difficult to absorb the rising retirement payments to CalPERS without compromising other city services. The result, at times, has been unpopular new taxes and fees, and voters are often not told that more of their money is needed for retirement costs (see Bibliography item 11).

Pension Unfunded Liabilities

- According to the Annual Financial Reports dated June 1, 2017, Unfunded Accrued Liabilities for the four Yolo County cities are alarming relative to city balance sheets. Davis, for example, has \$110.1 million of unfunded obligations. On the low end, the liability for Winters is \$4.4 million. These liability levels have grown significantly in the last two years as shown in Figure 3 below.

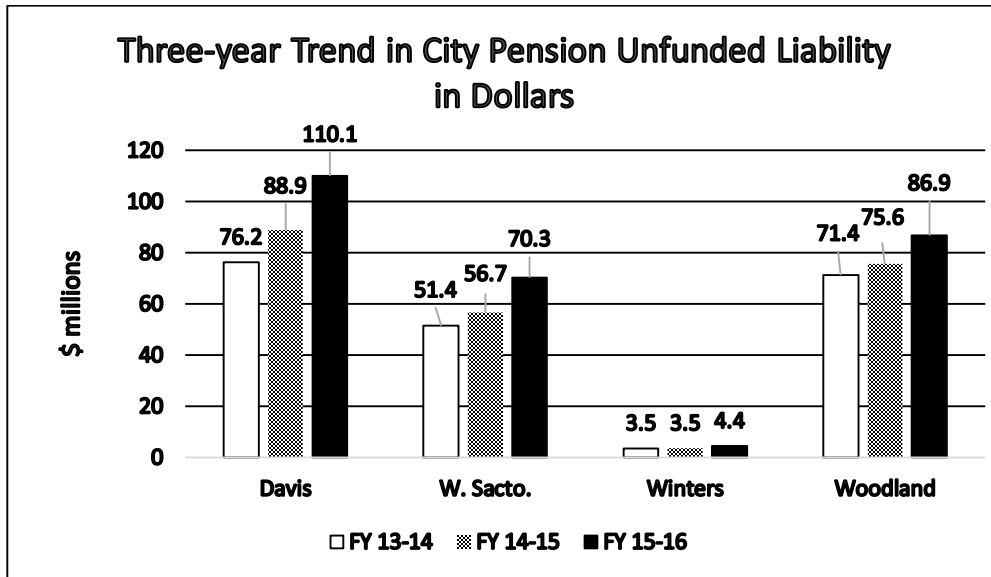


Figure 3 – City Unfunded Liability Dollars over Three Years

- CalPERS is significantly escalating city-required “catch-up” payments due to changes it has made in rate smoothing calculations, amortization of unfunded liability dollars, accelerated retirements of baby boomers, and new mortality estimates for beneficiaries. These “catch-up” payments are scheduled to extend through at least FY 2022-23. These ramped up calculations will double some cities’ total Unfunded Accrued Liability payments for all pension funds over the next six years. These “catch-up” payments are based on projections, so if investment returns are better or worse than predicted, the level of payments will vary.
- When a “normal” contribution is insufficient, and the pension plan becomes underfunded, the level of underfunding is compounded every year because there isn’t enough money in the fund earning interest and providing investment returns. According to CalPERS actuarial tables, the longer that “catch-up” payments are deferred into the future (amortized over longer time periods), the worse the underfunding becomes, depending on the investment rate of return.
- According to the California Policy Center, “Virtually every pension reform over the past decade or so has exempted the majority of active public employees from helping to pay down the unfunded liability” (see Bibliography item 6) unless cost sharing is successfully negotiated into labor contracts such as done by the city of Woodland. Instead, most increased employee payments apply only to the “normal” employee contribution. Public employee unions, quite understandably, negotiate for the lowest possible employee contributions to pension funds. The “normal cost” has historically been calculated by CalPERS based on financially optimistic projections. Grand Jury interviews, past CalPERS actuarial reports, and city annual financial reports reveal that only minimal catch-up payments were made each year in exchange for bigger catch-up payments in the future.
- At present, the “future” is being dealt with by elected and appointed governmental officials who foresee pension and retiree benefit costs rising dramatically faster than

revenues, according to City Annual Financial Reports and Annual Fiscal Adopted Budgets.

- Most pension plans remain underfunded even after a longer than usual bull stock market. When stocks and real estate have been running up in value for eight years, pension plans should not be underfunded. According to CalPERS Annual Valuation Reports’ statistics, CalPERS and the public employee unions that dominate CalPERS have done a disservice to taxpayers, public agencies, and ultimately to the individual participants who are counting on CalPERS to know what they are doing with respect to investment strategies.
- The Public Employees’ Pension Reform Act (PEPRA) of 2013 and the current proposed 2018 reform working its way through the state Legislature includes strategies that address special “Golden Handshake” benefits negotiated in the past. These “Golden Handshake” benefits are partially responsible for compromising the sustainability of the CalPERS pension programs used by the four Yolo County cities (see Bibliography items 3, 4 and 5).
- Based on the most recent three years shown in annual financial reports (FY13-14 through FY15-16), the “funded status” (see Glossary) of the four cities’ pension plans are showing signs of declining by 7-8% annually. “Funded status” reflects having sufficient current assets to pay future pension payments. The recent declines are a function of past contributions and less-than-projected fund investment returns. For example, the “funded status” of Davis’s three pension plans has dropped from an average of 72% to 64%, meaning that the city currently has only enough assets to pay two thirds of its future pension payments. CalPERS statewide liability funding in 2016 stood at 68%. Refer to the following Figure 4 for the four-city facts.

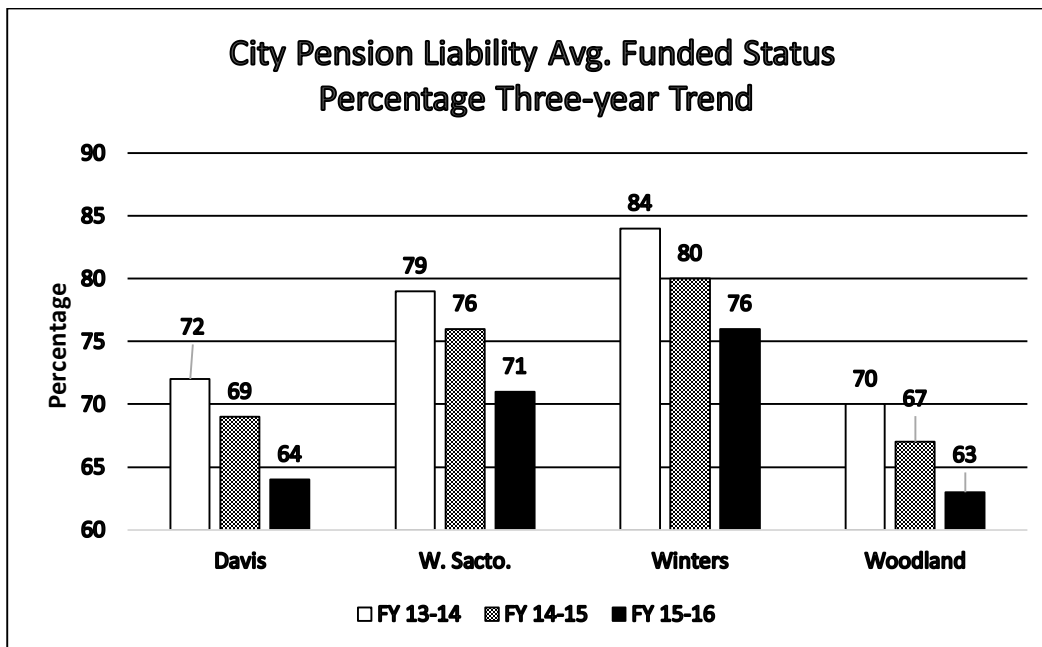


Figure 4 – Percentage of City Pensions future liabilities that have been “funded” or invested.

- To create a more financially sustainable retirement system, the University of California and some California cities have offered a hybrid pension option, such as a 401(k) combined with a much smaller employer-paid pension (see Bibliography item 7). This

type of system is also included in the proposed Public Employees’ Pension Reform Act of 2018 (Senate Bill B-32[see Bibliography item 5]).

Retiree Medical Insurance Unfunded Liabilities

- Retiree medical insurance subsidies fall into an expense category that cities call Other Post-Employment Benefits (OPEB [see Glossary]).
- Yolo County cities’ future obligations for retiree medical insurance are even more alarming than their pension liabilities. Currently, according to the most recent Annual Financial Reports, the four cities do not have sufficient current assets to pay future medical insurance liabilities. West Sacramento has the highest funded status at 48%, meaning the city has enough assets to pay half its future liability. Winters has the lowest, at 0%. Figure 5 below provides four-city information.

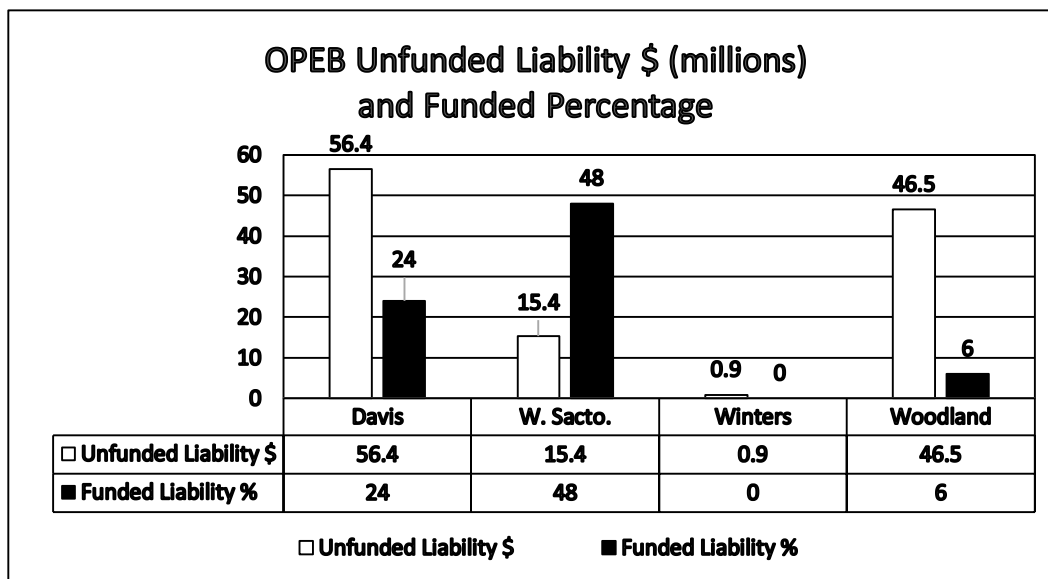


Figure 5 – Other Post-Employment Benefits Unfunded Dollar Liability and “Funded” %.

- With respect to retiree medical insurance, most California cities were “pay as you go” until recently. In other words, cities budgeted and paid for each year’s required costs with little planning for the future. According to the FY2017-18 Adopted Budget, beginning in FY2013-14, the City of Woodland began funding OPEB contributions over and above historical pay-as-you-go levels. Each of Yolo County’s cities is approaching this issue with different strategies, according to their respective budget documents.

City Council Impact

- City Councils have a fiduciary and fiscal responsibility regarding pension and retirement systems that is guided by the California Government Code. Under CA Government Code section 45342, “Any pension or retirement system adopted shall be on a sound actuarial basis and provide for contributions by both the city and the employee members of the system which shall be based on percentages of payroll to be changed only by adjustments on account of experience under the system.” Additionally, “Contributions shall be in the amounts which will accumulate at retirement a fund sufficient to carry out the promise to pay benefits to the individual on account of his service as a member of the system, without further contributions from any source” (CA Government Code section 45343).

- Historically, elected city councils have been pressured to agree to pension benefit enhancements based on overly optimistic, often inaccurate investment earnings projections. As a result, too many decision makers failed to realize that pension contributions would eventually become a significant burden on cities, counties and other governmental entities, and by extension, taxpayers. The “normal” contributions (see Bibliography item 6) by employee and employer have been considered sufficient for pension plans to remain fully funded and fiscally solvent.
- In future years, most of the current local officials in each city will be gone due to normal voluntary or election turnover. Meanwhile, finding adequate monies to keep city pension and medical insurance plans solvent remains a critical and ongoing requirement and challenge for elected officials and their supporting city staff. The most common method of finding new revenue sources for retirement costs is through proposed new city taxes and fees, such as sales tax increases or parcel taxes. However, rarely are these tax or fee initiatives labeled as strategies to pay for employee retirement costs.
- According to Grand Jury interviews and city financial documents, developing and utilizing financial forecasting tools, such as those mentioned by the city of Davis in its Adopted Budget 2017-18, significantly improves continuity of knowledge across successive city councils. This financial forecasting tool shows the evolution of the city general fund’s share of total pension costs. Woodland also has a pension and OPEB forecasting analysis to educate its elected officials and staffs.

State vs. Local Decision Making

Making changes to city pension plans and Other Post-Employment Benefits is severely complicated by ever-changing state regulations. Regulations governing retirement benefit plans are spelled out in the California Public Employees’ Pension Reform Act of 2013 and the proposed California Public Employees’ Pension Reform Act 2018 (see Bibliography items 4 and 5). CalPERS also has its own actuarial valuation (see Glossary) and investment return criteria. In addition, local public employee labor contracts influence some benefit levels, employee contribution rates, and retirement ages.

FINDINGS

- F1. For many Yolo County residents, poor transparency and difficulties in accessing information make it hard to understand the consequences of mushrooming retirement benefit expenses and liabilities. This jeopardizes the citizens’ ability to hold elected officials responsible for providing adequate funding to all high-priority services.
- F2. Several studies reveal that the retirement benefit system has been compromised by “golden handshakes” (e.g. special pension benefit deals or enhancements) and failure to consider the cost of lifetime benefits and likely investment earning levels. This happens every time a public agency negotiates a contract with its employees. Future fiscal solutions will depend, in part, on the public’s willingness to hold state and local politicians accountable for their fiduciary responsibility as required by law and ethics (see Bibliography item 10).
- F3. Many city councils seem to have found it politically unpalatable or fiscally difficult to find adequate funding resources to make high enough payments to reduce unfunded pension and other post-employment benefit liabilities beyond the required payments. Additionally,

when revenue generation is increased (e.g., from bonds, parcel taxes, sales, or utility taxes or fees), the money collected that may be restricted for a specific purpose, makes available other unrestricted general funds to fund retirement cost increases. This is not always clearly communicated to the public.

- F4. Beyond CalPERS requirements, the four cities approach the transparency, analysis, management and containment of growing retiree costs in different ways. There is an opportunity for increased collaboration among the cities. For example, Davis has developed a financial forecasting tool that projects revenues and expenses many years into the future. Some cities show retirement costs' share of the "General" or "All" Funds.

RECOMMENDATIONS

- R1. By February 1, 2019, City Councils and staff should conduct public education campaigns to increase transparency and awareness of the alarming burdensome impact on city service priorities that is being created by retirement pension and medical insurance costs. Examples of public education could be in the form of education forums, explanatory inserts in utility statements, multi-media articles and/or candid conversation at governmental meetings.
- R2. By February 1, 2019, City Councils and staff should create a simple statistical template and/or graph that shows three-year past (actual) and projected (look back, look forward) pension costs and liabilities and their impact (% of total) on the city budget General and All Fund base. This is necessary to assure transparency to the public (for an example developed by the Grand Jury, see the Appendix).
- R3. By July 1, 2019, Yolo County City Councils should investigate and consider alternatives to the existing CalPERS managed pension systems in order to achieve a more sustainable and less burdensome financial impact on city budgets. An alternative hybrid-defined pension option is included in the proposed Public Employees' Pension Reform Action of 2018 (Senate Bill B-32). Any alternative plans considered by city governments should be transparent to the public.
- R4. By September 1, 2018, collaboration among cities in Yolo County should be increased so that best practices in analysis and cost containment of pensions and other retiree benefits can be shared. The best practices and innovative ideas should be transparent to the public.

REQUIRED RESPONSES

Pursuant to Penal Code section 933.05, the grand jury requests responses as follows:

From the following governing bodies:

- City Councils in Davis, West Sacramento, Winters, and Woodland – F1, F2, F3, F4; R1, R2, R3, R4.

INVITED RESPONSES

- City Managers in Davis, West Sacramento, Winters and Woodland – F1, F2, F3, F4; R1, R2, R3, R4.

The governing body indicated above should be aware that the comment or response of the governing body must be conducted subject to notice, agenda, and open meeting requirements of the Brown Act.

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GLOSSARY

- **Accrued Liability** – The total dollars needed as of the valuation date to fund all benefits earned in the past for current members.
- **Actuarial Valuation** – The determination, as of a valuation date of the Normal Cost, Accrued liability, and related actuarial present values of a pension or other benefit plan. These valuations are performed annually or when an employer is contemplating a change to its plan provisions.
- **Catch-up Costs** – This is explained under Unfunded Accrued Liability (UAL).
- **Funded Status** – A measure of how well funded, or how “on track” a plan or risk pool is with respect to assets versus accrued liabilities. A percentage greater than 100 means the plan or risk pool has more assets than liabilities and a percentage less than 100 means liabilities are greater than assets.
- **Normal Costs** – The annual payment (cost) for the upcoming fiscal year to pay for future retirement benefits for current employees. The normal cost should be viewed as the long-term contribution rate and is the amount that it will cost to pay for future benefits.
- **Other Post-Employment Benefits (OPEB)** – Retiree benefits other than pensions, normally consisting on an employer’s contribution to medical insurance during retirement.
- **Public Employee Pension Reform Act (PEPRA)** – California legislative reforms passed and implemented in 2003. There is a pending additional 2018 reform act currently moving through the legislature.
- **Unfunded Accrued Liability (UAL)** – When a plan or pool’s value of assets is less than its Accrued Liability, the difference is the plan’s or pool’s Unfunded Accrued Liability (or unfunded liability). If the unfunded liability is positive, the plan or pool will have to make contributions exceeding the Normal Cost. This is commonly referred to as “catch-up” costs.

DISCLAIMER

Reports issued by the Grand Jury do not identify individuals interviewed. Penal Code section 929 requires that reports of the Grand Jury not contain the name of any person or facts leading to the identity of any person who provides information to the Grand Jury.

APPENDIX

City Pension and OPEB Cost Trend Information Template

(created by the Grand Jury as an example for all cities to use as a simple tool to provide transparency for citizens to understand retirement benefits' impact on city budgets)

2017-18 Grand Jury Budget Committee											
City Pension and OPEB Analysis Information											
5-year look back and 5-year look forward											
	FY12-13	FY13-14	FY14-15	FY15-16	FY16-17	FY17-18	FY18-19	FY19-20	FY20-21	FY21-22	
General Fund											
PERS Misc. Employee*	\$										
PERS Safety*	\$										
Total	\$										
% of General Fund	%										
Other Post-Employ. Ben.**	\$										
% of General Fund	%										
Total Pension and OPEB	\$										
% of General Fund	%										
All Funds											
PERS Misc. Employee*	\$										
PERS Safety*	\$										
Total	\$										
% of All Funds	%										
Other Post-Employ. Ben.**	\$										
% of All Funds	%										
Total Pension and OPEB	\$										
% of All Funds	%										
Funded Liability Based on CALPERS and OPEB Actuarial Calculations											
PERS	\$										
	%										
OPEB***	\$										
	%										
*Actual Payments for Employer Costs from CalPERS Annual Valuation Report (Includes UAL + Actual Normal Costs)											
Employers Costs exclude:											
1. Statutory Employee Costs if not paid by City											
2. Negotiated Employees Share of Employers Costs											
**Annual OPEB Costs based on Retiree Healthcare Plan Actuarial Obligations											
***Based on Government Accounting Standard Board ruling 45 Actuarial Valuations and Projections											
Other post-employment benefits (OPEB) are the benefits that an employee will begin to receive at the start of retirement (not including pension benefits paid to the retired employee).											