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Taxpayers watchdog since 1945
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New SDCTA analysis finds San Diego County's pension costs increased 38 percent - to $418 million in 2013

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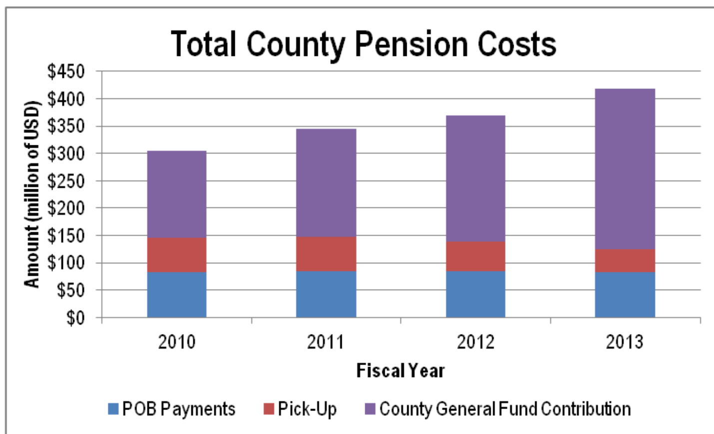
Summary & Background

A new analysis of the San Diego County's pension system by the **San Diego County Taxpayers Association's** (SDCTA or Association) found the county's total pension-related costs increased by 37 percent – from approximately $304 million in FY 2010 to $418 million in FY 2013.[1] Underperforming investments and a lack of pension reforms drove the increase, which has consumed a larger share of the county general fund used to pay for law enforcement, parks and other services.



SDCTA has released a series of reports examining the region's government employee pension plans, focusing on the impact on local government budgets. The Association also developed a Pension Certification Program to educate public officials, civic leaders and members of the news media on the complex issues encompassing local government retirement benefits.

In November 2011, the Association released a study evaluating the County of San Diego's (County) pension costs. The study reviewed the County's pension costs, including the costs of previously issued Pension Obligation Bonds (POBs) between Fiscal Year 2000 and FY 2010.

The study also offered seven recommendations as a means to reduce pension costs and their impact on taxpayers. Our new analysis provides a brief update on the County's pension costs over the past two fiscal years and examines what taxpayers can expect to pay in the upcoming fiscal year.[2]

Despite some reforms implemented by the County of San Diego, including reducing the subsidization of employee pension costs and introducing lower cost pension benefits to new employees, the County's pension costs have increased. Increases in unfunded liabilities due to underperforming investments are a primary driver of the increase.

In September 2012, the Governor signed Assembly Bill 340, the California Public Employees' Pension Reform Act of 2013, which includes reforms for new employees hired by counties throughout the state. Reforms include requiring jurisdictions adopt a new lower level of pension benefits for new hires, requiring new employees share in pension costs and redefining what type of compensation is determined "pensionable."[3] CalPERS recently issued a letter outlining its interpretation of "pensionable compensation." Within its letter, CalPERS states a number of additional premium pays, such as various educational pays and bilingual pay, can be included in an employee's salary when calculating pension earnings. This interpretation could potentially eliminate future savings for the county and cities that would have been generated if pensionable compensation was limited to base pay. At this point it is unclear if the San Diego County Employees Retirement Association (SDCERA) will have a similar interpretation of the law when it is implemented for employees.

Findings:

Unfunded Liabilities by the Numbers

An **unfunded liability** occurs when factors such as investments and employees share of pension costs do not match assumptions made by SDCERA[4] to forecast expenses. Discrepancies result in an unfunded liability that requires the County to make annual payments (the total amount of the unfunded liability is not paid all at once). The extra, and

[1] All data included within this report has been reviewed by County of San Diego officials.

[2] This report is based off of the review of the County's recent actuarial pension valuations, as well as Comprehensive Annual Financial Statements for those same years.

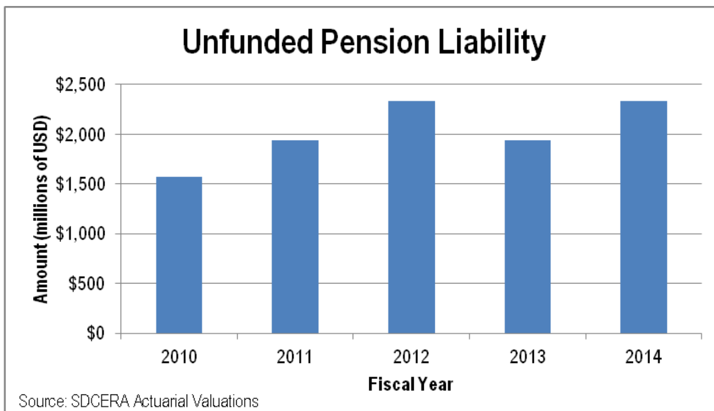
[3] Please refer to SDCTA Backgrounder: Review of California Public Employees' Pension Reform Act of 2013 for more information.

[4] According to SDCERA, County employees account for approximately 93 percent of the total system, and thus the County is not responsible for the total costs of the pension system.

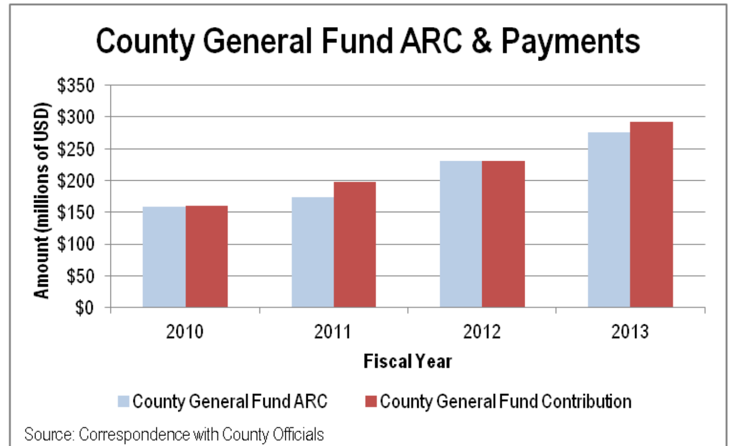
often unexpected, costs place greater pressure on municipal budgets already stressed.

While some cities have implemented significant reforms in an effort to reduce annual pension costs, the County's pension system, SDCERA, is somewhat behind on reforms. Many pension systems, including the California Public Employees' Retirement System (CalPERS) and the San Diego City Employees' Retirement System (SDCERS), have reduced the assumed investment rate of return to 7.5 percent annually. In May, SDCERA reduced the assumed rate of return from 8 percent to 7.75 percent annually. In 2010 SDCERA was assuming 8.25 percent. While the decision to reduce the investment rate of return increases the unfunded liability, the inability to realize these returns also leads to an increase in the unfunded liability.

In FY 2010, the County's total unfunded liability was **$1.56 billion**. In FY 2014 that amount is projected to increase by 49 percent to **$2.33 billion**. In FYs 2008 and 2009, the County's investment returns did not meet its expected target of 8.25 percent. The following two years returns exceeded the expected target, but then failed to reach the adjusted target of 8 percent returns for FY 2012. These up and down results, along with the cost of paying for a lower expected rate of return, have led to a steady decline in the funding of the county's pension system.



Annual Required Contributions by the Numbers
Since FY 2010, the County of San Diego has seen its general fund **Annual Required Contribution (ARC)**, also known as pension payments, increase by 74 percent. This is due in part to the increase in the County's unfunded liability. Except for FY 2012, the County has made contributions above and beyond the ARC. For FY 2013, the County has budgeted $293 million from its general fund – the pot of money used to pay for public safety, parks and other services – for pension costs.



Employer Pick-Up Costs
Through labor agreements negotiated with County employees, a portion of the employee pension payment is "picked up" by the County – a perk numerous local cities have eliminated to reduce pension costs. In FY 2010, employee pick-up costs totaled more than $57 million. In FY 2013, it is estimated this benefit will cost County taxpayers $41.7 million.[5] Overall, employee pick-up costs since FY 2010 have totaled nearly $216 million.

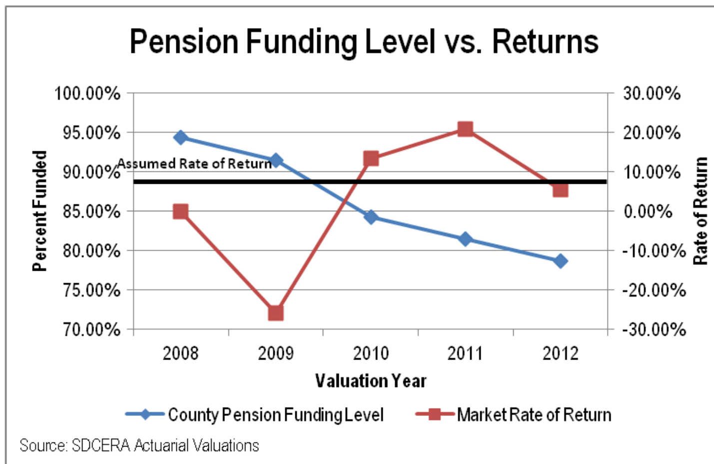
The good news is the number of employees enrolled in the pension system has dropped from 16,981 in FY 2010 to 16,457 in FY 2012.[6] In addition, contract extensions with employee labor groups in early 2011 included a reduction in the amount of "pick ups" offered to employees. The reduction in the number of employees in addition to the reduction of the offset means the County has contributed less on behalf of employees since FY 2010.

Funding Status
Any analysis of pension plans is incomplete until one views the **funding status** of the plan. The funding status measures how "on track" the pension plan is – in other words, what is expected to be available to pay for the benefits compared to what was promised to employees. Losses in the market and increases in benefits contribute to a drop in the funding status.

In three of the four years between FY 2008 and FY 2012, the county's investment returns did not reach the assumed rate of return. Thus, the difference was added to the County's unfunded liability **with the additional costs paid for by**

[5] Based off data received by County staff. FY 2013 figures are budgeted costs.
[6] San Diego County Employees Retirement Association Actuarial Valuations.

taxpayers. These losses accounted for a steady decline of the pension system's funding level and a rise in pension costs.



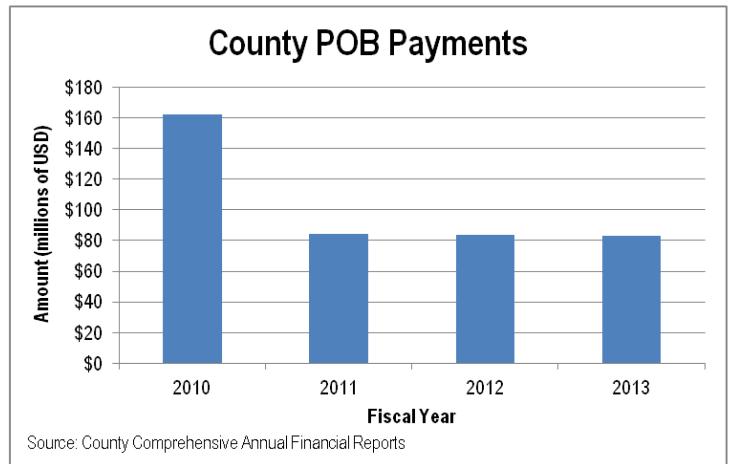
Pension Obligation Bond Payments

Pension Obligation Bonds (POBs) are bonds issued by a state or local government to pay its pension debt. Since 1994, the County has issued four series of POBs. Proceeds from each issuance were used to either pay down the County's unfunded liability, refund previous bonds, or both. Table 1 outlines the amount of bonds issued since 1994, as well as the amounts applied to pay down the unfunded liability and amounts used to refund previously issued bonds. Since 2000, the County has paid almost $1 billion towards POBs. As of June 30, 2012, the County has approximately $807 million of POBs outstanding.

Between FY 2010 and FY 2013, the County contributed over $414 million toward its outstanding POBs. In FY 2010, the County contributed an additional $100 million on top of its required payments in an effort to realize savings on annual debt service payments.

Table 1: Pension Obligation Bonds Issued
(Nominal Dollars)

Year	Original Bond Amount	Proceeds Applied to UAAL	Proceeds Used for Refunding
1994	$430,430,000	$428,500,000	$0
2002	$737,340,000	$550,000,000	$156,425,000
2004	$454,113,000	$450,000,000	$0
2008	$443,515,000	$0	$441,125,000



Cost of Employee Salary Increases

Pension costs are directly tied to how much employees earn while working. County employees are eligible to receive salary increases in two ways: negotiated "across-the-board" salary increases and step increases. Negotiated salary increases are a result of labor negotiations between the County and its employees. Step increases are typically given to employees based on the amount of time employees hold a particular job classification. In the County, there is a five percent difference between each step within a job classification. Therefore, each time an employee moves to a higher step within a job classification, they are receiving a five percent salary increase. An employee can receive both a step increase and a negotiated increase.

Between FY 2010 and FY 2013,[7] the County paid $17.7 million in step increases. These increases have a direct impact the County's future ARC payments because the additional compensation dives up employee pensions.

Conclusion

Past actions and poor investment performance will impact the County's budget beginning July 1. Despite years in which SDCERA experienced greater than expected investment returns, the County's unfunded liability has continued to increase, thus increasing its annual pension payment.

Since SDCTA's first pension report regarding the County in 2011, the San Diego County Board of Supervisors has yet to implement a number of SDCTA recommended reforms in an effort to reduce costs. Moving forward, the County should use a strict interpretation of the language within AB 340 when implementing reforms. This means limiting pensionable compensation strictly to base pay to the

[7] Actuals for FY 2014 only include period up to January 25, 2013.

maximum extent allowable by law. The requirement that employees pay the full cost of their pensions also would mean the County would see immediate savings and long-term benefits as well.

SDCTA Recommended Reforms

Many of the labor contracts for the County's 25 employee groups are scheduled to expire in June 2013. Thus, contract negotiations with these bargaining units are either currently underway or scheduled to begin. These negotiations are an opportunity for the Board of Supervisors to adopt labor contracts that include the following reforms SDCTA recommended in November 2011 (amended from the initial suggestions due to the adoption of Assembly Bill 340):

- **Employee Contribution Rates:** Current employees should be immediately required to pay contributions at least equal to the normal employee contribution rate, as required by state law.
- **Calculation of Retirement on Base Pay:** SDCTA believes the County and SDCERA should explore legally the option of implementing a more strict definition of "pensionable compensation" as was outlined under Proposition B in the City of San Diego, and was the spirit of the law adopted by the state legislature. This would lead to reduced pension costs for employees that have yet to be hired, thus reducing future costs to the county and taxpayers. Other "ancillary benefits" offered to employees should be granted on a cash basis and not be calculated in an employee's final pension payout.
- **Funding of System:** The County should continue to pay the normal cost as determined by the system actuary each and every year, despite the system's funding level or adoption of contribution rates by SDCERA that are lower than the normal cost.
- **Funding Status:** The County should not increase pensionable earnings of employees (via salary increases or benefit increases) unless the pension system is at least 80 percent funded, and remains 80 percent funded if any increase in pensionable earnings is adopted. Any proposed increase in pensionable earnings above the actuarially assumed rate must be accompanied by an actuarial valuation that outlines the effect on the funding ratio.
    - When determining the County's funding status and the ability to increase pensionable earnings, assets of the pension fund must be reduced by the outstanding balance of any pension obligation bonds.
- **Appointments to the County Retirement Board:** The San Diego County Board of Supervisors appoints four individuals to serve on the board of the San Diego County Employees Retirement Association, which manages the County's pension system. The Board of Supervisors should require these individuals to have relevant professional certifications, 15 years experience in pension administration, pension actuarial practices, investment management (including real estate), banking, or certified public accounting. Experience/certification requirements should be waived should one of the appointments be a member of the Board of Supervisors.
- **Reduce Assumed Rate of Return:** While the Board of Supervisors are not directly responsible for the assumptions adopted by SDCERA, the board representative on the SDCERA board should continue to advocate for an additional reduction to the current 7.75 percent expected rate of return.

In addition, the County should negotiate with employee groups to reduce the compensation increase between steps within job classifications. Since FY 2010, step and negotiated salary increases have cost the County nearly $18 million.

*The **San Diego County Taxpayers Association** is a non-profit, non-partisan organization, dedicated to promoting accountable, cost-effective and efficient government and opposing unnecessary taxes and fees. Founded in 1945, SDCTA has spent the past six decades saving the region's taxpayers billions of dollars, as well as generating information to help educate the public.*