

New Sonoma's Report on the County's Pension Crisis

How We Got Here and Building a Framework for Solutions

April, 2014

Introduction

A fair and sustainable retirement system plays a critical role in recruiting and retaining talented employees on whom we depend for quality public services, such as taking care of our fellow citizens in need, maintaining our roads, protecting our environment, policing our streets and highways, and prosecuting lawbreakers. The system is also designed to provide a level of secure income to these employees, once they retire. To be viable, the County's retirement system must be affordable for both the employees and the taxpayers who support it.

This report was published by New Sonoma, a nonpartisan, volunteer group of financial experts and concerned citizens. All the financial information in this report is taken from publically available documents. This report provides the first-of-its kind rating and assessment of the financial impacts of hundreds of millions of dollars in unfunded retiree debt owed by the County. It also compares Sonoma County with our neighboring counties and Tulare County, a county with a sound retirement system to demonstrate how our retirement system compares with others.

Ensuring a common understanding of the current pension situation and how we got here is critical to fostering a lively and informed debate among all stakeholders, including; employees, retirees, taxpayers, and elected officials.

Prior to 2002 we had a sustainable pension system. From the 1940's until 2002, Sonoma County provided its employees with sustainable pension levels that provided career employees with 60% of their salary upon retirement combined with social security and health care benefits. It was a sustainable, affordable system that required the County to contribute 7% of the payroll and employees 7% of their salary to properly fund the system. From 1994 to 2001 the County's pension costs averaged \$20 to \$25 million per year.

Today, this is not the case. Sonoma County's retiree pension and health care system provides neither retirement security nor financial sustainability and it is in dire need of re-design. At the end of 2012 the retirement fund had unfunded liabilities of \$527 million and unfunded retiree health care liabilities of \$297 million. In addition, the pension fund has consumed \$600 million in pension obligation bond funds that taxpayers will pay principal and interest on for the next 20 years.

At its simplest, an unfunded liability is the additional amount of money required to be infused into the system today, to fully support the promises made to retirees and current employees for service already rendered. It does not include amounts required to fund benefits for future service. In fact, most of the money going into the system today is to pay off these unfunded liabilities.

Each year that the County delays action to address its fundamental structural pension issues, the more risk the system faces and the harder and more painful it will be to fix. Recently in Stockton, the retirees lost their medical benefits in the bankruptcy settlement and in Detroit, the bankruptcy judge ruled that pensions can be impaired, meaning retirees will see their benefits significantly reduced.

This report is a call to action on the part of our elected leaders, County employees, employee unions, and citizens to work together to create a sustainable pension system that will provide retirement security for our valued employees and enable the County to continue to provide the services we need to maintain our quality of life and a thriving economy.

The Key Drivers of the Problem – Retroactive Increases and Accelerated Retirements

In 2002, the Sonoma County Board of Supervisors enacted pension increases for both General and Safety Employees and adopted the highest allowable formulas, 3% of salary per year of service at 50 years of age for Safety Employees and 3% at 60 for General Employees. The increased benefits were combined with a court settlement called the Ventura Decision, which also added 46 special pay items to what was considered pensionable compensation.

All of these benefit increases were applied retroactively back to the date people were hired. This means that many employees were able to retire at younger ages with richer benefits. Since employee and taxpayer contributions needed to fund these improved benefits during prior periods of service were never contributed during the course of their employment, the unfunded liability increased substantially and newly retired employees received a windfall being paid for by taxpayers.

For General Employees, the average pension for new retirees rose from an average of \$22,468 per year to \$37,715 per year the year after they were enacted. This means the average retiree will receive an additional \$15,247 per year for the rest of their life. If a person bought an annuity for that amount it would cost them over \$300,000. The average term of employment for all retirees is 12 years so the additional annual amount for career employees would be significantly higher.

For Safety Employees, the retroactive increases resulted in a 69% increase in pensions for new retirees from an average cost of \$35,803 in 2002 to \$60,697 in 2006. So the average annual pension for Safety Employees was increased by \$24,894 per year. An annuity to provide the additional annual income would cost about \$500,000.

After the increase, the average retirement age for General Employees dropped from 62 to 57 and for Safety Employees from 56 to 51. This had a huge impact on the funding status and created additional unfunded liabilities because pensions were funded for 5 fewer years and retirees received benefits for 5 more years.

Currently, the funding ratio for retiree pension and health care benefits already earned is between 50% and 60%, meaning there is only 50 to 60 cents on the dollar available to pay for already earned benefits.

How the Increase Was Supposed to Have Been Paid For

The County Supervisors were told by the Sonoma County Retirement Association before pension increases were enacted that they had “designed” the increase so that it could be covered with an additional 3% of payroll contribution to the pension fund by the employees. Several Board Resolutions we received stated that the General Employees were paying 100% of the past and future cost of the increase and Safety Employees were paying half.

For the average employee this meant an additional contribution of \$2,400 per year. Instead of a percentage increase, since you don’t know how long people will pay their 3% the employees should have been required when they retired to write a check to their pension fund account for \$300,000 to \$500,000. That is the only way to make them pay for the increase as was agreed.

What the Plan Administrators of the retirement board did not tell the supervisors was the cost they presented for General Employees did not include the impact of accelerated retirements. Those

accelerated retirements have cost the County tens of millions in additional pension costs each year as more and more employees started drawing their pensions, instead of contributing to them.

The costs of the benefit increases were also magnified by the lower than anticipated stock market returns. The pension fund's actuary used an assumed rate of investment return of 8% when calculating the cost of the increase. Since the increase, the investment fund has fallen \$570 million short of its assumed rate of return. As a result of increased retirements and investment shortfalls, the actual cost of the increase is approximately three times the cost that was provided to the Supervisors.

The Failure to Provide Required Public Notification of the Benefit Increase

After sending out letters requesting information under the Freedom of Information Act, New Sonoma received and reviewed the County documents surrounding the benefit increase. We discovered that when they were enacted, the Supervisors did not follow the requirements to perform their own actuarial study of the costs, nor did they notify the public of the increase as required by Section 7507 of the California Government Code. Some legal experts believe this should void the increase back to the date it was enacted.

Understanding the Consequences of Further Inaction

Increased pension costs in the years ahead have far reaching implications for the all County residents, including; (1) unsustainable annual costs for taxpayers, (2) burden on active County employees, (3) threats to vital public services, and (4) the potential for the County to run out of money and go bankrupt.

So far, additional pension costs have caused deep cuts to services and have greatly reduced the County's ability to maintain its roads and infrastructure. According to the Supervisor's Ad Hoc Committee Report on Roads, 86% of the County's roads are not receiving pavement preservation and we now have the third worst roads in the state according to the state's Pavement Condition Index's (CPI) report. And California has the second worst roads in the country after New Jersey. So arguably Sonoma County has some of the worst roads in the Country.

In addition to service insolvency, the County is approaching balance sheet insolvency. New government accounting standards have been enacted that will have a drastic effect on the County's balance sheet. Currently, the County lists \$1.2 billion in net assets in the 2012-2013 budget. After the new reporting requirements, the County will need to write off \$472 million in pension assets and post about \$824 million in new pension and employee health care liabilities, taking the County's net assets to zero.

County Never Enforced the Requirement for the Employees to Pay for the Increase

The initial cost estimates for the increase provided by the County's Actuary Rick Roeder to the Sonoma County Employee Retirement Association Plan Administrator in 2002 stated that if employees contributed an additional 3% of salary for 20 years, the \$93 million cost would be offset by the employees.

In his 2002 Annual Actuarial Report Mr. Roeder came up with a completely different cost for the increase. The new, more detailed cost analysis concluded that increasing the General Employee formula to 3% at 60 and Safety Employees to 3% at 55 would increase the unfunded liability of the plan by \$152 million, even after adding in the new employee contributions.

Even though the employees had agreed to pay the 3% of salary estimated cost of the increase the Supervisors agreed to pick up more of their contribution. The employee MOU's indicate that when the County negotiated the 3% of salary additional contribution with the Safety employees the County agreed to pick up 2% of their previous contributions so the net Safety Employee contribution was 1% of salary.

In 2008, after paying the 3% of salary for 6 years, SEIU employees received a 2.25% pickup of their previous contribution so their net contribution was .75% of salary. So even though the employee contributions were falling significantly short of paying for the increase, the Board of Supervisors negotiated for the employees to pay even less.

The Current Supervisors Have Ignored Their Own Pension Report

The Board of Supervisors has ignored its own Ad Hoc Committee Pension Report dated November 3, 2011, which included the following text on Page 18 identifying the failure of employees to pay their share and the recommendation to address this in labor negotiations. Here is the text from the report:

"In 2002, Sonoma County agreed to retroactive increases which became effective in 2004 for general members and 2006 for safety members. This decision while part of a legal settlement and negotiations was made with the understanding that employees would bear the full cost of the enhanced retroactive benefit. At the time, the long term cost was actuarially estimated and labor negotiations provided for contract provisions to pay for the cost over the course of 20 years. However, those initial estimates and stock market volatility caused an increased cost to the County to cover pension costs".

"The Ad Hoc Committee recommends staff commission a new calculation to identify the shortfall, if any, and to work with the labor organizations through negotiations to meet the intent of the prior agreements regarding the enhanced benefit formulas costs".

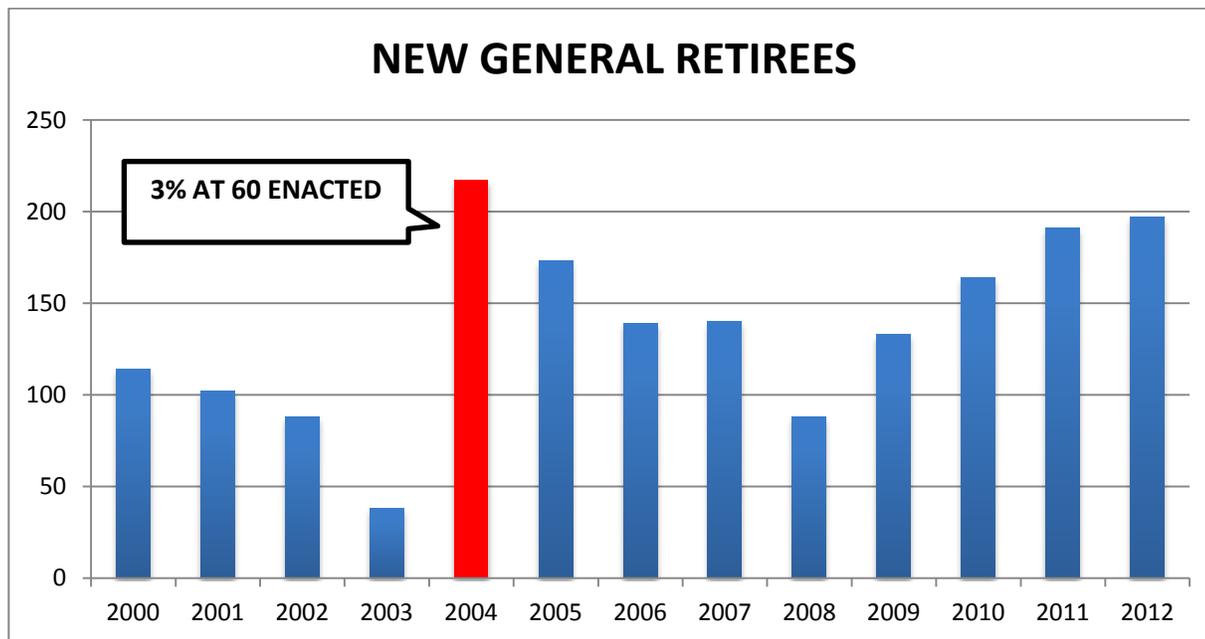
We have asked the Supervisors for the results of this calculation and were informed it has never been performed. As a result, we believe the citizens of Sonoma County deserve a full accounting and explanation of what went wrong and what corrective actions should be taken to bring the County into compliance with their own Board Resolutions requiring the employees to pay.

Because of the numerous problems with the increase process including: (1) not notifying the public, (2) not presenting accurate cost estimates to the Board of Supervisors, and (3) ignoring the Board Resolutions requiring the employees to pay for the increase, New Sonoma believes an independent committee of experts should be hired by the County to evaluate the situation and propose corrective actions to bring the fund into compliance with the law and the resolutions.

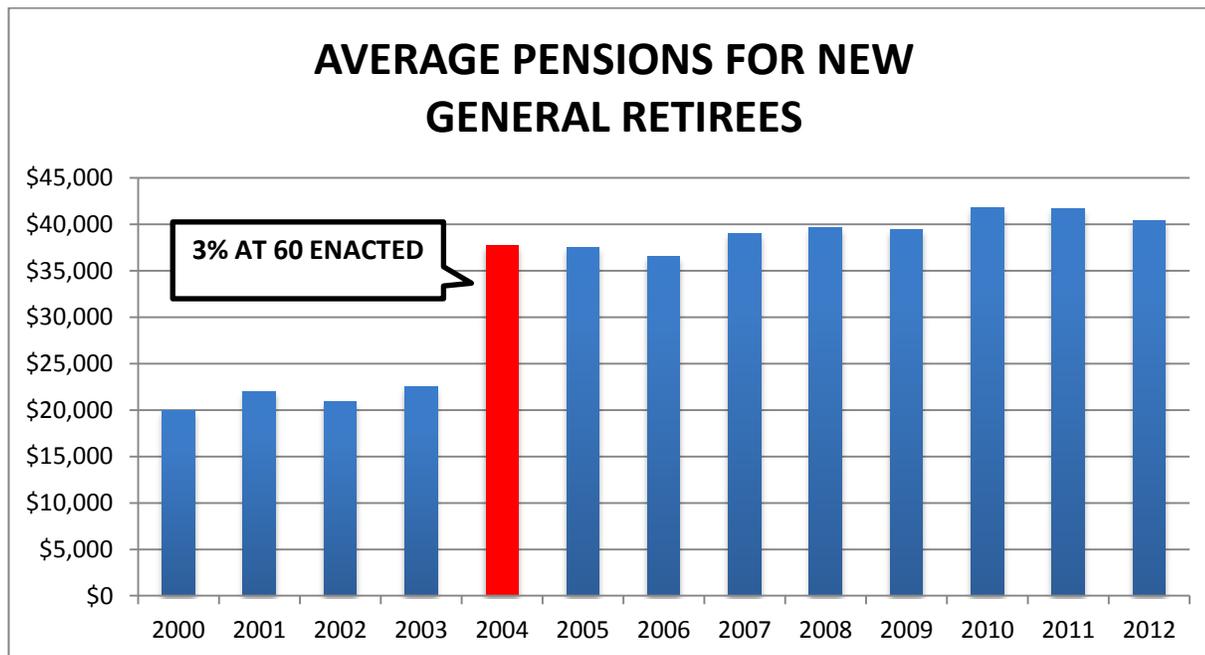
We also believe that a Pension Advisory Committee made up of experts, union and retiree representatives should be formed to develop a plan for paying off the pension's unfunded liabilities over the two decades and to ensure that the County complies with governance issues in the future. It is evident that there are too many conflicts of interest between staff and the supervisors over pensions and an independent committee needs to be formed.

The charts on the following pages demonstrate the problems faced by all stakeholders including; taxpayers, employees and retirees.

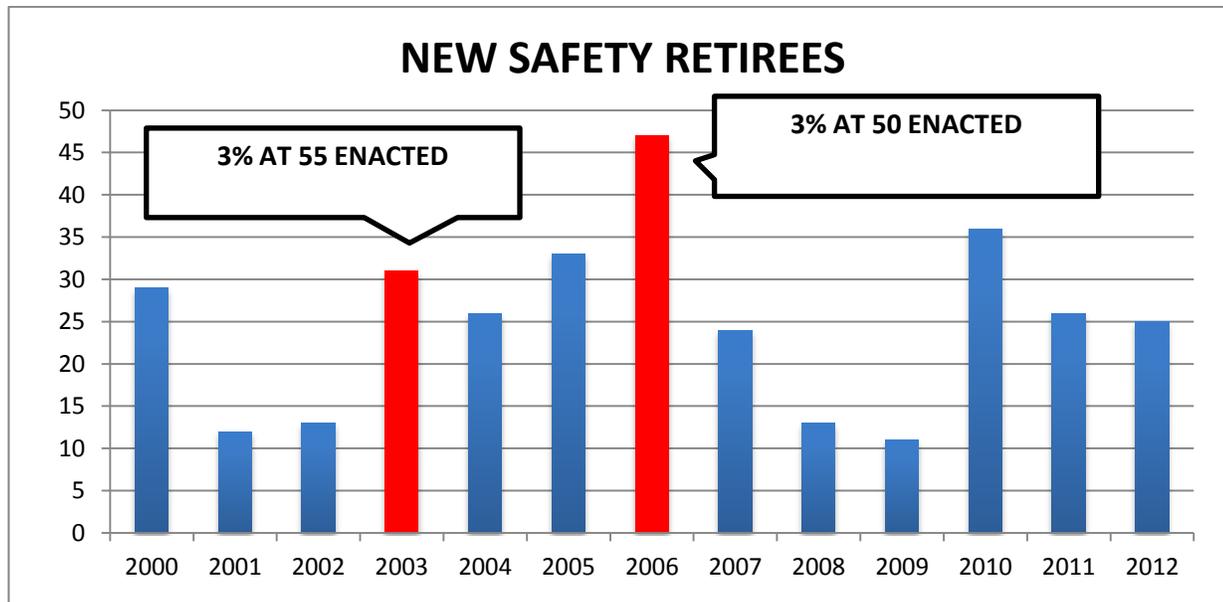
The chart below demonstrates how the number of new retirees jumped significantly after the increase. In addition, the average age of new retirees dropped 5 years from 62 to 57. This meant people paid into the retirement system for 5 fewer years and will receive retirement funds for 5 additional years. As previously discussed, the retirement association did not have their actuary include the impact of accelerated retirements in their cost analysis, as he recommended.



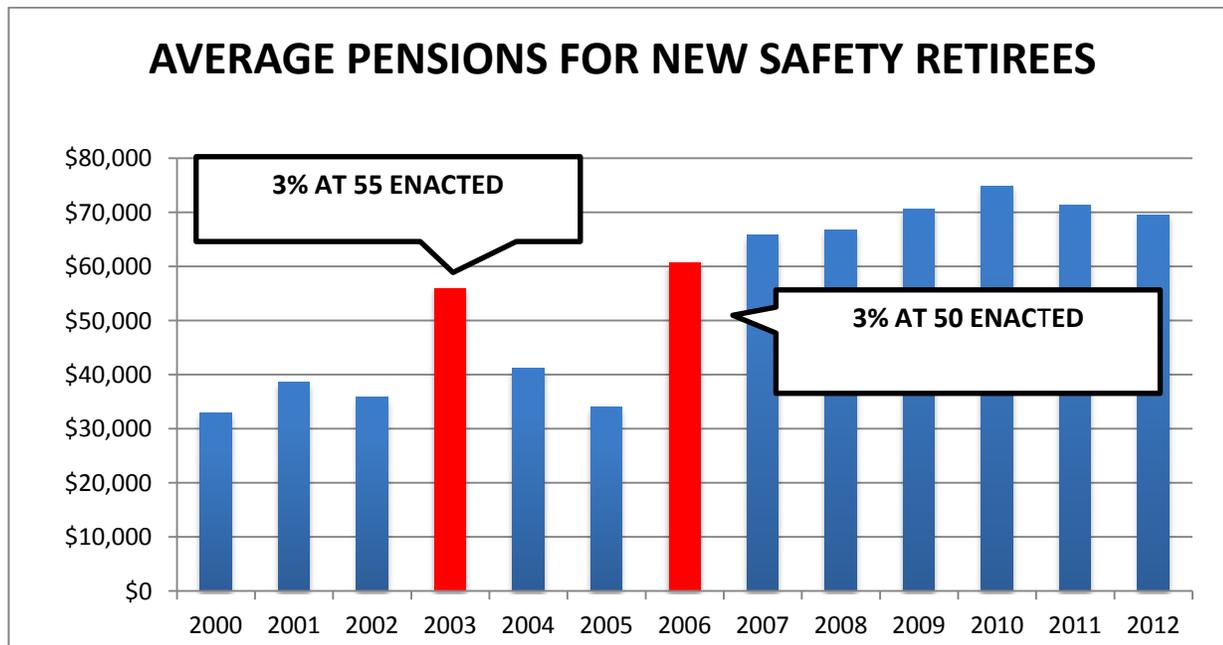
In addition to lowering the retirement age, the increase to 3% at 60 also resulted in an immediate jump in pensions for new retirees of 66% from an average cost of \$22,468 in 2003 to \$37,715 the following year.



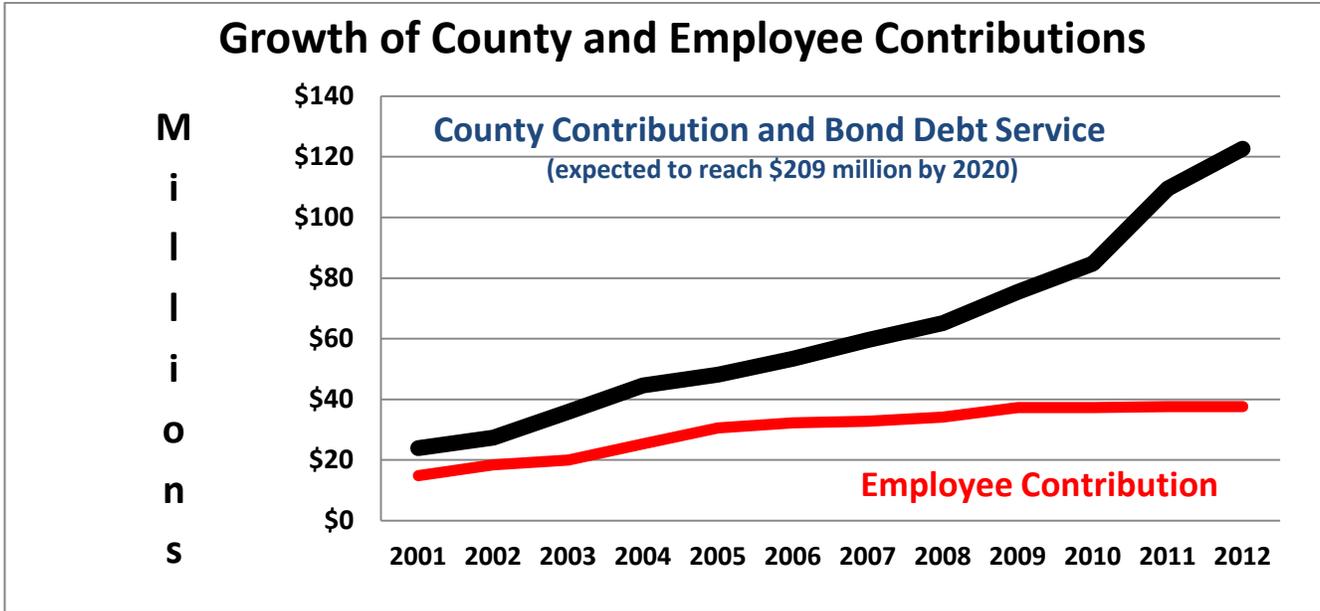
The Sonoma County Board of Supervisors adopted two new pension formulas for Safety Employees. A 3% at 55 formula took effect in 2003 and a 3% at 50 formula took effect in 2006. As a result, the average age of new retirees dropped from 56 to 51 resulting in 5 fewer years of employee contributions and 5 more years of retirement.



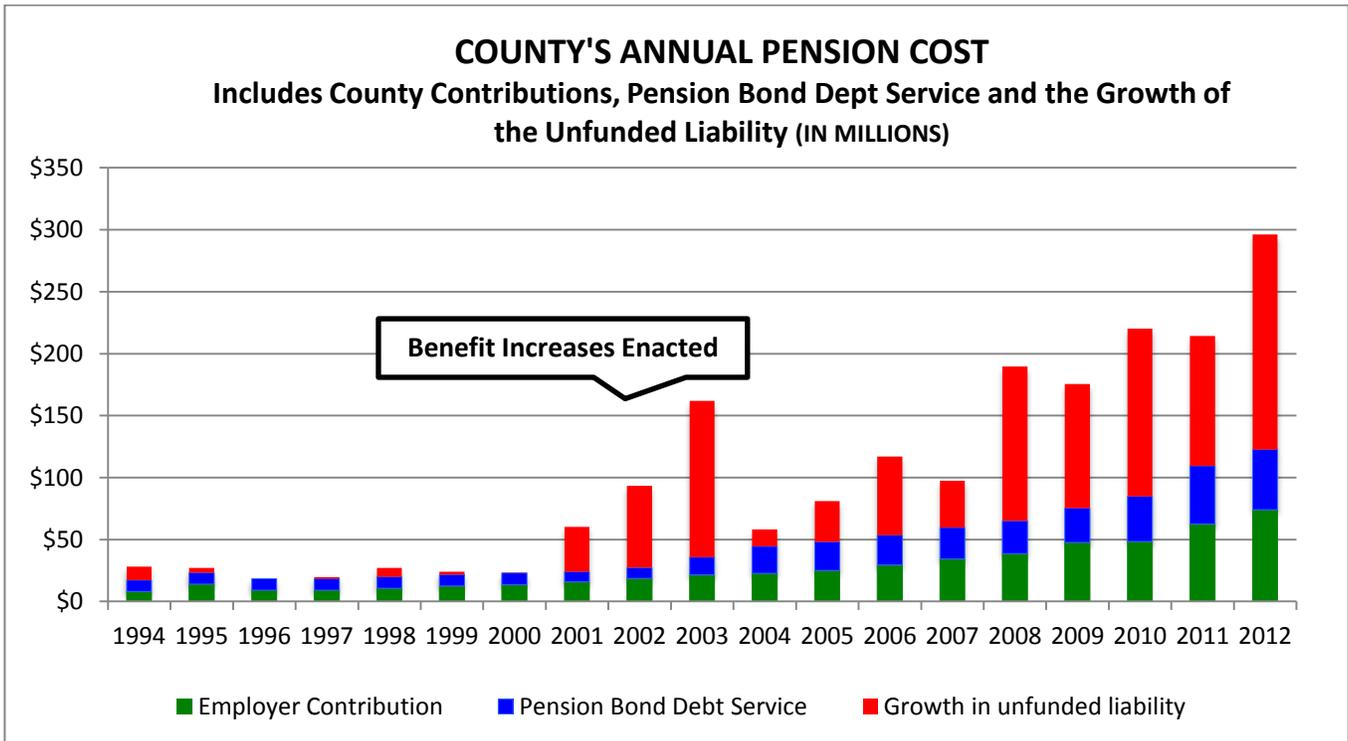
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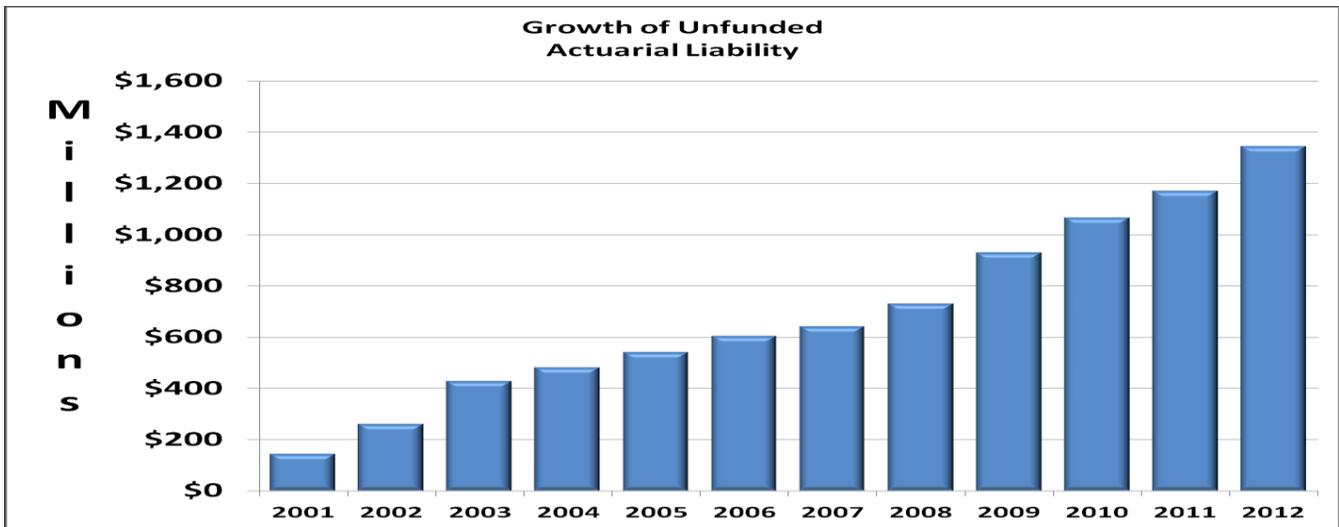
This graph demonstrates how the cost for pensions has soared for the County, now reaching 40% of payroll. However, the cost that employees pay, has stayed flat at 12% of payroll or less than the amount shown because the graph does not account for the County’s pickup of employee contributions, which is difficult information to obtain from County reports.



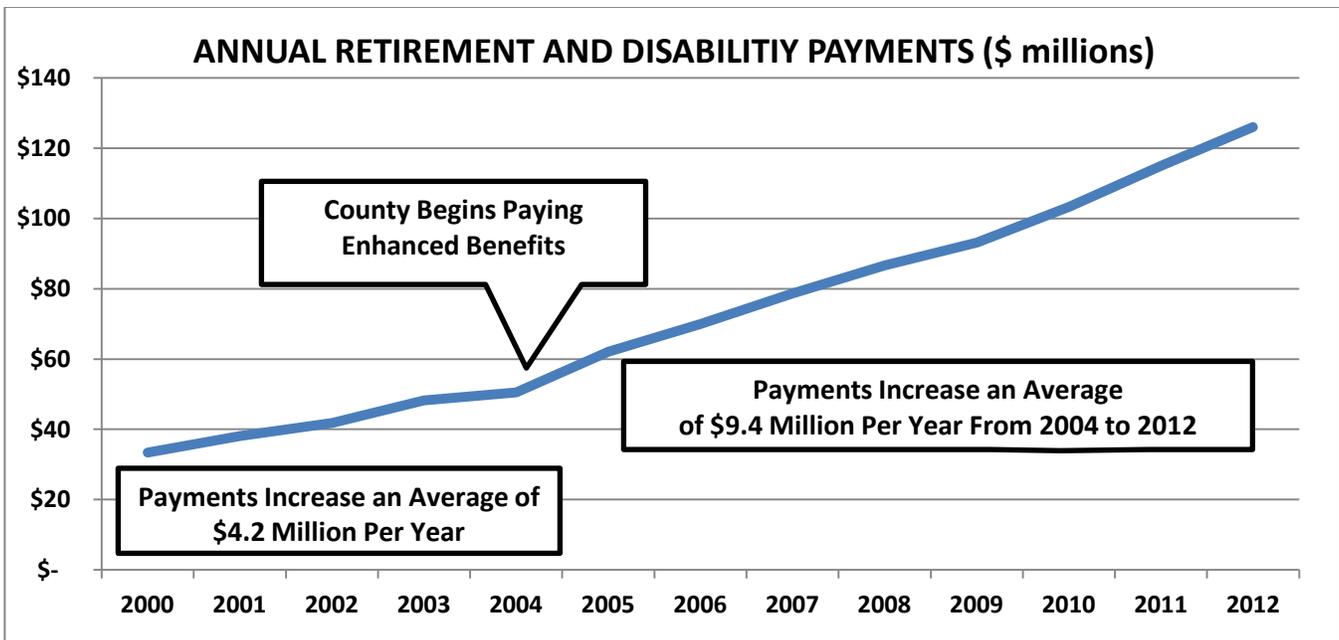
This chart provides the total annual cost of pensions each year. Pension costs were stable at about \$25 million per year from 1994 to 2000 and from 2001 to 2012 the average annual cost jumped **600%** to an average of \$155 million per year.



This chart shows the growth of the unfunded liability, which is money owed to current employees and retirees for work already performed. It is the difference between what they are owed and the assets in the fund. Bond funds used to buy down the debt are added back in to provide the true unfunded liability the County faces. The pension bond debt is currently at \$495 million. It will end up costing the County \$856 million when interest is added. In addition, the County had \$527 million in unfunded pension liabilities at the end of 2012 as well as \$297 million in unfunded medical liabilities. These amounts assume the County will receive a 7.5% return on its investment earnings. If they receive less, the unfunded liability increases dramatically.

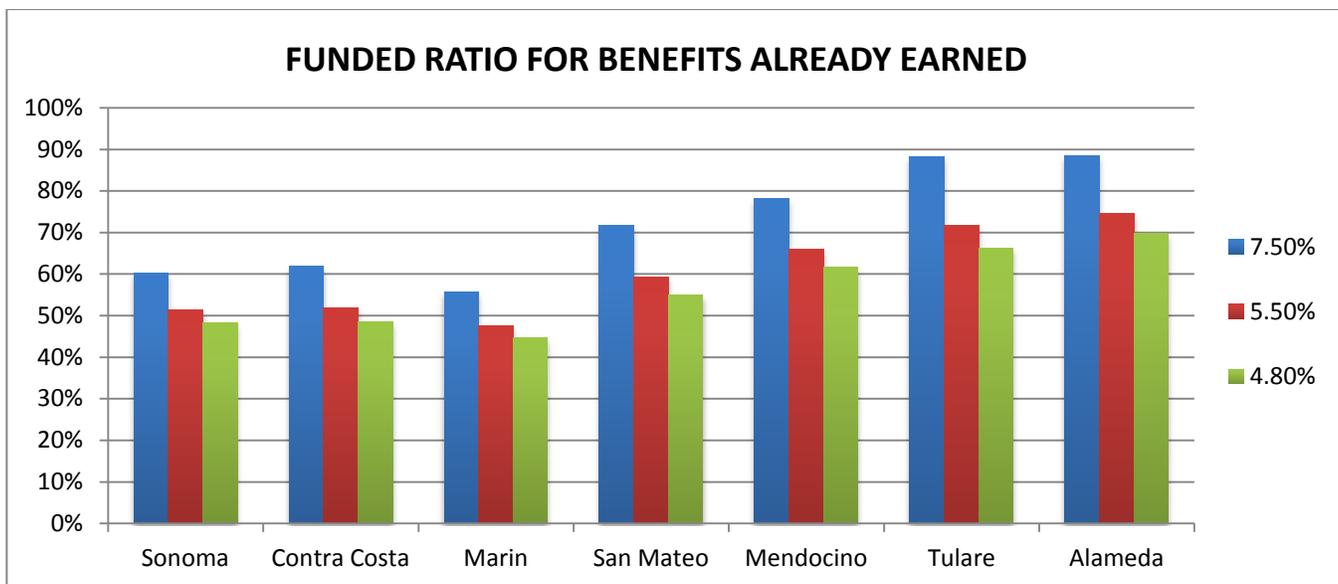


This graph shows the disbursements to retirees and disabled workers. The payments have increased 435% over the past 12 years from \$28 million in 2000 to \$122 million in 2012. From 2000 to 2004 payments to retirees increased by about \$4.2 million per year. After the increase in benefits, payments to retirees increased an average of \$9.4 million per year.

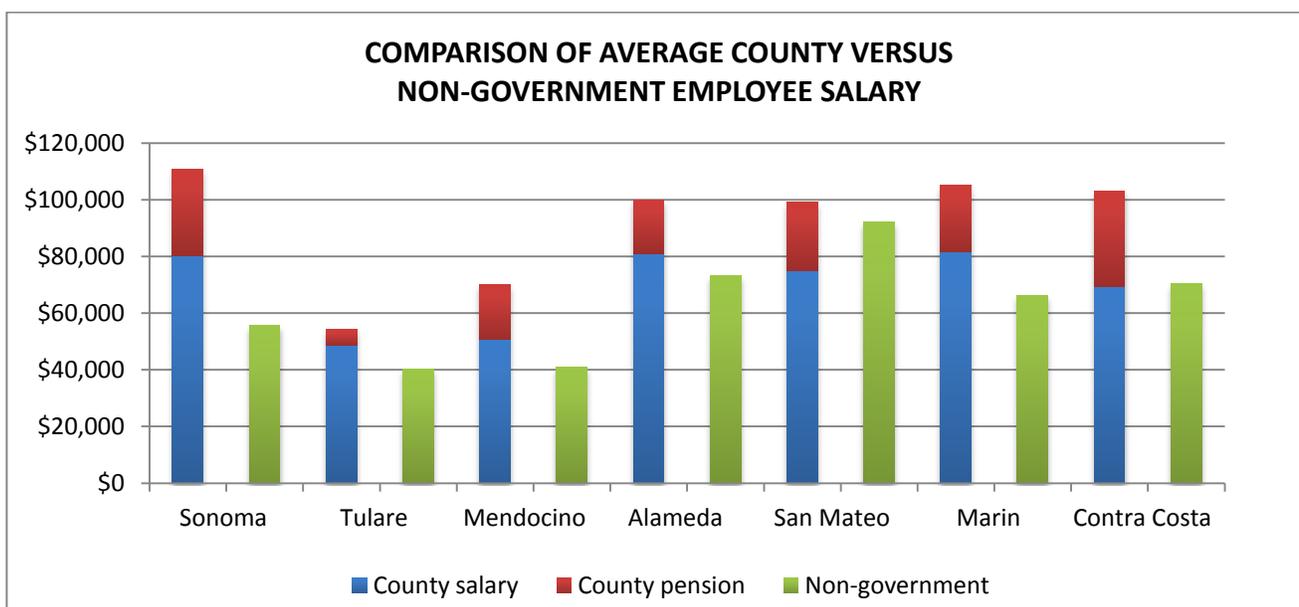


Comparing Sonoma County Pension Costs with its Neighboring Counties

The Earned Retiree Benefits Funding Ratio is the present value of pension and other post employment benefits earned by retirees and employees to date. Generally 80% funded is considered a plan that is not in stress. A funded ratio of 60%, as in Sonoma County is a plan in significant financial stress and risk of insolvency. We calculated the funded ratio based upon three rates of investment return of 7.5%. 5.5% and 4.8%. Tulare County did not retroactively increase benefits and therefore has a funded ratio of almost 90%.



Average county employee salary and pension costs are now \$110,000 per year, double the salary and retirement costs of the average county resident. A 3% employer contribution to a 401k account was added to the non-government employee salary for comparison purposes. That is the most typical amount contributed by employers.



Comparison of Sonoma with Tulare County

Tulare County has about the same population as Sonoma County, but their finances are in great shape because they never retroactively increased pensions and they controlled salaries. Their payroll is 37% less than Sonoma County's even though they have 577 or 15% more employees. This data is from the 2012 Annual Actuarial Valuations of both counties.

	Tulare	Sonoma	Difference
1. Population (2011)	449,253	488,253	Sonoma 8.6% larger
2. Active employees	4,197	3,620	Tulare 16% higher
3. Total projected compensation	\$220 million	\$303 million	Sonoma 37% higher
4. Average pensionable salary	\$52,384	\$83,636	Sonoma 60% higher
5. Pension bonds sold	\$41 million	\$592 million	Sonoma 1300% higher
6. County contribution to pension's	\$30 million	\$69 million	Sonoma 130% higher
7. Pension bond debt service	\$0	\$48 million	
8. Total pension costs	\$30 million	\$117 million	Sonoma 290% higher
9. 2012 unfunded pension Liability	\$119.5 million	\$527 million	Sonoma 343% higher
10. Unfunded liability w/o bond proceeds	\$119.5 million	\$1,119 million	Sonoma 836% higher

BUILDING A FRAMEWORK FOR SOLUTIONS

With a clear understanding of the nature and extent of the challenges we face as a County, we must find a workable solution. Indeed, only by addressing and solving this urgent financial challenge can we move to a healthy local economy and provide retirement security for employees and retirees.

To begin this process New Sonoma believes a Citizens Advisory Board made up of union, retiree and taxpayer representatives along with independent legal, actuarial, and financial experts needs to be formed to develop a long term solution to this growing crisis. It is our intent to ask the Supervisors to form this Board and if they refuse, to place an initiative on the ballot that will let the voters decide. The initiative would also include other measures, such as reducing pension formulas going forward if the Reed Initiative slated for the 2016 election passes.

The path to comprehensive pension reform should begin with agreement on a definition of retirement security – once we have agreement on a level of post-retirement income that ensures security and that the County can afford, we can design a sustainable system to provide that security.

Sonoma County residents, retirees and employees should share the following goals in creating a secure, sustainable retirement system that:

- Attracts and retains quality employees
- Provides a level of benefits that retirees can plan on being there
- Accumulates assets to cover 80% or more of its projected liabilities
- Allows the County to continue to invest in public services
- Eliminates the need for piecemeal reform by instituting self-correcting mechanisms that are triggered when funding levels dip below acceptable thresholds.

Any comprehensive solution should be informed by the following:

1. Accurate and transparent assumptions: Today's system was largely built by policymakers using little accurate data. Retirees, employees and taxpayers rely on government leaders to be honest about the system's liabilities and to have safeguards in place that require accurate accounting. Public employees should depend upon their union leadership to insist on conservative, realistic assumptions. Using overly optimistic assumptions hurts everyone because these assumptions underestimate the true cost of pensions and increase the risk that not enough money will be set aside to pay for granted pension benefits.

2. Equitable and reasonable changes: Fair and balanced eligibility rules, benefit levels and contributions for all members must be required of any retirement system reform. This report underscores the truth that any reform impacting only new employees will not affect the existing \$1 billion in unfunded pension and medical liability for past service. This problem is over a decade in the making and all stakeholders must now share in the solution. The following, among many other ideas, should be analyzed as possible areas of reform:

- Increasing the retirement age
- Lowering the accrual rate of benefits
- Cost of living adjustments
- Hybrid plans and portability
- Eliminating the ability to spike pensions and purchase Service Credits

As we analyze the various options for fixing our retirement system, we must again remind ourselves that real people and real families are connected to every change we consider. While all stakeholders must be prepared to collaborate in achieving a fair and sustainable system, we must also consider possible hardships that these changes may impose.

Therefore, reforms could be structured so that they have a smaller impact on plan members at lower income and lower benefit levels. One of the principal purposes of a public retirement system is to sustain public workers during their retirement years. Reforms that provide protection to sustenance level benefits must be part of any reform.

3. Intergenerational fairness: New County employees are receiving a lower pension formula (2% at 62), but are required to pay the additional 3% of pay for an enhanced formula their predecessors' received. In addition, they shoulder the greatest risk that money will not be there in 20 to 30 years when it is time for them to retire.

And when there are budget cuts today that result in lower wages and furlough days, it is the current employees that endure these challenges. Any solution needs to ensure fairness between newer and more veteran employees and retirees.

4. Comprehensive and self-correcting processes: As the collaboration on reform begins, it is important that any solutions protect the County from ever again facing the massively underfunded system that it has today. To maintain a defined benefit system at all, it is critical that the County adopt structures that provide for automatic self corrections.

5. Unfunded liability is the lion's share of the problem: A real challenge in reforming the pension system is that it is extremely underfunded today and any solution must address the unfunded liability, the bill for past service. It is likely that any solution will require a change to benefits to both retirees and current employees in order to address this problem.

THE TIME TO ACT IS NOW

The Board of Supervisors have enacted some reforms to limit spiking of pensions and have changed benefit levels for new hires. However, these reforms will not provide substantial savings for decades. It is time to take a different approach to solving this problem. We must begin this time by defining retirement security and designing a system that provides security in retirement for our valued public employees.

This new system will necessarily also address budgetary concerns because no one is secure if they are promised a benefit that the County cannot afford. Each day the County avoids comprehensive reform, the liability grows. It is unfair to ask taxpayers to pay for the growing level of required contributions and it is dishonest to let County employees and retirees believe that full benefits will be there for their retirement.

The time to act is now because it is in the interest of everyone to solve this problem, once and for all.