2004-2005 MARIN COUNTY CIVIL GRAND JURY

The Bloated Retirement Plans of Marin County, Its Cities and Towns (Revised)

Date of Report: May 9, 2005

SUMMARY

The 2004-2005 Marin County Civil Grand Jury (Grand Jury) became concerned about retirement benefits (i.e., pensions plus retiree healthcare) after the Board of Supervisors received substantial criticism in newspapers for increasing pension benefits.

The Grand Jury found that Marin County (the County) and its cities and towns (Municipalities) provide pension plans to their employees that are many times more generous than similar plans found in the private sector. The volatility of the cost of these pensions has caused extreme stress on the budgets of many of these entities. Despite this, there is an inexorable push from unions, through the state legislature, to continue increasing pension levels. Such large benefit levels do not seem justified by the argument that they are needed for hiring and retention of employees. Irrespective of whether the level of total compensation (salary plus benefits) is right or wrong, the mix (between salary and benefits) seems wrong in that far too much emphasis is placed on retirement benefits.

In the matter of retiree healthcare, the Grand Jury has found that the County and the Municipalities are facing an imminent requirement to include retiree healthcare obligations on their balance sheets. However, the Grand Jury found no evidence that these local governments understand the extent of these obligations, nor have they begun the process of understanding their retiree healthcare promises, of valuing their retiree healthcare obligations, and of dealing with them. This is especially troubling in the case of the County and some of the Municipalities where the obligations will apparently be very large, even as much as hundreds of millions of dollars in the case of the County.

The 2004-2005 Grand Jury recommends that the County and the Municipalities take the following actions:

- Sponsor pension reforms, including rolling back pension levels to historical, lower levels for new hires.
- Provide lower level pensions in favor of forms of compensation whose employer costs are less volatile.
- Work with plan administrators to establish more stable funding methods for pensions.
- Stop spending temporary found (i.e., unanticipated) money on recurring obligations.
- Lobby the unions to act responsibly and lobby the legislature to stop legislating plans that undermine public employers' abilities to control the structure of compensation.
- Rethink compensation strategy with a goal of sponsoring systemic (i.e., statewide) changes.
- Sponsor programs to help employees understand their retirement, so they can take an active role in their retirement planning.
- Request that the California Public Employees' Retirement System (CalPERS) actuaries (and, in the case of the County and the City of San Rafael, the MCERA actuary) do a

better job of explaining pension and retiree healthcare changes and issues to policymakers.

- Perform retiree healthcare valuations in the very near future.
- Make knowledgeable decisions, sooner rather than later, about retiree healthcare promises.

BACKGROUND

In mid-2004, the Marin County Board of Supervisors (Board of Supervisors) approved, through union negotiations, a series of pension changes for County employees. The pension changes generated so much questioning from the public that members of the Board of Supervisors responded, as reported in several articles in the Marin Independent Journal (IJ) in the ensuing months.

Later in 2004, the Grand Jury read reports in the IJ that one of the towns of Marin was having substantial difficulty in finalizing its FY 2004-2005 budget. Escalating pension cost was cited as one of the primary reasons that the budget could not be completed on a timely basis.

Subsequently, a review of the financial statements of the Marin County Employees' Retirement Association (MCERA) indicated that MCERA expended nearly $7 million for retiree healthcare and life insurance benefits, an amount approximating 13% of the total amount spent on pensions. Since healthcare costs have been escalating materially in recent years, the Grand Jury wondered to what extent retiree healthcare costs could be exerting pressure on the County's and its Municipalities' budgets.

Thus, a number of questions had raised the interest of the Grand Jury to explore the County's retirement benefits as well as those of the Municipalities.

INVESTIGATIVE PROCESS

The Grand Jury interviewed representatives of the County, including representatives of MCERA, members of the Board of Supervisors, representatives from several of Marin's Municipalities, several consulting actuaries, and requested information from representatives of CalPERS.

The Grand Jury reviewed information from MCERA, each of Marin's Municipalities, CalPERS, numerous newspaper articles on pensions and healthcare for retirees, the 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (i.e., The 2004 Annual Social Security Report), the County Employees' Retirement Law of 1937 (1937 Act), and material from the Employee Benefits Research Institute (EBRI).

The Grand Jury conducted Internet searches on CalPERS for pension cost requirements of Marin's Municipalities, Government Accounting Standards Board (GASB) for healthcare of retirees, and Social Security for on-line benefit calculators.

For more detail on the information considered by the Grand Jury, refer to the Bibliography at the end of this report.

For definitions of terms used in this report, please see the Glossary following this report.

DISCUSSION

In the public sector, pensions provide substantially greater retirement benefits than do comparable plans found in the private sector. When times are bad, these greater benefits in the public sector generate tremendous pressure on budgets, as often pension costs go up when revenues go down. Despite the pressure, there are unrelenting on-going demands to expand public sector pensions. Furthermore, the pressure is exacerbated by an additional hidden pension-like benefit – retiree healthcare. Retiree healthcare benefits represent true costs, often substantial, that have been largely ignored. This should change in the next few years when impending accounting standards bring retiree healthcare obligations to light.

Comparison of Pension Levels in the Private Sector and Public Sector

In the public sector, employers usually provide pensions using a standard type of formula expressed as a percent of pay (i.e., the benefit factor) for each year of service, multiplied by the employee's final average pay, payable at a stipulated retirement age. For example, commencing at age 55, under a common public sector plan, a retiree might be provided with 2% of his final average pay for each year of service. Under such a plan a retiree with 30 years of service could retire at 55 with a benefit of 60% of final pay.

The Grand Jury would like to have compared the level of pensions provided in the public sector directly with the corresponding levels in the private sector but there are a number of reasons why it is difficult to make this comparison. The most important reason is that private sector employees are covered by Social Security, so Social Security benefits must be included in any comparison of pension levels to make the comparison valid. Nearly all public sector employees considered in this report (i.e., County employees and employees of the Municipalities) are not covered by Social Security (at least not for employment with their Marin public sector employer). Additionally, it is common for pension plans in the private sector to take a partial credit for Social Security benefits. This reduces the level of private sector pensions.

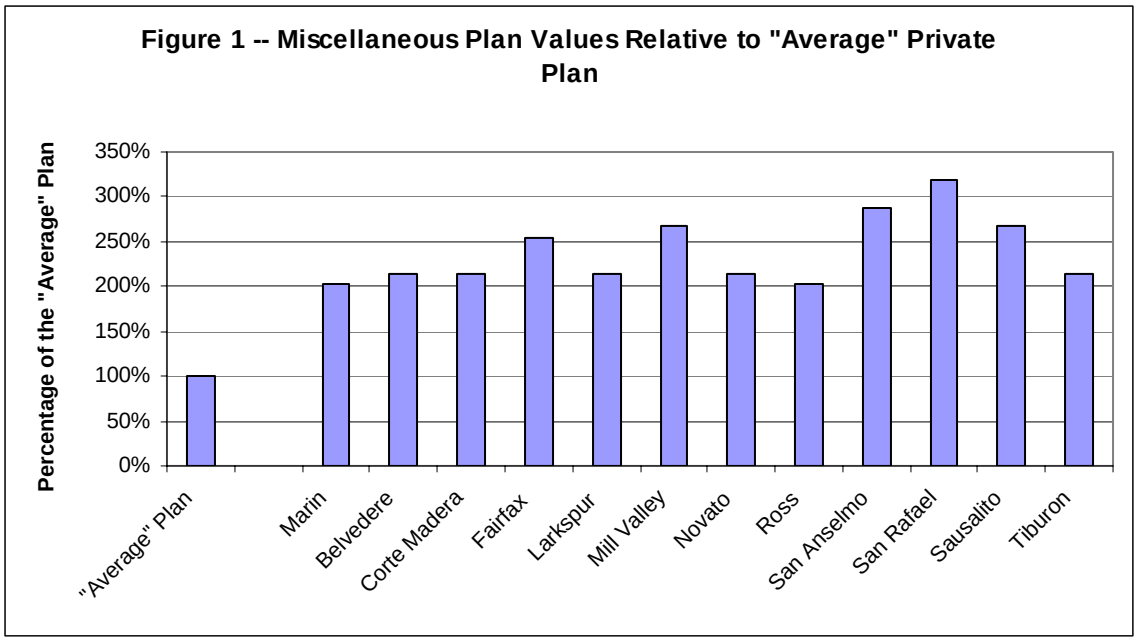
The Grand Jury asked a number of consulting actuaries to give their estimates of the level of benefits provided by pension plans in the private sector in order to provide an assessment of the effect of the factors indicated above. These consulting actuaries were asked to carry out their assessments only with respect to major employers, because such employers were considered to be more comparable to public sector employers than smaller employers. Their results suggest that the average benefit factor in the private sector (including Social Security) could be 2.1% per year. This pertains to age 63 retirements for a 5-year final-average pay plan with no cost-of-living adjustment (COLA), except for the Social Security portion. Although this "average" plan pertains to only about half the employers, it still provides a basis of comparison, and, if anything, probably overstates the value of private sector retirement benefits. Details of these estimates are shown in Appendix A.

It is this "average" plan (i.e., 2.1% of 5-year final-average pay, retirement at age 63 and partial COLA) that will be used as the basis of comparison with the plans offered by the County and its Municipalities. This "average" plan is used only by an estimated half of the major employers; the

other half provide different types of pensions, e.g., the cash balance pension, or even no pension, all of which have lower benefits than the “average” plan (see Appendix A for details).

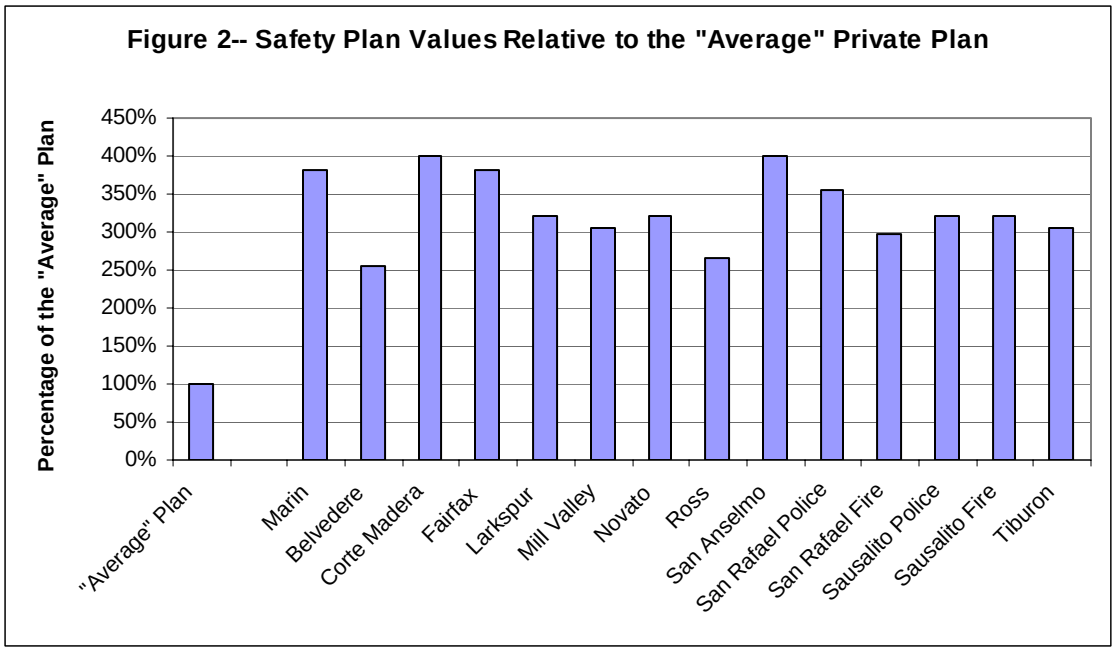
The value of public sector pensions can be viewed, on an over-simplified basis, with respect to the benefit factor, the retirement age at which full benefits are payable, the number of years over which final pay is averaged, and the COLA. In nearly all cases, public sector plans are more valuable than private sector plans because (i) the benefit factor is higher, (ii) the retirement age for full benefits is lower, (iii) the number of years over which final pay is averaged is shorter and (iv) a COLA is provided.

Several consulting actuaries were asked to give relative values of these provisions of public sector pensions compared to the “average” plan. The results indicate that the values of the public sector pensions ranges from 2 times to over 4 times the value of the “average” private sector pension (including Social Security), a staggering difference. Figure 1 shows the contrast of the “average” pension in the private sector to miscellaneous plans (i.e., plans provided to public sector employees other than law enforcement and fire protection personnel) provided by the County and its Municipalities.



As indicated in Figure 1, the miscellaneous plans provided by the County and its Municipalities range from being about 2 times to 3 ¼ times richer than the “average” plan.

The safety plans provided by the County and the Municipalities (i.e., plans provided to law enforcement and fire protection personnel in the public sector) range from 2 ½ times to 4 times richer than the average plan, as shown in Figure 2.



Public sector pensions require employee contributions, ranging from 7% to 10% of pay for miscellaneous plans and from 9% to over 13% for safety plans. On the surface, this would seem to compare to the private sector wherein employees have to contribute about 6% of their pay for Social Security benefits, plus additional amounts to employer sponsored savings plans. In the public sector, however, employers are permitted to pick up some or all of the required employee contributions to their pension plans, meaning that the employer, not the employee, actually pays the contribution. It also means that the amount the employee pays toward retirement is reduced. The County and its Municipalities have different bargaining agreements for the amounts employees contribute. For the most part, however, the employers pick up half or more of the employee contributions.

The Volatile Costs of Public Sector Plans

Representatives from several of Marin's Municipalities indicated that the entities they represent are under financial stress. They pointed to shortfalls in funding from the State as a primary cause, adding that pressure induced by increased benefit costs was also a major contributor. For those Municipalities in which benefit costs caused great stress on budgets, increased pension costs were cited as a major component of the problem. The levels of pension plan costs as a percentage of payroll over the last three fiscal years (FY 2002-2003 through FY 2004-2005) and the forthcoming fiscal year (FY 2005-2006) have increased dramatically.

Figure 3 illustrates the dramatic increases in the costs of miscellaneous pension plans of the County and its Municipalities. These increases, which went from an average of about 2% of miscellaneous payroll in FY 02-03 to 15% of miscellaneous payroll just 3 years later, came at the worst possible time, i.e., a time when revenues were falling. More details on these costs can be found in Appendix B.

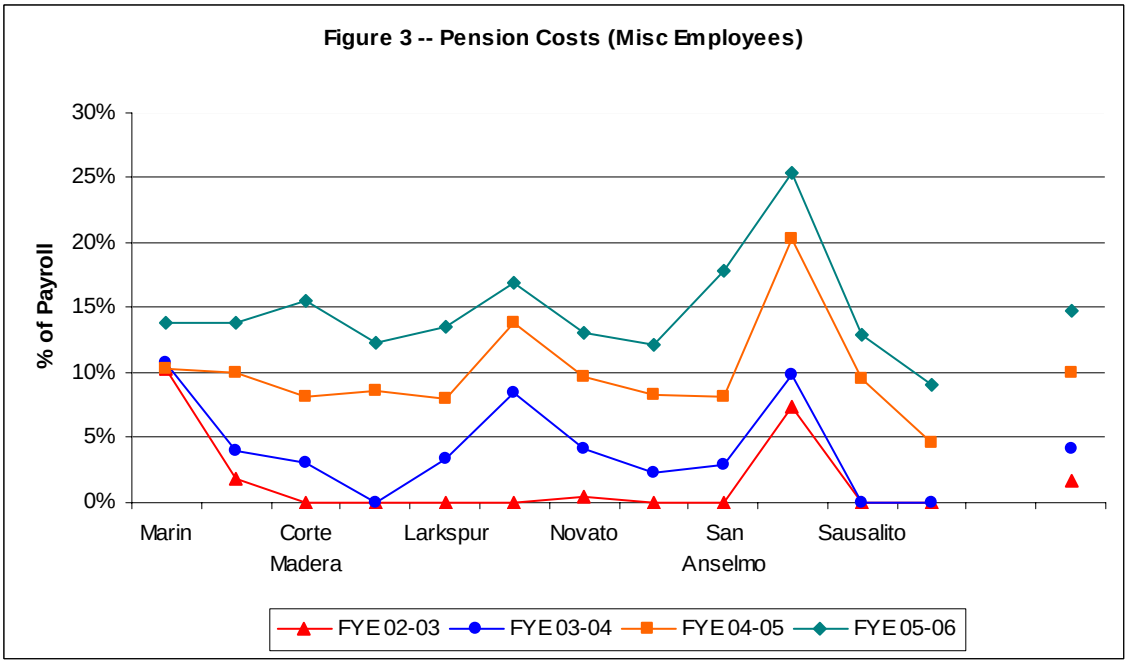
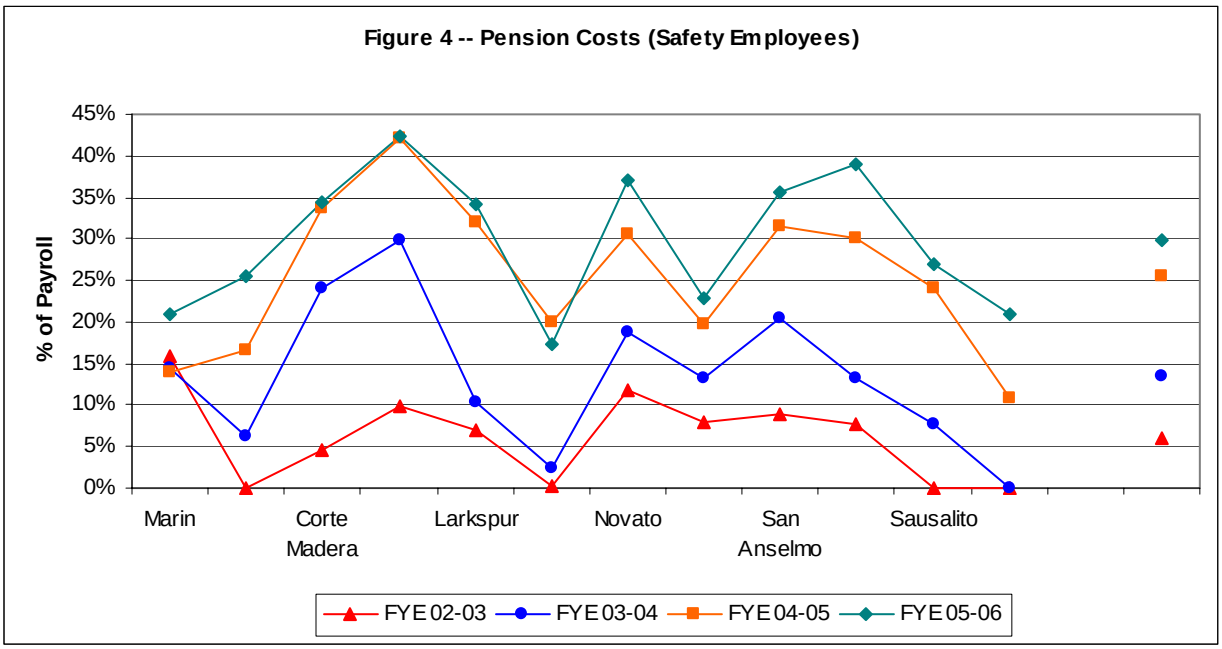


Figure 4 illustrates corresponding increases in pension costs for safety plans.



For these plans, the increases went from an average of 5% of safety payroll in FY 02-03 to 30% just three years later.

In addition to stressing the budgets of the County and its Municipalities, the escalation of pension costs has put pressure on the California Employees' Retirement System (CalPERS) to deal with the extreme cost fluctuations. CalPERS has attempted to stabilize pension costs, but the events of the past few years have shown that their methods have not worked. Ironically, pension costs have actually risen dramatically at the precise time that employers could least afford them, namely at a time when they were under stress from diminished sources of revenue.

CalPERS, in a September 2004 seminar entitled "Addressing Employer Rate Fluctuation," acknowledged the problem and indicated that it did not have a solution. While the seminar dealt with a number of possible ways to stabilize pension costs, it also produced a number of exhibits that looked at forecasts of cost levels for several plans over the next 20 years. These forecasts raise issues of concern:

- For state miscellaneous employees, the forecasts indicated that cost levels could be about 3% of payroll provided favorable long-term investment results were achieved. Conversely, the cost levels for the same plan could ultimately become 40% of payroll if the long-term investment results were unfavorable.
- The results are even more sobering for safety plans. For the California Highway Patrol plan (a safety plan), the forecasts showed that the cost levels could quickly become 0% of payroll if long-term investment results were favorable. On the other hand, the costs could ultimately become about 65% of payroll if the long-term investment results were unfavorable.

CalPERS chose to illustrate those possible outcomes as extremes; however, the County and its Municipalities have multiple plans in place that could reflect the extremes in pension costs described at the CalPERS seminar.

Clearly, if the County and its Municipalities provided pension plans that were not so generous, their exposure to this type of cost uncertainty would be reduced.

Not all Municipalities indicated that they were under the same level of financial stress. In fact, our interviews indicated that the Municipalities fell into two groups. The first group had been able to balance their budgets with relative ease because:

- They had established long-term budget forecasts that reflected pension costs under favorable as well as unfavorable times (i.e., sensitivity analyses). Therefore, these Municipalities ensured that they had sufficient revenue sources to enable them to continue to pay for their pensions even if their financial situation deteriorated.
- They continued to pay the employee contribution to the pension plan even though pension law would have allowed them to forego paying these contributions. Thus, such Municipalities retained the discipline of making pension contributions even though they could have foregone them.

- They took a long-term view (i.e., forecasts) of the costs of potential pension increases, rather than taking a short-term look. Thus, they were able to see the long-term cost impact of pension increases on their budgets.
- They viewed reduced pension costs of the type that occurred in the early years of the 20th century as being temporary not permanent. Thus, they viewed the benefit of the reduced pension costs as found money that could and should be spent only on one-time projects or be committed to building of reserves rather than being used to increase entitlements.

The second group of Municipalities had substantial difficulty in balancing their budgets. Among the pension-related reasons for their problems were:

- They viewed reduced pension costs as an opportunity to improve pension benefits, ignoring both the long-term implications of the increased pensions and the possibility that unfavorable financial times could arise.
- They relied on cost estimates from their actuaries who failed to provide adequate forecasting of results and failed to show the sensitivity of pension plan costs to both favorable and unfavorable results of investments.
- They viewed reduced pension costs, often reduced to zero, not as temporary but as permanent recurring budget windfalls. They then committed the money for long-term expenditures such as substantial capital improvements that would require an on-going source of revenue.
- They committed no money to reserves and retained no discipline in regard to the making of pension contributions.

Municipalities that fall into this second group have had to reduce services, layoff staff, continue to operate on a short-handed basis, and defer making capital improvements.

The County resembles the first group of Municipalities, with additional factors at play. For instance, the County is more reliant on property taxes, whereas the Municipalities tend to rely more on sales taxes. From this standpoint, the County's revenue sources have been more reliable. This does not, however, explain the anomaly of how the County's pension costs were relatively flat while pension costs from the Municipalities have increased substantially (see Figures 3 and 4). This was caused, at least in part, by the execution of a Pension Obligation Bond (POB).

The County's pension plan had an unfunded obligation. At the end of FY2002-2003, when the County executed its POB, this unfunded obligation was nearly $110 million. The issuer of the POB gave the County an amount equal to this unfunded obligation which was deposited in the pension plan trust. Because the plan assets were increased by the amount of the unfunded obligation, the unfunded obligation became zero, as did the part of the pension plan cost attributable to the unfunded obligation. The County's actuary estimated the amount needed to service the original unfunded obligation was approximately 3% of miscellaneous payroll plus 7% of safety payroll. Thus, the County's contribution to the pension plan was significantly reduced because of the POB, even though the County still had to service the debt on the POB. The structured payments of the POB debt service, however, are designed to be less than the amounts

the County otherwise would have had to contribute over time to the pension plan to pay off the unfunded liability.

Because the County was able to issue the POB at an interest rate (4.9%) that is lower than the actuarially assumed rate used to pay off the unfunded liability (8.25%), the amount the County has to pay annually for debt service for the POB is less than the amount that it ordinarily would have had to pay for the plan's unfunded liability. In effect, the County has refinanced its unfunded pension liability, paying it off at 4.9% instead of 8.25%. What is left out in the examination of pension plan costs for the County is the cost of debt service for the POB. That amount, approximately 3% of pay, should be added to the County pension plan costs for FY2004-2005 and beyond.

Pressure to Increase Pension Levels

Even though public sector pensions have been seen to be materially richer than pensions provided in the private sector, there is continuing pressure to provide even more pension increases. A number of interviewees, after saying how happy they were to have a public sector pension, described the process as operating in these steps:

- Unions representing public sector employees lobby the legislature.
- The legislature enacts legislation enabling CalPERS (the entity that provides plans to all Municipalities other than San Rafael) and MCERA (the entity which, under the 1937 Act, provides pensions to the County and San Rafael) to provide more generous benefits.
- Some government entity or entities (e.g., the State, a county, or a city) will adopt the more generous pension benefits.
- Public sector entities proximate to the entity with the more generous benefits now find themselves at a competitive disadvantage to attract and retain employees and will then feel the need to pass along the more generous benefits to its employees, as well. Thus, the more generous benefits spread throughout the state.

The pressure to increase pensions appears to be constant. However, the ability to increase pensions is augmented in good times, such as those that existed in the late 1990s. At that time, following a decade long run-up of assets, pension plans were substantially funded in contrast to more recent years. This drove pension costs down, reducing stress on budgets. Many public sector entities then felt secure in offering increases in pensions. In fact, in the late 1990s, legislation enabled "superfunded" plans to transfer employer assets to cover employee contributions. Moreover, CalPERS plans were labeled as being "superfunded," and according to several of our interviewees, the long-term contribution rates for the "superfunded" plans were represented to be zero for several years. Many public sector entities took advantage of this "found" money (which turned out to be temporary) to make pension improvements that had added long-term costs. To be fair to CalPERS, many interviewees indicated that CalPERS did not sell the "superfunded" status of the plans as proof that the zero cost would last in perpetuity.

In some situations, public sector entities require that their employees actually pay for the pension improvement. The employees do so, in theory, by foregoing a portion of their prospective pay increases. This trade-off is determined when CalPERS actuaries (for the entities that CalPERS

represents) and the actuaries of the non-CalPERS plans (e.g., MCERA for the County and for San Rafael) determine how much the richer benefits would cost.

When employees, through their unions, are able to barter richer pension benefits for a portion of their pay increases, interesting things happen.

- First, the added pension benefit cost lasts for years, while the foregone pay increase may or may not be reversed in subsequent negotiations.
- Second, there is a transfer in compensation values to employees near retirement from younger (or future) employees.

Some interviewees portrayed the windfall inherent in this transfer of compensation. This can be illustrated by a hypothetical example of an employee who will have 20 years of service at age 50 and will earn $50,000 in the last year of employment. The example also assumes that the employee will live to age 80 and ignores any benefits that might be payable to dependents. The employee, who is 48 and could retire with full benefits at 50, benefits from a pension increase wherein the benefit factor is increased from 2.5% per year of service to 3% per year of service. The plan actuary indicated that this pension increase would cost 5% of pay. The public sector entity and the unions then agree to barter a seemingly equivalent 5% pay increase for the pension increase.

Under the original pension formula, the employee would get a benefit equal to $25,000 per year (2.5% per year, multiplied by 20 years, multiplied by $50,000). Under the increased pension formula, the employee would now get a benefit equal to $30,000 per year (3% per year, multiplied by 20 years, multiplied by $50,000). Thus, by foregoing a total of $5,000 in salary (two years multiplied by 5% of $50,000), the employee would receive an annual increase from the pension in the amount of $5,000 per year. This increased amount is payable for the 30 years that the employee lives after retirement, $150,000 in total, which amounts to a 30 to 1 return. Meanwhile, someone has to pay for the $150,000 in added benefits that the employee will receive. This amount is paid out of future budgets, and will largely be included in the costs of compensation of younger or future employees. (Note: this illustration was simplified to make a point. If the employee were to receive a pay increase instead of a pension increase, then the original pension would be higher than illustrated. On the other hand, COLAs were not illustrated. The effect of COLAs would favor the employee with the increased pension.)

In addition to this type of windfall situation, several interviewees pointed to another situation that they characterized as scandalous or outrageous. This is the disability pension for safety employees which was given as another example of legislation that was generated from pressure by the unions. The legislation stipulated certain health conditions as being disabilities, whether or not they would truly make the individual disabled. Thus a safety employee who would not ordinarily be thought of as being disabled could be entitled to the favorable disability pension, even when such an employee could be physically able to take a second job.

In the public sector, the ethic to promote pension increases, as well as to promote favorable pension interpretations regarding disability pensions, stands in vivid contrast to that found in the private sector. Many interviewees indicated that a public sector pension is “vested for life,” meaning that once an employee is hired for a public sector job, unless the benefit level is

bartered away in later negotiations, the employee gets a lifetime guarantee of the level of pension benefits in place at time of hire. The employer does not have the ability to reduce the benefit level in the future.

On the other hand, in the private sector, the employer can unilaterally reduce or eliminate future pension increases, so long as the benefits earned to the date of the reduction are preserved. In the past 10-15 years, largely owing to changes in pension law and a desire to better control benefits costs, many private sector employers have reduced pensions, often by changing the type of plan to a cash balance plan or by reducing or eliminating the existing pension plan. In fact, because the costs of defined contribution plans are much easier for employers to control, the incidence of defined contribution plans, primarily 401(k) plans, has escalated substantially.

Earlier, we indicated that Social Security was a central part of the pension promise in the private sector. In the general population, often exclusive of the public sector, it is common to see reductions in the Social Security promise. Examples include: increase of the Social Security retirement age, change in the Social Security benefit formula with the effect of reducing its level in the future, and taxation of Social Security benefits. Additionally, the employee contribution schedule for Social Security has been raised periodically over the years. These types of pension changes do not happen in public sector plans.

Public Sector Pensions and Compensation Policy

The argument is often made that retirement benefits in the public sector are large, and the quid pro quo is that salary levels are small. It is not the intent of this report to examine that statement. In the course of the investigation, however, the Grand Jury did come upon three items that are on point:

- An informal study of a dozen public sector positions compared to similar private sector positions showed that the public sector paid more about half the time.
- A top level County employee indicated that, except for top executive positions, public sector salary levels were competitive with private sector salary levels.
- Information from EBRI indicates that public sector salary levels are materially higher than private sector salary levels when small employers are used in the comparison. Public sector salary levels, however, are approximately equal to those in the private sector when only larger employers are considered.

The intent of this report is to examine policies that provide exceptionally large pensions, regardless of salary levels. To this end, a number of questions were posed regarding compensation (i.e., salary plus benefits) in the public sector. The following discussion provides a synopsis of the answers received.

Pension levels, particularly using 3% formulae, can generate pensions that equal 90% of pay. Such full pensions can become payable at the earliest possible retirement ages. When asked about these benefit levels, the consulting actuaries each said that lower benefit levels would be sufficient to maintain pre-retirement income: an 80% level would be sufficient for employees earning in the range of $30,000 to $40,000, and a 50% level for employees earning over $100,000.

One of the consulting actuaries interviewed noted that the 3% formulae and retirement at age 50 were pension elements that had evolved over time. Historically, the typical pension formulae were 2% at age 60 for miscellaneous employees and 2% at age 50 for safety employees. The interviewee went on to say that although the retirement age of 50 for safety employees was appropriate at the time the pension formula was developed, a later age (e.g., 55) might be more appropriate now.

The Grand Jury found a divergence of opinion in regard to the existing compensation mix, which provides high pension levels ostensibly with low salary levels. Some members of the Grand Jury had theorized that younger employees, who need the money for the front-end expenses of living (e.g., to buy a house, to raise a family, and to pay the expense of schooling), are poorly served by the mix. Some interviewees indicated that the compensation mix was appropriate because it provided an adequate retirement income. However, they agreed that the compensation mix obviated the need for personal savings and personal involvement in structuring retirement. The interviewees went on to say that there were doubts as to whether employees would do a particularly good job in managing their own retirements. Other interviewees stated that the compensation mix would make it difficult to attract young employees. In Marin, in particular, the price of housing and overall cost of living suggest that, especially for younger employees, the balance should shift more to salary, and less to benefits. However, these interviewees went on to state, that changing the compensation mix would not be workable because changing the mix would have a deleterious effect on hiring and retaining employees.

The interviewees referred to the process described above in which the legislature enacts laws enabling pension increases. Subsequently, the increases are adopted by some entities thus putting pressure on other entities to adopt similar increases to keep their benefits competitive. With reciprocity prevalent in public sector pensions, it is relatively easy for employees to switch their public sector employment to other public sector entities that have superior benefits. The interviewees said that it would be impractical for them to change their compensation mix to favor salary instead of benefits unless there was a systemic (i.e., statewide) change. The reason is that, absent a systemic change, they would lose good employees to other public sector entities with superior benefits.

Several interviewees acknowledged that having pensions that permit retirement with full benefits as early as age 50 could cause good employees to leave. However, these same interviewees noted that many employees in these positions actually didn't want to leave but wanted to continue their employment. At the same time, the interviewees acknowledged that employees who leave employment at this early age are not "washed up," and often obtain other jobs while simultaneously receiving their pensions.

Pension Reform In California

There has been considerable interest in reforming public sector pensions in California. This ranges from changes that had been advocated by the Governor to those suggested by various interest groups. Among the options being suggested are:

- Maintain pension plans as the centerpiece of public sector retirement. Such plans should permit career-employees to maintain living standards after retirement.

- Establish formula caps for public safety and miscellaneous employees. The suggestions noted are 2% at 50 for safety and 2% at 60 for miscellaneous.
- Require that the final salary used in the pension calculation be the average of the last three year's salary, as a minimum.
- No longer allow pension improvements (of the type illustrated on page 10 of this report) to increase the pension attributed to past service. The improvement would pertain to future service only.
- Rollback/repeal public sector retirement plans that provide benefits in excess of those required to maintain living standards after retirement. Excess benefits would be determined using existing income replacement benefit studies.
- Develop and implement new actuarial methods to stabilize pension cost levels over time. Establish reserve funding to smooth out fluctuations.
- Change the provisions of disability pensions to restrict benefits if an employee continues to work (or is able to do so) at a similar job after taking disability retirement.
- Require that surplus pension earnings (i.e., temporary found money) be used to pay off unfunded liabilities, POB debt, and pay for benefits already in place. Such earnings would not be allowed as the basis for pension improvements.
- Do not allow retirement boards and arbiters to have the authority to grant pension increases.

For the most part, suggested reforms that pertain to pension levels would apply only to future hires. Thus, for current employees, many of the problems that have been created in the past would be allowed to continue. Nevertheless, some combination of the reforms would allow the problems to be dealt with prospectively. Moreover, frameworks could be moved into place that would allow (and maybe require) the appropriate officials to make well-informed decisions that are fair for their employees and sensible for the entities that they represent.

Retiree Healthcare (the Other Pension)

The County and each of its eleven Municipalities provide a second important retirement benefit for their retirees, healthcare. This benefit has striking parallels to pensions, effectively making it another pension:

- The benefit is earned when the employee is actively at work. The payment of the benefit is contingent upon the employee actually retiring from the service of the employer.
- The benefit is provided subsequent to the employee's retirement.
- The benefit is typically provided for the lifetime of the retiree.
- The benefit is typically provided also to the surviving spouse of the retiree.
- As is the case with public sector pensions, which have annual cost-of-living increases, the cost of retiree healthcare benefits typically increases each year as the cost of healthcare rises.

On the other hand, there are a number of differences between pensions and retiree healthcare benefits:

- The retiree will typically have to pay a portion of the cost of retiree healthcare, i.e., the retiree contribution.
- While the pension benefit is largely funded by the employer (and, to a certain extent, by the employee before retirement), retiree healthcare is essentially unfunded before the employee's retirement. This means that the cost of retiree healthcare is, for the most part, borne by the succeeding generation(s) of employees.
- While pensions are largely regulated and ensconced in law, the extent of legislation and regulation on retiree healthcare is much less. This has caused retiree healthcare benefits to be poorly understood by employers, especially in the public sector.
- While pensions are subject to accounting standards, in the public sector this has been untrue for retiree healthcare benefits. In the private sector the advent of accounting standards for retiree healthcare is responsible for a substantial decrease of those benefits.

The County and each of its eleven Municipalities provide some level of retiree healthcare benefits to its retired employees. The Grand Jury, through information requests and subsequent follow up telephone calls, requested information on the retiree healthcare plans. Unlike pensions where reliable consistent information is routinely available, the Grand Jury found information on retiree healthcare hard to obtain for a variety of reasons:

- The County and its Municipalities provided several retiree healthcare plans. For the most part, differences in the plans are characterized by multiple levels of employer contributions.
- The provisions of an entity's retiree healthcare plans are often provided in Memoranda of Understanding (MOUs). The provisions typically change from year to year and, unlike pensions, are enumerated in a variety of ways.
- Information submitted on retiree healthcare, was varied and inconsistent from entity to entity.
- Contacts designated to supply follow up information at several Municipalities often had a limited understanding of their retiree healthcare promises.

In a retiree healthcare plan, the employer makes available a number of healthcare plans to the retired employee. The employee then can select among the plans and, if applicable, can elect to provide coverage for eligible dependents. The employer commitment, to which the GASB accounting standards apply, is typically expressed in one of two ways:

- The employer promises to pay a certain dollar amount toward retiree healthcare coverage. Often the dollar amount will increase annually, under the provisions of the relevant MOU.
- The employer promises to pay an amount equal to the cost of a certain specified coverage (e.g., the cost of Kaiser for the retiree only, or the cost of Kaiser for the retiree and

spouse). Under this approach, the employer's commitment can automatically increase from year to year.

Employers can be separated (imprecisely) into three groups: those with substantial commitments, those with medium commitments, and those with modest commitments. Membership of the groups was determined by the way each employer expressed its financial commitment, as shown in Table 1.

Table 1 – Retiree Healthcare Benefits Commitments

Entity	Retiree Healthcare Benefit Commitment	Characteristic of Retiree Healthcare Benefit
County, Corte Madera, Larkspur, Mill Valley, San Rafael	Substantial	Employer pays cost of benefit for retiree and spouse, or dollar value of promise is $350/month or more
San Anselmo, Sausalito, Tiburon	Medium	Employer pays cost of benefit for retiree only, or dollar value of promise is $200-$350/month
Belvedere, Fairfax, Novato, Ross	Modest	Employer pays $48.50/month, scheduled to increase to $97/month in 2008 (minimum for CalPERS Plans)

CalPERS' retiree healthcare plans are provided to all Municipalities except Mill Valley which offers different retiree healthcare choices. The County provides retirees with the same choices that are provided to its active employees. In many cases, the value of the retiree healthcare promise (shown above) is decreased when length of service requirements are imposed on the employee before full benefits become payable.

In both the private and public sectors, the pension obligation is calculated annually by the actuary and is monitored closely because the employer contribution is subject to change (often substantially) when the pension obligation changes. In the private sector, an employer's healthcare obligation for retirees is also monitored closely because it impacts financial statements. This is markedly different in the public sector (including the County and each of its Municipalities) where the absence of accounting requirements has led to avoidance of valuation of retiree healthcare obligations.

Knowledge of retiree healthcare obligations could have a large effect on an employer. In the early 1990s, when Financial Accounting Standards required that these obligations go onto the books of employers in the private sector, many things happened:

- Before the effective date of the Financial Accounting Standards, major employers with retiree healthcare plans performed actuarial valuations of their plans and then modeled the impact of the plans on their financial statements.
- Many employers were reportedly extremely surprised (occasionally astonished) by the magnitude of their retiree healthcare obligations, which were often in the hundreds of millions of dollars for large-sized employers or for medium-sized employers with rich plans. They were also extremely surprised by projections of increasing future benefit costs.

- Many employers with substantial retiree healthcare obligations then took steps to reduce those obligations. The steps included: increasing retiree contributions, changing the approach to Medicare coordination, increasing the requirements for benefit eligibility, eliminating some or all benefits for future hires, and eliminating some or all benefits for active employees.

A parallel series of events is beginning to occur in the public sector. For entities with revenues of $100 million or more, Government Accounting Standards will come into effect for fiscal years beginning after December 15, 2005 (later for smaller entities). For those fiscal years, the public sector entities' financial statements, and the financial statements of their plans, will need to include an obligation for retiree healthcare benefits.

It would have been useful to have valuations already completed so the County and the Municipalities could assess the prospective impact of the imminent Government Accounting Standards, but valuations have not been completed. With this in mind, the Grand Jury, as part of the interviews with consulting actuaries, inquired about methodology to obtain broad estimates of the retiree healthcare obligations of the County. The methodology provided was used to obtain rough estimates that were corroborated in comparisons with retiree healthcare estimates found on the Internet and in presentations on Government Accounting Standards. This methodology is detailed in Appendix C.

The Grand Jury's estimate of the obligations for the County's retiree healthcare plans is necessarily broad. Nevertheless, it is reasonable to expect the obligations to be between $150 million to $300 million. This range relates to a current year pay-as-you-go cost to the County of approximately $7 million.

Under the presumption that this is a realistic range, the County has a significant retiree healthcare obligation that will soon become a part of its financial statements. This obligation, at the estimated level, represents 45% to 90% of the FY2004-2005 budget. Of greater significance is the fact that none of the County officials interviewed had any indication of the magnitude of the obligation. The best that could be said is that an unpublished report on this topic, dated 1998, was discovered by one of the interviewees.

With respect to the Municipalities, the retiree healthcare obligations will depend upon the benefit level and the size of the workforce. The Grand Jury has not estimated the obligations for any Municipality, nor does it appear that the Municipalities are going to get any help in this regard from CalPERS which is the administrator of retiree healthcare benefits for all Municipalities other than Mill Valley. Furthermore, CalPERS has not performed valuations of retiree healthcare obligations and may not do so because of difficulties in data collection. What all this means is that, like the County, Marin's Municipalities will be faced with the prospect of adding an obligation of unknown magnitude to their financial statements.

FINDINGS

F1. Public sector pensions are substantially more valuable than private sector pensions. For Miscellaneous employees in Marin, pensions are 2 to 3 ¼ times as valuable as private sector pensions; for safety employees, they are 2 ½ to 4 times as valuable.

F2. Most public sector employees in Marin do not participate in Social Security and thus contribute less (no Social Security taxes) to their retirement than do employees in the private sector.

F3. The employers' costs for public sector pensions in Marin are extremely volatile, causing financial stress to the County and its Municipalities. Average pension costs for miscellaneous plans for the County and its Municipalities increased from 2% of miscellaneous payroll in FY2002-2003 to 15% in FY2005-2006. For safety plans, the increase was from 5% of safety payroll in FY 2002-2003 to 30% in FY 2005-2006.

F4. The County issued a Pension Obligation Bond (POB) to transfer the unfunded liability of its pension plan (about $110 million) off the pension books at the end of FY2003-2004. For future years, this reduced the County's contribution to its pension plan; however, to make a fair evaluation of County pension costs, the cost of debt service of the POB (about 3% of payroll) should be counted.

F5. Despite extremely high pension levels and the financial stress that increases in pension costs bring upon public sector budgets, there is continuous pressure to increase public sector pensions. Unions apply this pressure on the legislature which then enacts legislation enabling pension increases to proliferate throughout the state.

F6. Once pension increases are adopted by a public sector employer, they cannot be rescinded without a bargained compensatory improvement in some other element of compensation. This contrasts vividly to the private sector wherein reductions in the future promises, in either pensions or Social Security, are common.

F7. Unless systemic (i.e., statewide) changes are made, the employers' abilities to attract and retain good employees would be undermined. Extremely large pensions, coupled with allegedly lower salary levels, impact hiring and retention. However, changing the mix, to increase salaries while decreasing pensions, would be harmful to public sector employers.

F8. A number of reasonable pension reform proposals have been developed, and/or are being developed, to deal with the problems of public sector pensions.

F9. In addition to pensions, the County and its Municipalities maintain retiree healthcare plans for their employees. Although these plans share many characteristics with pensions, unlike the case with pensions, neither the County nor any of its Municipalities have been required to include retiree healthcare obligations on their financial statements.

F10. Imminent changes required by GASB will require that public sector entities include retiree healthcare obligations on their books. In the private sector, similar Financial Accounting Standards already have caused many employers to discover substantial unknown obligations and, in many cases, to reduce those obligations by cutting retiree healthcare benefits.

F11. Neither the County nor its Municipalities have any idea of the size of its retiree healthcare obligations. The Grand Jury has roughly estimated the County's obligations as ranging from $150 million to $300 million.

RECOMMENDATIONS

The 2004-2005 Grand Jury recommends that the County and its Municipalities take the following actions:

R1. Sponsor pension reforms, including rolling back pension levels to historical, lower levels for new hires.

R2. Provide lower level pensions in favor of forms of compensation whose employer costs are less volatile.

R3. Work with plan administrators, in most cases CalPERS, to establish more stable funding models for pensions.

R4. Stop spending found money, which is temporary, on recurring obligations.

R5. Lobby the unions to act responsibly and lobby the legislature to stop legislating plans that undermine public employers' abilities to control the structure of compensation.

R6. Rethink compensation strategy with a goal of sponsoring systemic (i.e., statewide) changes (including changes in disability retirement).

R7. Sponsor programs to help employees understand their retirement, so they can take an active role in their retirement planning.

R8. Request that CalPERS' actuaries (and, in the case of the County and the City of San Rafael, the MCERA actuary) do a more thorough job of explaining pension and retiree healthcare changes and issues to policymakers. Make sure that the explanations of costs of any changes in either of these areas, include both sensitivity analysis (i.e., cost ranges that show what happens if either favorable or unfavorable experience is obtained prospectively) and forecasting (i.e., long-term, rather than single-year, cost estimates).

R9. Perform retiree healthcare valuations in the near future to ascertain the financial impact of the impending GASB standards.

R10. Make knowledgeable decisions, sooner rather than later, about retiree healthcare promises.

REQUEST FOR RESPONSES

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

- From the Board of Supervisors – F1-F11 and R1-R10.
- From the City/Town Council and City/Town Manager of each of Marin's 11 Municipalities (from each) – F1-F3, F5-F11 and R1-R10.
- From MCERA Board of Directors – F1-F2, F4, F8-F9, F11 and R1-R2, R7-R10.

- From each union that bargains benefits with the County and the Municipalities: F1-F3, F5-F10 and R5-R7.

GLOSSARY

Cash balance plan – A cash balance plan is a pension that defines the pension promise in terms that are more characteristic of a defined contribution plan. The promise is defined in terms of a stated account balance. For example, an employee's account may be credited with a salary credit (such as 5% of salary each year) and an interest credit (at either a fixed or variable rate each year). In this way, unlike defined contribution plans, changes in the plan's assets, through good or poor investment experience, do not directly impact the benefit promise. Instead, good or poor investment experience impacts the employer's contribution, as it does for a pension. At retirement, the retired employee's benefit is based upon the employee's account.

COLA – A cost of living adjustment, COLA, is a provision of a pension whereby the annual pension increases by a specified amount each year. The amount is typically a fixed percentage (e.g., 2%), although the amount may be pegged to a consumer price index (CPI) increase.

Compensation – Compensation means the total of the employee's salary and benefits. Benefits include deferred benefits such as pensions and retiree healthcare.

Defined contribution plan – A defined contribution plan, in contrast to pensions (as defined below), does not promise a specific amount of benefits at retirement. In defined contribution plans, the employer and/or the employee contributes to the employee's individual account. The contribution rate is established by the plan and may be subject to some discretion by the employer, the employee, or both. The contributions are invested on behalf of the employee. The employee will eventually receive the value of the account, which is based upon the contributions and investment gains (or losses). The value of the employee's individual account will fluctuate based upon the plan's investment experience. Examples of defined contribution plans include 401(k) plans in the private sector and 457 plans in the public sector.

Pensions – A pension is a promise to provide a specified monthly benefit at retirement. For the purpose of this investigation, the pension is calculated based upon factors that include the benefit factor, salary, and service. For example, the annual pension could be equal to two percent (the benefit factor) of final salary for each year of service. These types of pensions, which are common in the public sector, are also called defined benefit pensions.

POB – Pension obligation bond (POB) is an arrangement whereby a public sector entity borrows an amount often equal to the unfunded liability of the pension. The employer then pays that amount into the pension plan, eliminating its unfunded obligation and the need to fund the unfunded obligation through pension costs. The employer does, however, have to repay the indebtedness of the amount borrowed. Typically, the interest rate on the amount borrowed is less than the interest rate charged on the unfunded liability. Thus, the repayment of indebtedness can be (and is) structured in a way to make payments on the indebtedness less than would be required to pay the cost of the unfunded obligation. In the long-term, the POB lowers the cost to the public sector employer only if the interest rate on the POB is less than the amounts earned by

the pension plan on the amount borrowed (including a margin to pay the expenses of issuing the POB).

Private sector – Non-government entities. For the purpose of this investigation, attention has been focused on large private sector employers because those employers tend to have retirement plans and issues that are more closely aligned with the public sector than do smaller private sector employers.

Public sector – Government entities such as the Federal government, state government, and local government. For the purpose of this investigation attention has been limited to plans of local government, i.e., the County, its Municipalities, but not special districts within the County.

Reciprocity – Reciprocity is the policy, under state law, designed to encourage public sector employees to move freely from one public sector entity to another. Under reciprocity, if an employee makes such a move, the employee's pension benefits under the pension of the first entity will be based upon salaries earned at the second entity. Salaries earned at the second entity are typically higher than salaries earned at the first entity. Thus, the employee's pension at the first entity grows after the employee has left the service of the first entity.

Retiree healthcare – The retiree healthcare benefit is a promise to provide healthcare benefits at retirement. The common retiree healthcare benefit provided is a promise by the employer to pay either a certain dollar amount toward the retiree's healthcare premium (e.g., the employer will pay $200 per month toward the retiree's healthcare premium) or the retiree healthcare premium itself (e.g., the employer will pay an amount equal to the Kaiser single party rate).

Retirement benefits – Benefits provided to retired employees. Such benefits typically require that the employee has achieved a designated minimum age before commencement of benefits and that the employee has a designated number of years of service with the employer to be entitled to benefits. For the purpose of this investigation, only pensions and retiree healthcare are the retirement benefits considered.

BIBLIOGRAPHY

From the Municipalities:

- Plan booklets for pension benefits and retiree healthcare benefits, and MOUs regarding pensions and/or retiree healthcare benefits
- Most recent pension actuarial report and/or financial statement (note: these were subsequently requested and received from CalPERS as many Municipalities could not supply their plans' reports)
- Most recent actuarial report and/or financial statement and/or monthly insurance/HMO premium statement (including employee and retiree contribution payment).

From MCERA:

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- Actuarial Valuation as of June 30, 2003, The Safety Plan of the Town of Tiburon (Employer# 676).

From websites:

- CalPERS website (regarding pension contribution rates): http://www.calpers.ca.gov/index.jsp?bc=/employer/actuarial-gasb/contrib-rates/rates/home.xml
- CalPERS website (regarding retiree healthcare plans): http://www.calpers.ca.gov/index.jsp?bc=/employer/program-services/health/home.xml
- CalPERS actuarial presentation *Addressing Employer Rate Fluctuation, September 2004*: http://www.calpers.ca.gov/eip-docs/employer/video/color-er-rate-fluctuation.pdf
- Government Accounting Standards (on healthcare for retirees) website: http://www.gasb.org/ and http://hoguejr.com/gasb.htm
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APPENDIX A Comparison of Private Sector Pension Plans to Retirement Plans of the County and the Municipalities

Table 1 – Benefit Factors for "Average" Plan* in the Private Sector (including Social Security)

Type of Plan	Percent of Employers With Such a Plan	Factor Under Consideration	Benefit Factor (or Impact on Benefit Factor)
I). Pension (Gross)	40-50%	Benefit factor before Social Security Coordination	1.5%
		Effect of Social Security Coordination	-0.2%
Ia). Pension (Net)		Benefit factor after Social Security Coordination	1.3%
Ib). Social Security		Value of Social Security	+0.8%
		Benefit Factor ("average" plan)	2.1% (Ia + Ib)
II). Cash Balance Plan	25-35%	Total Benefit Value Compared to "average" plan	1.8% (approx 80% of Ia + Ib)
III). Defined Contribution Plan, with no other Pension	15-35%	N/A	N/A

*Basis:

- The applicable retirement age for the plans illustrated is 63.
- The number of years used to establish final-average pay is 5 years.
- There is typically no cost-of-living increase (COLA) associated with these plans, except for the portion attributable to Social Security.

Table 2A shows key benefit provisions for miscellaneous plans of the County and its Municipalities. Table 2B shows the key benefit provisions for the safety plans.

Table 2A – Miscellaneous Plans

Public Entity	Benefit Factor	Retirement Age	Final Salary Years	COLA
County[1]	2.0%	55	3	2%
Belvedere	2.0%	55	1	2%
Corte Madera	2.0%	55	1	2%
Fairfax	2.5%	55	3	2%
Larkspur	2.0%	55	1	2%
Mill Valley	2.5%	55	1	2%
Novato	2.0%	55	1	2%
Ross	2.0%	55	3	2%
San Anselmo	2.7%	55	1	2%
San Rafael[2]	2.7%	55	1	3%
Sausalito	2.5%	55	1	2%
Tiburon	2.0%	55	1	2%

Notes:
[1]The County provides a number of schedules of retirement benefits for its miscellaneous employees. The one illustrated above covers the majority of active employees. Other active miscellaneous employees are covered by other schedules.
[2]The schedule illustrated for San Rafael covers a majority of its active miscellaneous employees. Other active miscellaneous employees are covered by other schedules.

Table 2B – Safety Plans

Public Entity	Benefit Factor	Retirement Age	Final Salary Years	COLA
County[1]	3.0%	50	3	2%
Belvedere	2.0%	50	3	2%
Corte Madera	3.0%	50	1	2%
Fairfax	3.0%	50	3	2%
Larkspur	3.0%	55	1	2%
Mill Valley	3.0%	55	3	2%
Novato	3.0%	55	1	2%
Ross	2.0%	50	1	2%
San Anselmo	3.0%	50	1	2%
San Rafael (Police/Fire)	3.0% / 2.0%	55 / 50	1 / 1	3% / 3%
Sausalito (Police/Fire)	3.0% / 3.0%	55 / 55	1 / 1	2% / 2%
Tiburon	3.0%	55	3	2%

Notes:
[1]The County provides a number of schedules of retirement benefits for its miscellaneous employees. The one illustrated above covers the majority of active employees. Other active miscellaneous employees are covered by other schedules.

Table 3. Relative Values of the Miscellaneous Plans and Safety Plans of the County and Its Municipalities Compared to the "Average" Plan of the Private Sector

Public Entity	Miscellaneous Plan Value Relative to Private Sector "Average" Plan	Safety Plan Value Relative to Private Sector "Average" Plan
County	203%	382%
Belvedere	213%	254%
Corte Madera	213%	400%
Fairfax	254%	382%
Larkspur	213%	320%
Mill Valley	266%	305%
Novato	213%	320%
Ross	203%	266%
San Anselmo	288%	400%
San Rafael (Safety = Police/Fire)	320%	355% / 296%
Sausalito (Safety =Police/Fire)	266%	320% / 320%
Tiburon	213%	305%

The "average" plan is as defined on page 3 of this report as 2.1% of 5-year final-average pay, retirement at age 63, and no COLA, except for the portion attributable to Social Security.

In examining the values of Table 3, please note that they are approximations designed to give an order of magnitude differential between the private sector plans and the plans provided by the County and its Municipalities. They are not exact, being subject to differences in actuarial assumptions and plan experience.

The relative values of the miscellaneous and safety plans compared to the "average" plan may seem quite high. They are the composite of factors designed to value the effect of the benefit factor, the retirement age, the final salary years and the COLA.

The primary reason that these plans are much more generous than the "average" plan can be attributed to the ability of employees under these plans to retire with full benefits much earlier than would be possible under the "average" plan. Early retirement with full benefits is costly because benefits are paid longer to early retirees and the period of time over which the benefits are funded is shorter.

To corroborate the credibility of these relative values, which were developed from relative value factors provided by several actuaries, the Grand Jury made a number of consistency checks.

First, the Grand Jury investigated the arithmetic behind the benefits improvements adopted by the County's Board of Supervisors. Our analysis is based upon information taken from one of the first Marin IJ articles that caught our attention:

- Under a new formula, an employee can retire earlier (50 versus 55), but has to reduce the benefit factor from 2.0% to 1.426%. The article indicated that, based upon an actuarial study done for the County, these improvements were essentially cost neutral, i.e., that this

new formula (a 1.426% at 50 formula) has the same cost as the old formula (a 2.0% at 55 formula).

- If the 1.426% factor were increased to 2.0%, then the benefit would be 40% greater (because 2.0% is 40% higher than 1.426%). Therefore, it follows that a 2.0% at 50 formula is 40% more valuable than a 1.426% at 50 formula.
- But, the 1.426% at 50 formula is the same value as the 2.0% at 55 formula.
- So, it follows that the 2.0% at 50 formula is 40% more valuable than the 2.0% at 55 formula.
- This implies that there is about a 7% per year increase in value for each year the employee can retire earlier with full benefits
- Comparing an age 50 retirement for a County employee with the age 63 retirement for the "average" private sector plan, the relative value for retirement age alone would be 241%, a level consistent with those used to develop the results of Table 3.

Second, the Grand Jury went to a pension mathematics text, Pension Mathematics With Numerical Illustrations, Second Edition. Material in chapter 9 of the text showed the relative values used by the Grand Jury that pertained to retirement age are reasonable. Other material in the text showed that relative values used by the Grand Jury that pertained to both the COLA and the final-average pay period are also reasonable.

Third, the Grand Jury constructed its own spreadsheet model. In the model, the Grand Jury looked at a hypothetical employee, hired at age 25 with a starting pay of $50,000. The hypothetical pension is given under a 2% of 1-year average pay formula with a 2% annual COLA after retirement. The Grand Jury assumed 3% annual pay increases, an 8.25% interest discount (same as for the County plan), 3% annual decrements due to turnover before retirement, and life expectancy to age 85. The model then looked at the pension costs for retirements with full benefits at ages 50, 55, 60, and 63 (the "average" plan retirement age). Using the model developed by the spreadsheet, the relative value of the pension with full benefits at age 50 versus age 63 is 238%, while the relative value of the pension with full benefits at age 55 versus age 63 is 175%. Again, the results are very consistent with those used in the development of Table 3.

APPENDIX B Comparative Financials of the County Retirement Plans and the Retirement Plans of the Municipalities

Tables 4A and 4B shows the annual funding requirements for the miscellaneous plans and safety plans, respectively, of the County and its Municipalities. The pension costs are shown as a percentage of their corresponding payrolls. The miscellaneous pension costs are shown as percentages of the corresponding miscellaneous payrolls, while the safety pension costs are shown as percentages of the corresponding safety payrolls. The County maintains several plans for miscellaneous and safety employees. The costs shown for the County are weighted averages over the County's plans.

Table 4A. Annual Funding Requirements for Miscellaneous Plans of the County and Its Municipalities.

Entity	FY 2002-2003 Costs	FY 2003-2004 Costs	FY 2004-2005 Costs	FY 2005-2006 Costs
County[1]	10.3%	10.4%	10.4%	13.9%
Belvedere	1.9%	4.1%	10.1%	13.8%
Corte Madera	0.0%	3.1%	8.2%	15.6%
Fairfax	0.0%	0.0%	8.7%	12.3%
Larkspur	0.0%	3.4%	8.1%	13.6%
Mill Valley	0.0%	8.5%	13.9%	16.9%
Novato	0.5%	4.2%	9.7%	13.2%
Ross	0.0%	2.3%	8.3%	12.2%
San Anselmo	0.0%	3.0%	8.1%	17.8%
San Rafael	7.4%	9.8%	20.4%	25.4%
Sausalito	0.0%	0.0%	9.5%	12.9%
Tiburon	0.0%	0.0%	4.6%	9.1%

Notes:
[1]The County's costs do not include the cost of its Pension Obligation Bond. The County's then current actuary indicated that the FY2003-2004 costs for miscellaneous employees would reduce by 3.1% on account of the POB.

Table 4B. Annual Funding Requirements for Safety Plans of the County and Its Municipalities

Entity	FY 2002-2003 Costs	FY 2003-2004 Costs	FY 2004-2005 Costs	FY 2005-2006 Costs
County[1]	15.8%	14.4%	14.0%	20.9%
Belvedere	0.0%	6.3%	16.5%	25.5%
Corte Madera	4.6%	24.0%	33.6%	34.5%
Fairfax	9.9%	29.9%	42.2%	42.4%
Larkspur	7.0%	10.4%	31.9%	34.2%
Mill Valley	0.1%	2.4%	19.9%	17.3%
Novato	11.7%	18.7%	30.6%	37.0%
Ross	7.9%	13.3%	19.7%	23.0%
San Anselmo	8.9%	20.4%	31.6%	35.6%
San Rafael – Police/Fire	7.7% / 7.7%	13.2% / 13.2%	35.2% / 25.0%	42.9% / 35.2%
Sausalito – Police/Fire	0.0% / 0.0%	7.6% / 7.7%	24.4% / 23.5%	31.5% / 22.5%
Tiburon	0.0%	0.0%	10.9%	20.8%

Notes:
[1]The County's costs do not include the cost of its Pension Obligation Bond. The County's then current actuary indicated that the FY2003-2004 costs for safety employees would reduce by 7.0% on account of the POB

For both miscellaneous and safety plans, in most cases, the cost increases were attributable to earnings on investments being less than the assumed return. Some entities, such as the County and a few Municipalities, did, however, have pension increases in the time period shown.

APPENDIX C -- GASB Calculation of Obligations of the County Retiree Healthcare Plans and the Retiree Healthcare Plans of the Municipalities

It is impractical for the Grand Jury to attempt to estimate retiree healthcare obligations for the County and all of its Municipalities. Nevertheless, the Grand Jury believes that an estimate of the County's obligations is instructive. The Municipalities could use the Grand Jury's assessment of the level of their retiree healthcare commitment and the County's estimates to gauge the magnitude of their own retiree healthcare obligations.

The Grand Jury's estimate of the retiree healthcare obligation of the County was prepared in several steps:

- Step 1 – The ratio of the County's pension plan's accrued liability to the pension plan's one year pay-as-you-go cost was estimated. The ratio was approximately 21 to 1.
- Step 2 – The ratio from Step 1 was multiplied by the one-year retiree healthcare pay-as-you-go cost, which for FYE 2004 was about $6.9 million (retiree life insurance included). The resulting amount is $144 million.
- Step 3 – The County charges retirees an amount equal to the cost of healthcare insurance minus the amount the County allocates each retiree for retiree healthcare coverage. The Grand Jury understands that the County uses blended rates to determine the cost of coverage. The use of these rates means that the County assumes the cost of coverage is the same for retirees as for active employees. In fact, costs for retirees can be expected to be much higher than those for active employees. The rule of thumb is that older people have higher costs for healthcare by about 3.5% for each year of age. On average, retirees will be on at least 20 years older than active employees, meaning that the cost of healthcare insurance should cost the County twice as much for the retiree as it does for the active employee. The County, however, subsidizes the retiree by charging as if the costs were the same. The Grand Jury estimates that the effect of the subsidy will add 50% to the obligation, bringing the amount to $216 million.
- Step 4 – Until 1986, County retirees were not required to participate in Medicare, meaning that many current retirees are not covered by it. The cost for the County to provide retiree healthcare coverage for retirees not covered by Medicare is substantial. It is reasonable to expect the County's costs for future retirees, who are covered by Medicare, to be lower than they are for current retirees. The cost of coverage that is Medicare coordinated is as much as 75% lower than uncoordinated coverage. These lower costs, however, apply only when the retiree is Medicare eligible, i.e., at age 65 and later. The Grand Jury has rather arbitrarily estimated that the impact on obligations will halve the obligation to $108 million.
- Step 5 – The pension plan's accrued liability reflects an assumed inflation rate of 4.25% and a COLA increasing at a rate slightly below 4%. In effect, this means that benefit levels have an underlying cost increase of roughly 4% per year. Retiree healthcare costs have increased substantially more than these amounts for a variety of reasons: increased technology, transfers of cost from the government, price inflation, etc. Moreover, the County has a long-standing practice of increasing its retiree healthcare obligation in lockstep with increases in retiree healthcare costs. This type of practice must be

considered in GASB calculations. As such, it is reasonable to use an inflation assumption more in line with retiree healthcare costs than the 4% assumption used for the pension plan. The Grand Jury elected to assume 9% annual healthcare inflation. The rule of thumb is that each added 1% of inflation adds 12% to the obligation bringing it to $190 million.

- Step 6 – It would be reasonable to complete the estimate at the end of Step 5. However, the Grand Jury understands that the GASB calculations may require use of a much lower interest rates to develop estimates unless the healthcare obligation is irrevocably funded. Based upon discussions with several County officials, the Grand Jury does not believe this will occur. Thus, GASB may require the county to use a lower interest rate. And if the interest rate were reduced by 4% (to 4.25%), the obligation would increase to $299 million.

Although it is not sure what the County's final obligation will be the Grand Jury believes it could easily fall in the range of $150 million to $300 million.

To corroborate its estimates, the Grand Jury was able to find material from the County's own actuary, who produced two sets of estimates applicable to a medium sized public sector entity. For each set of estimates, per capita obligations were established for miscellaneous employees, safety employees, and retirees. The first set of estimates, adjusted to reflect the numbers of the County's employees and retirees, led to an obligation of $160 million. The second set led to an obligation of $299 million. The only difference between the two sets of estimates was the interest rate assumption. The first set assumed 8%, while the second set assumed 4%. In effect, the first set of estimates confirmed the Grand Jury's estimates arrived through Step 5, whereas the second set of estimates confirmed the Grand Jury's estimates through Step 6.

As further corroboration, the Grand Jury reviewed the unpublished report, dated 1998, that was ostensibly prepared for the County. That report produced an estimated obligation of approximately $62 million. A number of adjustments need to be made to bring the estimate to the present:

The level of current costs needs to be brought forward. The so-called Plan 3 cap, which was $2,930, in 1997, is now $6,873. The increase (135% in 7 years) would increase the obligation to $145 million if all other retiree healthcare costs increased similarly.

The estimated retiree healthcare annual inflation was assumed at 7.25% per year. This is 1.75% lower than the inflation assumed by the Grand Jury. If the 9% healthcare inflation assumed by the Grand Jury were substituted, the obligation would increase to $175 million.

This amount corresponds closely to the amount estimated in Step 5 above, further corroborating the Grand Jury's estimate.