ORANGE COUNTY CITY PENSION LIABILTIES

Budget Transparency Critically Needed

GRAND JURY 2013-2014

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SUMMARY

Orange County (OC) cities rely almost entirely on two pension systems for their Public Safety (fire and police) and "Miscellaneous" employees (basically everyone except fire or police), both for their retirees and for current employees who will retire in the years ahead. Those two pension systems are 1) the California Public Employees Retirement System (CalPERS) and 2) the Orange County Employee Retirement System (OCERS) for cities which outsource their police services to the Orange County Sheriff's Department (OCSD) and/or their fire services to the Orange County Fire Authority (OCFA).

Current assets of both systems fall far short of what is needed to pay current and future retirees. CalPERS at the state level had assets of $236.8 billion, liabilities of $340.4 billion, unfunded liabilities of $103.6 billion and a funding ratio of 70% as of June 30, 2012[1]. OCERS had assets of $9.5 billion, liabilities of $15.1 billion, unfunded liabilities of $5.7 billion and a funding ratio of 63% as of December 31, 2012[2].

The 2013-2014 Grand Jury investigated the ability of OC cities to recover from these unfunded liabilities. Reviews of *public* financial data from the CalPERS/OCERS pension systems and city budgets, and more importantly reviews of city *internal* budget and planning data with city finance managers showed that there were reasons to accept that OC cities are making plans to pay down (amortize) these unfunded liabilities and will be able to do so.

There are important actions being taken by cities which provide some assurance that OC cities' optimism that they can recover from their unfunded pension obligations has some basis in reality. Most important of these is that CalPERS and OCERS are committed to amortize their unfunded pension liabilities over the next 20-30 years to zero via *Annual Required Contributions* (ARCs) from the agencies they support. So long as OC cities meet their ARCs, the unfunded liabilities should approach zero. OC cities so far have been able to meet CalPERS' ARCs.

OC cities' relationships with OCERS are more complex, but cities have also been able so far to pay for their outsourced fire/police services. Both the OCSD and the OCFA have their own unfunded pension obligations with OCERS. However, so long as the amortization of OCSD/OCFA unfunded liabilities is reflected in the costs of their services to the cities they support, and so long as the cities can pay these costs, these unfunded OCERS liabilities will be amortized as well.

In addition s*ome* cities have been successful in negotiating with their employee bargaining units for their employees to carry a larger portion of the burden of pension costs and in some cases for

[1] Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2013, page 132, http://www.calpers.ca.gov/eip-docs/about/pubs/cafr-2013.pdf

[2] OCERS by the Numbers, 2012, page 26, http://www.ocers.org/pdf/publications/brochures/bythenumbers.pdf

reduced benefits. This reduces the future overall costs of pensions and frees up funds that these cities can apply to amortizing their unfunded liabilities. Some cities are also looking at accelerating their amortization of unfunded pension liabilities.

Another long term factor in reducing unfunded pension liabilities is the Public Employees' Pension Reform Act (PEPRA), which went into effect January 1, 2013. However, since the reforms only affect employees hired after January, 2013, it will be many years before these reforms will have an impact on unfunded liabilities.

Unfunded pension liabilities can be extremely volatile because they are driven by two unpredictable elements:

1. Occasional extreme fluctuations in the market value of assets
2. Changes to key actuarial assumptions, and especially changes to assumed future rates of return on investments

Hence, budgeting to reduce unfunded pension liabilities presents particular challenges for cities:

1. Pension catch up contributions typically comprise a significant percentage of projected city General Fund expenditures
2. Projected annual contributions to catch up on unfunded liabilities are ramped up over two to five years by CalPERS and OCERS. The impact of amortizing unfunded liabilities is not completely revealed by looking only one year into the future, which is typically as far as city budgets are projected
3. Unlike most planned city expenditures, there is essentially no way to reduce or defer ***required*** pension contributions in future years
4. Projected unfunded pension liabilities are at risk of large changes year to year because Annual Required Contributions are so dependent on the fluctuating market value of assets and on key actuarial assumptions used in calculating the liabilities

Unfortunately, after examining a large sample of OC cities' budgets published online, the Grand Jury found those budgets to be inadequate to establish any confidence that these cities are addressing their unfunded pension liabilities. There are several reasons for this:

1. Cities typically do not show explicit line items for amortizing their unfunded pension liabilities
2. Cities typically only show budget projections one year into the future
3. Cities that outsource fire and/or police services to Orange County Sheriff's Department and/or Orange County Fire Authority typically provide minimal detail on planned future expenditures for these services even as OCSD/OCFA deal with their own unfunded pension liabilities with OCERS

It is extremely important to note the Grand Jury's assessment that a city's published budget data is inadequate to establish confidence that a city will be able to address its unfunded pension liabilities is not the same thing as an assessment that the city will be unable to address its unfunded liabilities.

The 2013-2014 Grand Jury is very concerned that although cities have somewhat improved the transparency of their budgets (partly in response to prior Grand Jury recommendations), *members of the public of Orange County cities will still find it difficult or impossible to understand the current and changing impacts of unfunded pension liabilities on their city budget*. *Of special concern to the Grand Jury is the lack of any traceability of OCERS OCSD/OCFA unfunded pension liabilities to the budgets of cities which outsource to these agencies.*

Given the potential impact of unfunded pension liabilities on Orange County cities and the current lack of information visible to the public, the Grand Jury finds that it is critically urgent that Orange County cities increase the transparency of this information. The Grand Jury believes that a better informed public will more effectively engage with their political leadership to address budget problems including the impact of large and volatile unfunded pension liabilities. There is, of course, the added benefit that being required to show budget planning further into the future and at a greater depth will require greater thoughtfulness on the part of cities in preparing such budgets. The 2013-2014 Grand Jury also believes that a discussion of the critical assumptions which form the basis in projecting out-year budgets and the associated risks inherent in these assumptions is needed as part of any city's budget.

REASON FOR THE STUDY

Orange County cities are obligated to provide on-going pension benefits to retired employees (and often to those employees' survivors) and to current employees who will retire sometime in the future. These cities use two major pension systems to provide these pensions: the California Public Employees' Retirement System (CalPERS) and the Orange County Employee Retirement System (OCERS). Significant portions of these pension systems are unfunded.

Pensions for public employees are taking larger and larger percentages of OC City budgets both for contributions to fund future pensions for current employees and to make up for insufficiently funded pension obligations for retired employees. Cities are also dealing with their need to have current employees contribute more toward their retirement. This report examines the size of OC cities' unfunded pension liabilities for both their general/administrative/ technical personnel and for their public safety personnel. It also examines metrics to help understand the relative financial impacts of unfunded liabilities on OC cities.

Media stories have raised major concerns that unfunded pension obligations are not only growing, but are growing exponentially at all levels of government. Unfunded pension liabilities with the CalPERS system have led two California cities to contemplate bankruptcy as a means of dealing with the problem, although such drastic steps have been avoided so far.

The 2013-2014 Grand Jury is aware that there is a political element to any discussion of unfunded pension liabilities. Unions may view the problem as being exaggerated as a means to weaken the power of public employee unions and strip hard-won benefits and influence future negotiations. Others are concerned with the affordability of pensions that many people describe as “generous”. The Public Employee Pension Reform Act (PEPRA) took effect in 2013 and is designed to end practices and policies that permitted very high pension payments to some retirees. No doubt some unfunded pension liabilities can be attributed to these practices, and it is true that most current employees are not subject to these reforms because they apply only to employees hired after January 1, 2013. However, the main contributors to current unfunded liabilities are the result of the Great Recession and changing actuarial assumptions.

The focus of this report is forward looking. In whatever fashion OC cities got to their present situation, the unfunded liabilities are real and must be dealt with. The objectives of this report are to:

1. provide factual information about the extent of unfunded city pension obligations
2. provide sufficient background information on pensions such that members of the public can follow and engage in informed discussion on unfunded pension obligations and their impact on a city
3. assess the availability and utility of pension information in city budgets

The public commitment to addressing the issues in a timely manner and accepting some pain now and not pushing the issues off to the future must be in place. If unfunded pension liabilities are not addressed, cities could reach a crisis where outcomes are painful enough that they affect the quality of life in Orange County. Money spent by OC cities to deal with unfunded pension obligations necessarily comes at the expense of other services cities provide to their residents. Catch up contributions to amortize these unfunded liabilities can be a significant expenditure in a city’s budget, and the growth and unpredictability of these unfunded liabilities make it difficult to budget for future years. Orange County cities made painful cuts in services to their residents in response to the 2008 Great Recession and would like to restore these services as the economy recovers. However, restoration of services will be delayed or even further reduced in many cities until unfunded liabilities are dealt with.

As a necessary part of the report’s discussion of pension funding, some basic explanations of key pension related terms are provided. The Grand Jury hopes this background will be an additional benefit of the report in helping the OC electorate to understand and make informed decisions in response to pension funding issues when they are discussed.

Although Orange County is relatively wealthy compared to many other California counties, unfunded pensions are still an issue for the county, its cities, and other county governmental entities. Although unfunded pension liabilities are a problem for every County governmental entity, due to the limited Grand Jury resources, this report focuses on pension issues for the 34 cities in Orange County. Another motivation for this choice is that discussions of unfunded pension liabilities in the media have typically not gone to the level of detail of individual cities.

A prior 2011-2012 Grand Jury report[3] identified the need for greater transparency in public employee compensation, especially in the area of employee pension costs. That report was well written and had very valid recommendations. Subsequent to that report city budgets now contain far more pension information for individual classes of employees, indeed sometimes down to individual positions. However, the pension costs are not summarized in most city budgets such that the cumulative costs of current employee pension obligations are visible. It is not possible to see the forest for the trees. In addition, the focus of the 2011-2012 Grand Jury report was on transparency of city pension-related compensation *for current employees* in city budgets. The need for transparency on the *cumulative* effect of pension obligations for both current and retired employee and on the impact of *unfunded pension liabilities* was not addressed.

This report does not examine other pension systems of importance to Orange County, which definitely have their own unfunded pension liabilities. In particular Special Districts, Teacher Retirement Systems, and Community College Districts are not studied. This report also does not address the other elephant in the room, which is a post-retirement obligation for medical care and similar non-pension benefits, an issue which deserves attention similar to that needed for pension funding.

BACKGROUND AND FACTS

Table 1 lists the 34 Orange County cities alphabetically, their population, and the pension systems they use. Note that some OC cities which use CalPERS for their Miscellaneous (non-safety) employees' pensions also have "outsourced" public safety (police and/or fire protection) to County agencies. Some cities contract with the Orange County Sheriff's Department (OCSD) for police services, some with the Orange County Fire Authority (OCFA) for fire protection and medical response services, and some cities contract with both. Cities that outsource for public safety services also inherit pension obligations (and any associated funding issues) from the County agencies to which they have outsourced. Ten OC cities rely on CalPERS for pensions

[3] "TRANSPARENCY BREAKING UP COMPENSATION FOR – *BUT WHY HIDE PENSION COSTS*", 2011-2012 Orange County Grand Jury Report, http://www.ocgrandjury.org/pdfs/transparencybreakingupcompensationfog.pdf

for all their public safety as well as their non-public safety employees, eleven for one but not both of their public safety services, and thirteen outsource both fire and police services.

Table 1. Orange County Cities, Population, and Pension Systems

City	Popula-tion	Non-Safety Employee Retirement System	Safety Employee - Police Protection	Safety Employee - Fire Protection
Aliso Viejo	47,823	CalPERS	Outsourced - OCSD	Outsourced – OCFA
Anaheim	336,365	CalPERS	In house – CalPERS	In house – CalPERS
Brea	39,282	CalPERS	In house – CalPERS	In house – CalPERS
Buena Park	80,530	CalPERS	In house – CalPERS	Outsourced – OCFA
Costa Mesa	109,960	CalPERS	In house – CalPERS	In house – CalPERS
Cypress	47,802	CalPERS	In house – CalPERS	Outsourced – OCFA
Dana Point	33,351	CalPERS	Outsourced - OCSD	Outsourced – OCFA
Fountain Valley	55,313	CalPERS	In house – CalPERS	In house – CalPERS
Fullerton	135,161	CalPERS	In house – CalPERS	In house – CalPERS
Garden Grove	170,883	CalPERS	In house – CalPERS	In house – CalPERS
Huntington Beach	189,992	CalPERS	In house – CalPERS	In house – CalPERS
Irvine	212,375	CalPERS	In house – CalPERS	Outsourced – OCFA
La Habra	60,239	CalPERS	In house – CalPERS	LA County FD
La Palma	15,568	CalPERS	In house – CalPERS	Outsourced – OCFA
Laguna Beach	22,723	CalPERS	In house – CalPERS	In house - CalPERS
Laguna Hills	30,344	CalPERS	Outsourced - OCSD	Outsourced – OCFA
Laguna Niguel	62,979	CalPERS	Outsourced - OCSD	Outsourced – OCFA
Laguna Woods	16,192	CalPERS	Outsourced - OCSD	Outsourced – OCFA
Lake Forest	77,264	CalPERS	Outsourced - OCSD	Outsourced – OCFA
Los Alamitos	11,449	CalPERS	In house – CalPERS	Outsourced – OCFA
Mission Viejo	93,483	CalPERS	Outsourced - OCSD	Outsourced – OCFA
Newport Beach	85,287	CalPERS	In house – CalPERS	In house - CalPERS
Orange	136,416	CalPERS	In house – CalPERS	In house - CalPERS
Placentia	50,533	CalPERS	In house – CalPERS	Outsourced – OCFA
Rancho Santa Margarita	47,853	CalPERS	Outsourced - OCSD	Outsourced – OCFA
San Clemente	63,522	Great West	Outsourced - OCSD	Outsourced – OCFA
San Juan Capistrano	34,593	OCERS	Outsourced - OCSD	Outsourced – OCFA
Santa Ana	329,427	CalPERS	In house – CalPERS	Outsourced – OCFA
Seal Beach	24,168	CalPERS	In house – CalPERS	Outsourced – OCFA
Stanton	38,186	CalPERS	Outsourced - OCSD	Outsourced – OCFA
Tustin	75,540	CalPERS	In house – CalPERS	Outsourced – OCFA
Villa Park	5,812	none	Outsourced - OCSD	Outsourced – OCFA
Westminster	89,701	CalPERS	In house – CalPERS	Outsourced – OCFA
Yorba Linda	64,234	CalPERS	Outsourced - OCSD	Outsourced – OCFA

Some notes on Table 1 follow:

1. Population data is from 2010 Census (except for Mission Viejo and Santa Ana where the data is from 2011)
2. Population data will be used later in the report as a way of scaling the size of unfunded liabilities on a per capita basis. (Using consistent census data, even if a bit old, does allow for a better apples-to-apples comparison among cities.)
3. La Habra in North OC outsources its fire protection to the adjacent Los Angeles County Fire Department
4. San Clemente uses Great West Retirement Systems for its non-safety employees, although it is considering transferring to CalPERS for these employees. It currently uses CalPERS for its five lifeguards
5. Villa Park no longer uses CalPERS for its non-safety employees, but unfunded liabilities still exist since the city previously did use CalPERS for pensions for these employees
6. Some CalPERS data later in the report is provided for "Safety" without specifying whether Safety includes Police or Fire or both. In other cases CalPERS provides data separately for Police and Fire
7. Many cities that currently outsource for fire and/or police services previously used in-house employees for these services and still use CalPERS for those retired employees and for the pension obligations incurred before active employees transferred to OCFA/OCSD

Some Key Terms Defined

Pension systems receive contributions from current employees and from their employers and accumulate and invest these assets to generate the stream of pension payments (the system's *liabilities*) for their members.

The difference between the assets they hold and the assets they should have on hand to meet their current pension payout obligations and to invest for future pension payments are their *unfunded liabilities*.

The ratio of total assets to total liabilities is the "*Funded Ratio*" for each pension system.

Pension systems specify *Annual Required Contributions* from employers that are comprised of current employee pension contributions, corresponding employer contributions, and catch up contributions from employers to amortize their unfunded obligations.

Appendix B provides an extensive glossary of pension related terms. Appendix C provides a general background discussion of pensions.

Overviews of CalPERS and OCERS

Both CalPERS and OCERS provide top level descriptions in their Annual Financial Reports that give excellent summaries of their systems, their scope, and some key financial indicators. Extracts from these publications are provided below.

California Public Employees' Retirement System (CalPERS) Overview from its Comprehensive Annual Financial Report (CAFR) 2013[4]

> "Established by legislation in 1931, the System became operational in 1932 for the purpose of providing a secure retirement to State employees. A defined benefit retirement plan, CalPERS provides benefits based on a member's years of service, age, and highest compensation.
>
> The California Public Employees' Retirement System (CalPERS) is now the nation's largest public pension fund with total net position in the Public Employees' Retirement Fund (PERF) of $262.0 billion as of June 30, 2013. CalPERS membership consists of 1,104,237 active and inactive members and 574,759 retirees, beneficiaries, and survivors. The PERF paid $16.6 billion in retirement benefits to 566,975 annuitants during the Fiscal Year 2012-2013, compared with $15.4 billion paid to 543,722 annuitants during the Fiscal Year 2011-2012. Benefit payments increased primarily due to an increase in the number of retirees and the average benefit amount, including cost-of-living-adjustments (COLA).
>
> As of June 30, 2012, the date of the most recent actuarial valuation, the PERF was funded at 83.1 percent, based on the actuarial value of assets. A better measure of benefit security is the funded status on the market value of assets basis. On that basis, as a result of the 0.14 percent investment return in 2011-2012, the funded status declined from 73.6 percent at June 30, 2011 to 69.6 percent at June 30, 2012. CalPERS is making good progress recovering from the financial crisis of 2008-2009 and Great Recession. As of June 30, 2013, the PERF was approximately 74 percent funded.
>
> The past fiscal year produced a landmark pension reform law in California called the Public Employees' Pension Reform Act (PEPRA), which went into effect on January 1, 2013. The reforms apply to nearly all California public employee pension systems, including CalPERS, and generally to public employees hired on January 1, 2013, or later, but not to public employees hired before the effective date."

[4] Comprehensive Annual Financial Report, Fiscal Year Ended June 13, 2013, CalPERS document located at http://www.calpers.ca.gov/eip-docs/about/pubs/2013-executive-summary.pdf

Orange County Employee Retirement System (OCERS) Overview from its Comprehensive Annual Financial Report (CAFR) 2012[5]

> "OCERS is a public retirement system that provides service retirement, disability, death and survivor benefits, administered in accordance with the County Employees Retirement Law of 1937 (Government Code Section 31450, et seq.), to its members.
>
> Member pension benefit payments increased by $46.3 million or 9.6% in 2012. The number of retired members and beneficiaries receiving a benefit payment increased 5% from 13,289 payees at the end of 2011 to 13,947 as of December 2012. The average annual benefit paid to retired members and beneficiaries during 2012 was $38,020 an increase of 4.4% over the average annual benefit payment of $36,422 in 2011.
>
> Contributions received from employers and employees totaled $629.0 million in 2012, an increase of 2.3% compared to 2011 contributions received of $614.8 million. The net year-to-date rate of return on investments on a fair value basis was approximately 12.26% in 2012, up from 0.74% return earned in 2011.
>
> OCERS maintains a funding goal to establish contributions that fully fund the System's liabilities, and that, as a percentage of payroll, remain as level as possible for each generation of active members.
>
> Based upon the most recent actuarial valuation as of December 31, 2012, prepared by the System's independent actuary, OCERS funding status for the pension plan, as measured by the ratio of the actuarial value of assets (which smooths market gains and losses over five years) to the actuarial value of liabilities, decreased from 67.03% at December 31, 2011 to 62.52% at December 31, 2012 due primarily to the impact of decreasing the investment assumed rate of return from 7.75% to 7.25%. The December 31, 2012, OCERS funding status of 62.52% reflected a UAAL [Unfunded Actuarial Accrued Liability] of $5.7 billion. OCERS funding status when measured using market value of assets was 63.17% at the end of 2012 compared to 62.60% at the end of 2011.
>
> OCERS had been using a 7.75 % assumed rate of return in its annual actuarial valuations since 2004. In 2011, the Board [of Retirement] received a recommendation from the System's actuary to reduce the assumed rate of return to either 7.5% or 7.25%. After a thorough review and lengthy discussions, the Board decided to maintain the existing assumption and revisit the matter in 2012 after they considered the revision to the investment asset allocation policy. Even with the subsequent improved projections for the revised asset allocation then evident, the System's actuary again recommended the System's rate of return be reduced to either 7.50% or 7.25%. The Board adopted 7.25%

[5] Comprehensive Annual Financial Report for the Fiscal Year Ended December 31, 2012, OCERS document

> as the System's assumed rate of return to be effective with the 2012 actuarial valuation. The ensuing cost impact to the employer's contribution rate as a result of this assumption change will be phased-in over two years."

Pension Reform in California (PEPRA)

Recent reforms in California's public employee retirement systems have tried to address pension cost drivers. These reforms have created two classes of employees: 1) employees who were members of a California public employee pension system prior to January 1, 2013 ("Legacy"), and 2) employees hired after January 1, 2013, who at the time of hiring were not members of a California public employee pension system ("New"). Briefly excerpted below are highlights of the pension reform legislation published by The California State Association of Counties[6]:

> "Two bills (AB 340 and AB 197) enacted the California Public Employees' Pension Reform Act (PEPRA). AB 340 made several changes to the pension benefits that may be offered to employees hired on or after January 1, 2013, including setting a new maximum benefit, a lower-cost pension formula for safety and non-safety employees with requirements to work longer in order to reach full retirement age and a cap on the amount used to calculate a pension. Among other things, AB 340 also enacted pension spiking reform for new and existing employees, required three-year averaging of final compensation for new employees, and provided counties with new authority to negotiate cost-sharing agreements with current employees."

These reforms will mitigate the pension problem in the long term. However, since these reforms generally only apply to New employees, there remains a large problem to be dealt with in the next 10-30 years, which is pension payments for employees already retired or covered as Legacy employees under the prior and far more generous pre-PEPRA rules. Given the slow rate of hiring by cities and the grandfathering of Legacy employees, it will be a long time before these reforms have any significant impact on pension liabilities.

Unfunded liabilities of CalPERS and OCERS are both large and volatile

Table 2 shows a history of the unfunded Public Employees' Retirement Fund (PERF) liabilities for CalPERS, both as dollar amounts and in terms of funding ratio of assets divided by liabilities.[7] Unfunded liabilities varied dramatically between 2003 and 2012 from $36.6 billion in unfunded liabilities in 2003 down to ($2.9) billion (parentheses indicate a negative number, which in turn implies an overfunded state) in 2007 and back up to $103.6 billion in 2012. The Great Recession from December 2007 to June 2009 led to the CalPERS funding ratio dropping dramatically from 101% in June of 2007 to 61% in June of 2009.

[6] California State Association of Counties, "2013 Public Employees Pension Reform Act Resources", http://www.csac.counties.org/2013-public-employees-pension-reform-act-resources

[7] Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2013, page 132, http://www.calpers.ca.gov/eip-docs/about/pubs/cafr-2013.pdf

Table 2. Unfunded Accrued Liabilities Historical Data for CalPERS

Actuarial Valuation Date	Actuarial Accrued Liabiity (AAL)	Market Value of Assets	UAAL	Funded Ratio - Market Value of Assets Basis
6/30/2003	$180,922	$144,330	$36,592	79.77%
6/30/2004	$194,609	$167,110	$27,499	85.87%
6/30/2005	$210,301	$189,103	$21,198	89.92%
6/30/2006	$228,131	$211,188	$16,943	92.57%
6/30/2007	$248,224	$251,162	-$2,938	101.18%
6/30/2008	$268,324	$238,041	$30,283	88.71%
6/30/2009	$294,042	$178,860	$115,182	60.83%
6/30/2010	$308,343	$201,632	$106,711	65.39%
6/30/2011	$328,567	$241,740	$86,827	73.57%
6/30/2012	$340,429	$236,800	$103,629	69.56%
Dollars are in Millions				

Figure 1 and Table 3 below are from an OCERS paper "The Evolution of OCERS Unfunded Actuarial Accrued Liability".[8] These data show the dramatic growth of unfunded pension liabilities in the OCERS system not dissimilar to CalPERS' experience. However, the data also provide a good example of why focusing on the raw dollars does not paint a complete picture and that funding ratios are needed to paint a complete picture. Figure 1 shows the OCERS pension system's accrued liabilities going from a small overfunded status in 2000 to an unfunded status approaching $5.7 billion by 2012.

What is missing from Figure 1 is the fact that the OCERS assets were also growing fairly dramatically during this period, although not fast enough to keep up with liabilities growth. Table 3 shows the same dramatic growth in OCERS unfunded liabilities as shown in Figure 1, but also shows the growth in value of OCERS assets paralleling the growth in liabilities. Unfortunately, asset growth did not keep up well enough with liabilities growth to avoid a significant decline in funding ratio. OCERS went from a funding ratio of 104% in 2000 to 63% in 2012. However, it should be noted that the funding ratio was relatively stable between 2004 and 2010 while at the same time the unfunded liability went from $2.2 billion to $3.8 billion. Media coverage that only deals in terms of unfunded liabilities without looking at funding ratios is misleading.

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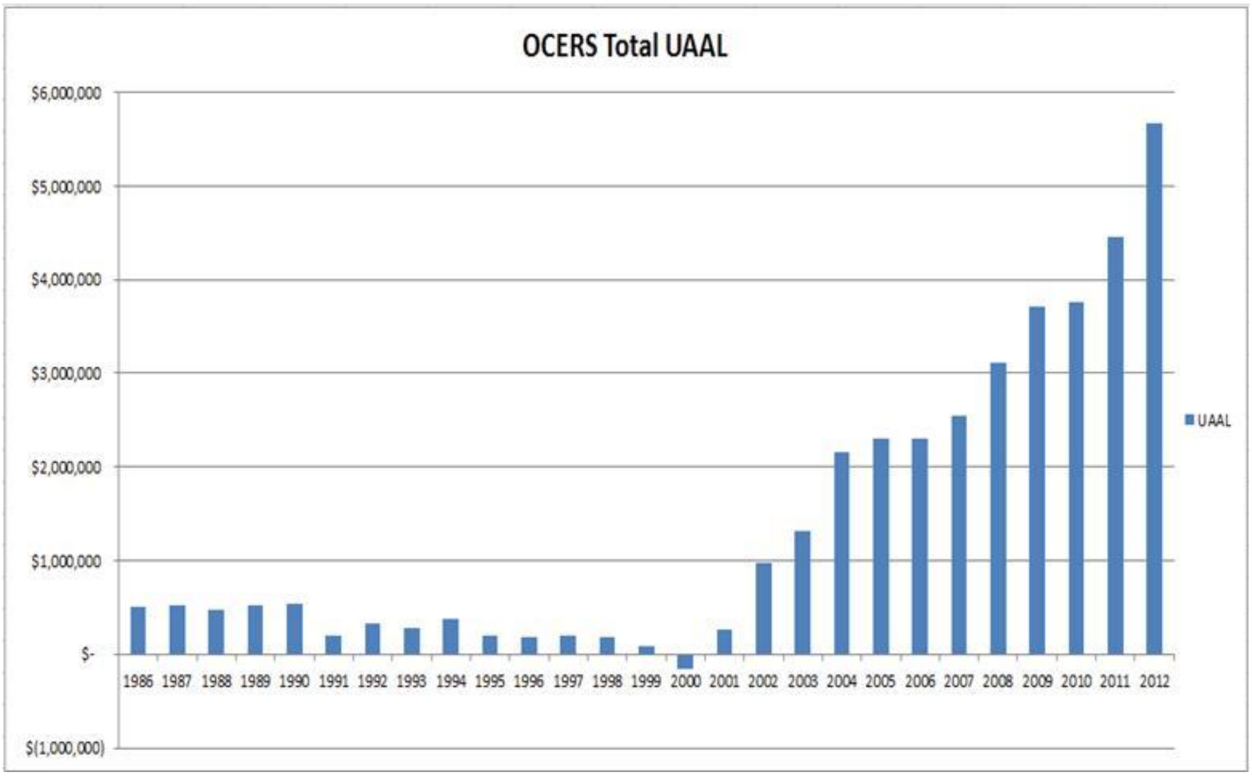
[8] The Evolution of OCERS Unfunded Actuarial Accrued Liability, dated December 31, 2012, http://www.ocers.org/pdf/finance/actuarial/evolution_of_ocers_uaal.pdf

Changes in the value of assets are not the only source of volatility in unfunded liabilities. For example, the seemingly small OCERS change in December, 2012, from an assumed rate of return on investments of 7.5% down to 7.25% caused the County of Orange's projected county retirement costs in 2015-2016 to grow by $50 million from $377 to $427 million.[9]

Figure 1. Unfunded Accrued Liabilities Historical Data for OCERS



[The Y axis in OCER's paper should have indicated dollars are in thousands.]

[9] County of Orange 2012 Strategic Financial Plan, December 18, 2012. http://cams.ocgov.com/Web_Publisher_Sam/Agenda12_18_2012_files/images/56-12182012.PDF

Table 3. Historical OCERS Assets, Unfunded Liabilities, and Funding Ratios

Actuarial Valuation Date December 31	Valuation Value of Plan Assets	Total Unfunded Actuarial Accrued Liabiliity (UAAL)	Funded Ratio
1985	$613,863	$462,121	57.05%
1986	$713,506	$507,409	58.44%
1987	$821,884	$522,098	61.16%
1988	$985,030	$468,828	67.75%
1989	$1,136,210	$515,778	68.78%
1990	$1,297,575	$543,340	70.49%
1991	$1,576,131	$196,763	88.84%
1992	$1,807,319	$332,763	84.45%
1993	$2,024,447	$280,572	87.83%
1994	$2,177,673	$372,386	85.40%
1995	$2,434,406	$199,478	92.43%
1996	$2,675,632	$176,262	93.82%
1997	$3,128,132	$204,835	93.85%
1998	$3,504,708	$177,978	95.17%
1999	$3,931,744	$85,535	97.87%
2000	$4,497,362	($162,337)	103.74%
2001	$4,586,844	$257,055	94.69%
2002	$4,695,675	$978,079	82.76%
2003	$4,790,099	$1,309,334	78.53%
2004	$5,245,821	$2,158,151	70.85%
2005	$5,786,617	$2,303,010	71.53%
2006	$6,466,085	$2,298,960	73.77%
2007	$7,288,900	$2,549,786	74.08%
2008	$7,748,380	$3,112,335	71.34%
2009	$8,154,687	$3,703,891	68.77%
2010	$8,672,592	$3,753,281	69.79%
2011	$9,064,355	$4,458,623	67.03%
2012	$9,469,208	$5,675,680	62.52%

METHOD OF STUDY

The Grand Jury took the actions listed below to accomplish this study:

1. Interviews were conducted with HR managers from three selected cities concerning their pension systems.
2. Interviews were conducted with finance managers from three selected cities concerning their pension systems.
3. Interview(s) were conducted with CalPERS experts on how they compute the value of their assets, project their future liabilities, and identify and deal with unfunded pension liabilities. Key actuarial assumption changes recently made and other changes that may occur in the near future and their impact on unfunded liabilities were also discussed as well as the impact of pension reform and further pension reforms being contemplated.
4. Interviews were conducted with OCERS senior managers on how they handle unfunded pension liabilities.
5. Analyses were made of CalPERS-provided data on unfunded liabilities for each city's Public Safety (Fire and Police) and Miscellaneous (i.e., their management and administrative staff or more simply stated - their non-Public Safety staff) employees. The analysis looked at the absolute dollar values of the unfunded liabilities as well as measuring the liabilities on a per capita basis and relative to the size of the General Funds of each city.
6. Criteria for minimum expectations for budget content and quality were identified and an assessment of OC city budget data published online against these criteria was conducted.

ANALYSIS

CalPERS Data on Unfunded Pension Liabilities of OC Cities

CalPERS provided the 2013-2014 Grand Jury with the funding status of each Miscellaneous/ Safety pension plan which CalPERS provides for OC cities as shown earlier in Table 1. Table 4 shows data as of June 30, 2012, for those 34 OC cities.

The city of Anaheim, which uses CalPERS for all its employees including fire and police, has an unfunded liability totaling $612 million. The city of Santa Ana has an unfunded liability totaling $461 million, and this total does not include any unfunded pension liabilities carried by the OCFA to whom Santa Ana outsources its fire protection.

The highest funding ratios (around 80%) are for "Second Tier" plans which pay a lower percentage of final salary and set a much higher minimum age of retirement. The rest of the plans vary significantly among OC cities, having funding ratios from a high of 77.5% to a low of

59%. *The aggregate unfunded CalPERS pension liabilities of the 34 OC cities shown in Table 2 using Market Value of Assets (the current baseline approach) is over $3.3 billion dollars.*

It is important to note that Table 4 does not show the total exposure to unfunded pension liabilities for those cities which outsource fire and/or police services to OCFA and OCSD, respectively and should be read accordingly. (Table 1 showed which cities outsourced these services.)

Table 4. Unfunded Pension Liabilities by City and Plan Using Market Value of Assets

CITY	PLAN	Accrued Liability	Market Value of Assets	UAL	Funded Ratio
ALISO VIEJO	MISCELLANEOUS	$2,570,113	$1,983,533	$586,580	77.2%
Anaheim	MISCELLANEOUS	$1,045,037,179	$712,496,875	$332,540,304	68.2%
Anaheim	SAFETY POLICE	$565,213,783	$395,053,409	$170,160,374	69.9%
Anaheim	SAFETY FIRE	$345,724,884	$236,154,719	$109,570,165	68.3%
Brea	SAFETY	$191,751,750	$127,377,145	$64,374,605	66.4%
Brea	MISCELLANEOUS	$102,226,046	$72,815,975	$29,410,071	71.2%
BUENA PARK	SAFETY	$185,001,886	$136,426,394	$48,575,492	73.7%
BUENA PARK	MISCELLANEOUS	$109,953,460	$77,968,001	$31,985,459	70.9%
Costa Mesa	MISCELLANEOUS	$225,186,488	$141,225,952	$83,960,536	62.7%
Costa Mesa	SAFETY POLICE	$212,645,063	$129,017,818	$83,627,245	60.7%
COSTA MESA	SAFETY FIRE	$161,328,098	$100,677,450	$60,650,648	62.4%
CYPRESS	SAFETY	$65,259,215	$47,574,444	$17,684,771	72.9%
Cypress	MISCELLANEOUS	$58,995,020	$44,534,686	$14,460,334	75.5%
DANA POINT	MISCELLANEOUS	$14,606,788	$11,273,064	$3,333,724	77.2%
FOUNTAIN VALLEY	SAFETY 1ST TIER	$144,802,443	$99,113,405	$45,689,038	68.4%
FOUNTAIN VALLEY	MISCELLANEOUS 1ST TIER	$78,548,900	$51,520,993	$27,027,907	65.6%
FOUNTAIN VALLEY	SAFETY POLICE 2ND TIER	$100,138	$75,901	$24,237	75.8%
FOUNTAIN VALLEY	MISCELLANEOUS 2ND TIER	$31,032	$24,768	$6,264	79.8%
FOUNTAIN VALLEY	SAFETY FIRE 2ND TIER	$422	$315	$107	74.6%
Fullerton	SAFETY	$372,812,731	$247,403,994	$125,408,737	66.4%
Fullerton	MISCELLANEOUS	$227,961,576	$170,608,016	$57,353,560	74.8%
Garden Grove	SAFETY	$387,791,595	$251,498,319	$136,293,276	64.9%
Garden Grove	MISCELLANEOUS	$231,098,351	$155,545,807	$75,552,544	67.3%
Huntington Beach	SAFETY	$552,535,708	$350,648,228	$201,887,480	63.5%
Huntington Beach	MISCELLANEOUS	$431,175,037	$298,603,254	$132,571,783	69.3%
Irvine	MISCELLANEOUS	$262,485,223	$168,840,560	$93,644,663	64.3%
Irvine	SAFETY	$162,425,349	$114,537,221	$47,888,128	70.5%
LA HABRA	SAFETY	$124,453,943	$87,149,408	$37,304,535	70.0%
La Habra	MISCELLANEOUS	$79,216,276	$59,609,354	$19,606,922	75.2%
LA HABRA	SAFETY POLICE 2ND TIER	$753	$563	$190	74.8%
LA PALMA	SAFETY	$33,248,911	$24,518,826	$8,730,085	73.7%
LA PALMA	MISCELLANEOUS	$22,117,712	$16,031,551	$6,086,161	72.5%
LA PALMA	SAFETY 2ND TIER	$7,511	$5,895	$1,616	78.5%
LA PALMA	MISCELLANEOUS 2ND TIER	$576	$460	$116	79.9%

CITY	PLAN	Accrued Liability	Market Value of Assets	UAL	Funded Ratio
Laguna Beach	MISCELLANEOUS	$80,291,956	$55,443,941	$24,848,015	69.1%
LAGUNA BEACH	SAFETY POLICE	$57,585,435	$42,465,368	$15,120,067	73.7%
LAGUNA BEACH	SAFETY FIRE	$45,735,935	$33,727,163	$12,008,772	73.7%
LAGUNA BEACH	SAFETY LIFEGUARD	$4,662,336	$3,533,903	$1,128,433	75.8%
LAGUNA BEACH	SAFETY FIRE 2ND TIER	$21,221	$16,085	$5,136	75.8%
LAGUNA BEACH	SAFETY POLICE 2ND TIER	$119	$90	$29	75.6%
LAGUNA HILLS	MISCELLANEOUS	$11,150,476	$8,428,814	$2,721,662	75.6%
LAGUNA NIGUEL	MISCELLANEOUS	$21,979,272	$16,962,917	$5,016,355	77.2%
LAGUNA NIGUEL	MISCELLANEOUS 2ND TIER	$576	$460	$116	79.9%
LAGUNA WOODS	MISCELLANEOUS	$1,799,940	$1,389,138	$410,802	77.2%
LAKE FOREST	MISCELLANEOUS	$16,886,211	$13,032,252	$3,853,959	77.2%
LOS ALAMITOS	SAFETY	$24,809,272	$18,091,332	$6,717,940	72.9%
LOS ALAMITOS	MISCELLANEOUS	$23,970,858	$17,582,564	$6,388,294	73.3%
Mission Viejo	MISCELLANEOUS	$55,336,400	$37,971,519	$17,364,881	68.6%
Newport Beach	SAFETY	$424,868,507	$252,131,503	$172,737,004	59.3%
Newport Beach	MISCELLANEOUS	$302,006,850	$200,149,332	$101,857,518	66.3%
Orange	SAFETY	$395,287,607	$265,861,717	$129,425,890	67.3%
Orange	MISCELLANEOUS	$271,876,517	$187,707,479	$84,169,038	69.0%
PLACENTIA	SAFETY	$69,929,197	$47,548,284	$22,380,913	68.0%
PLACENTIA	MISCELLANEOUS	$44,543,255	$34,400,240	$10,143,015	77.2%
PLACENTIA	MISCELLANEOUS 2ND TIER	$70	$56	$14	80.0%
RANCHO SM	MISCELLANEOUS 1ST TIER	$3,578,445	$2,373,225	$1,205,220	66.3%
RANCHO SM	MISCELLANEOUS 2ND TIER	$66	$53	$13	80.3%
SAN CLEMENTE	SAFETY LIFEGUARD	$4,771,964	$3,412,298	$1,359,666	71.5%
Santa Ana	SAFETY	$886,484,216	$639,122,005	$247,362,211	72.1%
Santa Ana	MISCELLANEOUS	$670,676,090	$456,703,295	$213,972,795	68.1%
SEAL BEACH	SAFETY	$55,626,490	$41,020,779	$14,605,711	73.7%
SEAL BEACH	MISCELLANEOUS	$37,784,994	$29,273,349	$8,511,645	77.5%
STANTON	MISCELLANEOUS	$16,135,869	$11,943,044	$4,192,825	74.0%
TUSTIN	SAFETY	$96,725,338	$67,268,742	$29,456,596	69.5%
Tustin	MISCELLANEOUS	$79,578,148	$60,726,631	$18,851,517	76.3%
TUSTIN	SAFETY POLICE 2ND TIER	$634	$474	$160	74.8%
VILLA PARK	MISCELLANEOUS	$3,584,194	$2,504,067	$1,080,127	69.9%
WESTMINSTER	SAFETY	$190,808,021	$140,326,367	$50,481,654	73.5%
Westminster	MISCELLANEOUS	$103,786,629	$70,524,912	$33,261,717	68.0%
Yorba Linda	MISCELLANEOUS	$52,656,198	$35,770,166	$16,886,032	67.9%

Per Capita Assessment

Since the cities in Table 4 vary greatly in size, the Grand Jury calculated these unfunded liabilities for a selected set of cities on a per capita basis to provide a normalized measure of the impact of these liabilities. Table 5 below provides this assessment for the 10 OC cities that rely on CalPERS for all their Miscellaneous and Safety employees. These 10 cities are the only ones for which an apples-to-apples comparison is possible because unfunded pension liabilities for those cities which outsource fire and/or police services to OCFA and OCSD are not available.

No city on the list stands apart as having an overwhelming liability when measured using this metric. However, the table does show that unfunded liabilities on a per capita basis do vary by a factor of well over two among these cities. Notably, the city with the highest per capita liability in the list is one of the wealthiest as well.

Table 5. Unfunded Actuarial Liabilities (UAL) by City Computed on a Per Capita Basis

City	Total Misc plus Public Safety UAL	City Population	Per Capita UAL for Misc plus Public Safety
Anaheim	$612,270,843	343,248	$1,783.76
Brea	$93,784,676	40,330	$2,325.43
Costa Mesa	$228,238,429	111,918	$2,039.34
FOUNTAIN VALLEY	$72,747,553	56,464	$1,288.39
Fullerton	$182,762,297	138,534	$1,319.26
Garden Grove	$211,845,820	174,389	$1,214.79
Huntington Beach	$334,459,263	194,708	$1,717.75
Laguna Beach	$53,110,452	23,176	$2,291.61
Newport Beach	$274,594,522	87,068	$3,153.79
Orange	$213,594,928	139,419	$1,532.04

Assessment of Unfunded Liabilities as a Percent of General Fund Revenues

Another (and potentially better) way of comparing the burden of unfunded pension liabilities is by looking at the ratio of the unfunded pension liabilities of a city to one year's General Fund revenues for that city. Arguably, the differences in wealth of these cities would be reflected in the differences in their General Fund revenues tied to property and sales taxes and would provide a better measure of the burden of these liabilities on the city's resources. The Grand Jury calculated these ratios in Table 6 for the same 10 cities shown in Table 5. Again the cities when assessed using this metric vary by over a factor of well over two, and again there is not any city in the list that stands apart as having an overwhelming liability when measured using this metric.

Also interesting is that different cities fare better depending on the metric used - per capita versus percent of General Fund. A significant drawback to the General Fund Percentage metric is the difficulty to achieve any reliable apples-to-apples comparison since city revenues are structured differently. In addition, some cities have their own water and power utilities which have their own associated revenues, and all cities have different sources of grant and bond revenues.

Table 6 – Unfunded Pension Liabilities as a Percentage of Annual General Fund Revenues

CITY	Total Misc plus Public Safety UAL	Total General Fund Assumed Revenues from Current Adopted Budget	Budget Year of Adopted Budget	Unfunded Pension Liability as a Percent of General Fund Revenues
Anaheim	$612,270,843	$491,847,000	2013	124.5%
Brea	$93,784,676	$49,431,294	2013-2014	189.7%
Costa Mesa	$228,238,429	$103,250,486	2013-2015	221.1%
FOUNTAIN VALLEY	$72,747,553	$37,032,042	2013-2014	196.4%
Fullerton	$182,762,297	$154,333,191	2013-2014	118.4%
Garden Grove	$211,845,820	$92,351,000	2013-2014	229.4%
Huntington Beach	$334,459,263	$298,239,325	2013-2014	112.1%
Laguna Beach	$53,110,452	$48,425,000	2013-2014	109.7%
Newport Beach	$274,594,522	$255,333,875	2013-2014	107.5%
Orange	$213,594,928	$90,139,158	2013-2014	237.0%

It is critical to note that attempts at measuring the impact of unfunded pension liabilities such as provided in Tables 5 and 6 would not be needed if the cities provided adequate budget data! It would be a simple matter of checking whether a city's predicted revenues for current and future years are sufficient to meet total planned expenditures in those years including the pension related expenditures. In order to have a balanced budget, increased pension expenditures will have to be matched with increased revenues and/or cuts to other major budget items.

Calculating Unfunded Liabilities using Market Value instead of Actuarial Value of Assets

On April 17, 2013, the CalPERS Board of Administration approved a recommendation to change its amortization and smoothing policies. Prior to this change, CalPERS employed a smoothing policy which spread investment returns over a 15-year period; after the change investment returns were smoothed over a 5-year period. As a result, the dramatic impact of the 2007-2009 Great Recession on investment returns, which fell in the middle of this 5 year period, was much more heavily weighted than when 15 years of returns were used.

Table 7 below shows data for the plans listed in Table 1 as of June 30, 2012, but now showing unfunded liabilities computed using Actuarial Value of Assets instead of Market Value of Assets. These data were provided at Grand Jury request in order to assess the impact of the CalPERS decision in 2012 to use Market Value instead of Actuarial Value of Assets in computing unfunded liabilities. Recall that the aggregate unfunded liabilities using Market Value of Assets from Table 4 was $3.3 billion. The aggregate unfunded CalPERS pension liabilities from Table 7 of the 34 OC cities calculated using Actuarial Value of Assets (the prior baseline approach) is $1.9 billion dollars.

The 2013 decision by CalPERS to use Market Value instead of Actuarial Value resulted in an increase in the calculation of unfunded liabilities of OC cities of *<u>$1.4 billion</u>*!

Table 7. Unfunded Liabilities using Actuarial Value of Assets

CITY	PLAN	Accrued Liability	Actuarial Value of Assets	UAL (AVA)	Funded Ratio
ALISO VIEJO	MISCELLANEOUS PLAN	$2,570,113	$2,343,664	$226,449	91.2%
Anaheim	MISCELLANEOUS PLAN	$1,045,037,179	$854,296,252	$190,740,927	81.7%
Anaheim	SAFETY POLICE PLAN	$565,213,783	$473,232,689	$91,981,094	83.7%
Anaheim	SAFETY FIRE PLAN	$345,724,884	$283,210,761	$62,514,123	81.9%
Brea	SAFETY PLAN	$191,751,750	$152,827,533	$38,924,217	79.7%
Brea	MISCELLANEOUS PLAN	$102,226,046	$87,360,704	$14,865,342	85.5%
BUENA PARK	SAFETY PLAN	$185,001,886	$162,856,590	$22,145,296	88.0%
BUENA PARK	MISCELLANEOUS PLAN	$109,953,460	$93,518,527	$16,434,933	85.1%
Costa Mesa	MISCELLANEOUS PLAN	$225,186,488	$169,039,653	$56,146,835	75.1%
Costa Mesa	SAFETY POLICE PLAN	$212,645,063	$153,878,616	$58,766,447	72.4%
COSTA MESA	SAFETY FIRE PLAN	$161,328,098	$120,181,921	$41,146,177	74.5%
CYPRESS	SAFETY PLAN	$65,259,215	$56,791,149	$8,468,066	87.0%
Cypress	MISCELLANEOUS PLAN	$58,995,020	$53,426,741	$5,568,279	90.6%
DANA POINT	MISCELLANEOUS PLAN	$14,606,788	$13,319,805	$1,286,983	91.2%
FOUNTAIN VALLEY	SAFETY FIRST TIER PLAN	$144,802,443	$118,314,870	$26,487,573	81.7%
FOUNTAIN VALLEY	MISCELLANEOUS FIRST TIER PLAN	$78,548,900	$61,269,357	$17,279,543	78.0%
FOUNTAIN VALLEY	SAFETY POLICE SECOND TIER PLAN	$100,138	$90,352	$9,786	90.2%
FOUNTAIN VALLEY	MISCELLANEOUS SECOND TIER PLAN	$31,032	$29,439	$1,593	94.9%
FOUNTAIN VALLEY	SAFETY FIRE SECOND TIER PLAN	$422	$378	$44	89.6%
Fullerton	SAFETY PLAN	$372,812,731	$296,723,845	$76,088,886	79.6%
Fullerton	MISCELLANEOUS PLAN	$227,961,576	$204,542,656	$23,418,920	89.7%
Garden Grove	SAFETY PLAN	$387,791,595	$301,757,326	$86,034,269	77.8%
Garden Grove	MISCELLANEOUS PLAN	$231,098,351	$186,575,813	$44,522,538	80.7%
Huntington Beach	SAFETY PLAN	$552,535,708	$420,518,819	$132,016,889	76.1%
Huntington Beach	MISCELLANEOUS PLAN	$431,175,037	$357,911,394	$73,263,643	83.0%
Irvine	MISCELLANEOUS PLAN	$262,485,223	$198,147,071	$64,338,152	75.5%
Irvine	SAFETY PLAN	$162,425,349	$134,847,398	$27,577,951	83.0%
LA HABRA	SAFETY PLAN	$124,453,943	$104,033,061	$20,420,882	83.6%
La Habra	MISCELLANEOUS PLAN	$79,216,276	$71,487,604	$7,728,672	90.2%
LA HABRA	SAFETY POLICE SECOND TIER PLAN	$753	$675	$78	89.6%
LA PALMA	SAFETY PLAN	$33,248,911	$29,268,914	$3,979,997	88.0%
LA PALMA	MISCELLANEOUS PLAN	$22,117,712	$18,886,895	$3,230,817	85.4%
LA PALMA	SAFETY SECOND TIER PLAN	$7,511	$7,025	$486	93.5%
LA PALMA	MISCELLANEOUS SECOND TIER PLAN	$576	$546	$30	94.8%
Laguna Beach	MISCELLANEOUS PLAN	$80,291,956	$66,214,802	$14,077,154	82.5%
LAGUNA BEACH	SAFETY POLICE PLAN	$57,585,435	$50,692,281	$6,893,154	88.0%
LAGUNA BEACH	SAFETY FIRE PLAN	$45,735,935	$40,261,203	$5,474,732	88.0%
LAGUNA BEACH	SAFETY LIFEGUARD PLAN	$4,662,336	$4,206,731	$455,605	90.2%
LAGUNA BEACH	SAFETY FIRE SECOND TIER PLAN	$21,221	$19,147	$2,074	90.2%
LAGUNA BEACH	SAFETY POLICE SECOND TIER PLAN	$119	$107	$12	89.9%

CITY	PLAN	Accrued Liability	Actuarial Value of Assets	UAL (AVA)	Funded Ratio
LAGUNA HILLS	MISCELLANEOUS PLAN	$11,150,476	$10,018,286	$1,132,190	89.8%
LAGUNA NIGUEL	MISCELLANEOUS PLAN	$21,979,272	$20,042,710	$1,936,562	91.2%
LAGUNA NIGUEL	MISCELLANEOUS SECOND TIER PLAN	$576	$546	$30	94.8%
LAGUNA WOODS	MISCELLANEOUS PLAN	$1,799,940	$1,641,350	$158,590	91.2%
LAKE FOREST	MISCELLANEOUS PLAN	$16,886,211	$15,398,391	$1,487,820	91.2%
LOS ALAMITOS	SAFETY PLAN	$24,809,272	$21,596,207	$3,213,065	87.0%
LOS ALAMITOS	MISCELLANEOUS PLAN	$23,970,858	$20,714,154	$3,256,704	86.4%
Mission Viejo	MISCELLANEOUS PLAN	$55,336,400	$44,251,357	$11,085,043	80.0%
Newport Beach	SAFETY PLAN	$424,868,507	$302,365,698	$122,502,809	71.2%
Newport Beach	MISCELLANEOUS PLAN	$302,006,850	$238,869,992	$63,136,858	79.1%
Orange	SAFETY PLAN	$395,287,607	$318,640,102	$76,647,505	80.6%
Orange	MISCELLANEOUS PLAN	$271,876,517	$225,061,652	$46,814,865	82.8%
PLACENTIA	SAFETY PLAN	$69,929,197	$56,759,921	$13,169,276	81.2%
PLACENTIA	MISCELLANEOUS PLAN	$44,543,255	$40,645,959	$3,897,296	91.3%
PLACENTIA	MISCELLANEOUS SECOND TIER PLAN	$70	$66	$4	94.3%
RANCHO SM	MISCELLANEOUS FIRST TIER PLAN	$3,578,445	$2,822,266	$756,179	78.9%
RANCHO SM	MISCELLANEOUS SECOND TIER PLAN	$66	$63	$3	95.5%
SAN CLEMENTE	SAFETY LIFEGUARD PLAN	$4,771,964	$4,061,973	$709,991	85.1%
Santa Ana	SAFETY PLAN	$886,484,216	$766,597,172	$119,887,044	86.5%
Santa Ana	MISCELLANEOUS PLAN	$670,676,090	$547,675,894	$123,000,196	81.7%
SEAL BEACH	MISCELLANEOUS PLAN	$37,784,994	$34,588,228	$3,196,766	91.5%
SEAL BEACH	SAFETY PLAN	$55,626,490	$48,967,828	$6,658,662	88.0%
STANTON	MISCELLANEOUS PLAN	$16,135,869	$14,111,427	$2,024,442	87.5%
TUSTIN	SAFETY PLAN	$96,725,338	$80,300,869	$16,424,469	83.0%
Tustin	MISCELLANEOUS PLAN	$79,578,148	$72,395,531	$7,182,617	91.0%
TUSTIN	SAFETY POLICE SECOND TIER PLAN	$634	$568	$66	89.6%
VILLA PARK	MISCELLANEOUS PLAN	$3,584,194	$2,958,706	$625,488	82.5%
WESTMINSTER	SAFETY PLAN	$190,808,021	$167,512,113	$23,295,908	87.8%
Westminster	MISCELLANEOUS PLAN	$103,786,629	$84,550,883	$19,235,746	81.5%
Yorba Linda	MISCELLANEOUS PLAN	$52,656,198	$42,905,265	$9,750,933	81.5%

Grand Jury Interviews

As discussed under Method of Study, the Grand Jury conducted interviews with experts representing the three key players in the pension processes for cities: city human resources managers, city finance managers, and senior staff from CalPERS and OCERS, the primary pension systems used by OC cities. Before summarizing those individual discussions, it will be useful to share some candid comments without being more specific as to where these comments came from.

The one word used to describe public employee pensions was “generous”. Given Grand Jury members’ knowledge of Social Security and private employer pensions, it finds that adjective appropriate. However, whether the pensions were generous before pension reform or are generous even after pension reform, the focus of this Grand Jury is on the ability of cities to deal with unfunded *obligations* tied to these pensions and on how *transparent* city budgets are with respect to the impact of these liabilities.

One other topic discussed was the recent practice of cities offsetting newly required increased employee contributions to their pensions by raising employees' salaries by a corresponding percentage. A city, instead of directly paying part of what is nominally the employee's share of pension contributions to the pension system instead pays it to the employee, who in turn pays it to the pension system as part of his/her contribution. To take a real example, the city of Garden Grove decided to offset an increase of 3% in public safety employee pension contributions with a 3% increase in salary.[10] In some ways this looks like a very tempting zero-sum game; the new rules are followed, and the city's budget and employee's take home pay are essentially unaffected. The catch is that the employee will now have a base salary at retirement 3% higher than the pension system had been assuming in predicting its pension payout to that employee. This increased pension payment will be made for the remainder of that employee's life, i.e., *a new unfunded pension liability has been created*.

Interviews with CalPERS

Experts from CalPERS were very helpful in discussing with the Grand Jury the actuarial assumptions they use in projecting pension liabilities. Of particular interest was the recent decision by CalPERS to use Market Value of Assets instead of Actuarial Value of Assets. The choice is obviously a philosophical one since Actuarial Value had been the standard approach for many years. On April 17, 2013, the CalPERS Board of Administration approved a recommendation to change its amortization and smoothing policies. Prior to this change, CalPERS employed an amortization and smoothing policy which spread investment returns over a 15-year period; after the change investment returns were smoothed over a 5-year period. The consequence of this change in asset valuation method was discussed in the Analysis section of this report.

Other possible changes to critical actuarial assumptions were also discussed. CalPERS plans to move from the mortality tables they currently use to tables used by the Social Security system, which reflect the longer life expectancies enjoyed by US residents. Also being considered is a further move to mortality tables which reflect the life expectancies of the residents of California who live almost two years longer than the average US resident. Good news for Californians is

[10] "Police to get Raises to Offset Higher Pension Payments", Voice of Orange County article dated September 24, 2013, http://www.voiceofoc.org/oc_central/garden_grove/article_e96a94d4-24de-11e3-b184-0019bb2963f4.html

not good news for pension liabilities since California pension systems can expect to be paying pensions to their retirees for two to four years longer than they had been planning.

Interview with OCERS

Senior Managers from OCERS discussed their perspective on unfunded pension liabilities for Orange County cities which outsource fire and/or police to OCFA and OCSD. OCERS experienced the same increase in unfunded pension liabilities for all pensions managed by OCERS as did CalPERS due to the impact of the Great Recession which began in 2007 on the value of their assets. In 2012, OCERS changed their assumed rate of return on assets from 7.75% to 7.25%, which had a large impact on their computation of unfunded liabilities. They also moved to amortizing unfunded liabilities over 20 years instead of 30 years. Both these changes significantly increased the catch up contributions they require from their members. On a positive note, OCERS is starting to see a recovery in the current prices of their equity and real estate holdings, which is beginning to be reflected in the actuarial (smoothed) values of their assets.

Like CalPERS, OCERS also worries about events that could cause their unfunded liabilities to grow – the greatest possible impact would come from a decision to further reduce the actuarial assumption of the rate of investment return on their assets. Another concern is whether even the 7.25% rate of return can be maintained over the next several years. Many markets have recovered to pre-Great Recession valuations after a six year bull market, which may be losing steam. Despite the uncertainties, OCERS managers are confident that their system is robust enough to work through short term ups and downs and that they will continue to improve their funding status.

OCERS managers also pointed out that tracing the flow of OCERS unfunded pension liabilities to cities is much harder than tracing the equivalent flow from CalPERS to Orange County cities. CalPERS has a direct fiduciary relationship with individual cities and communicates the pension contributions required from each city via its Annual Valuation Reports. CalPERS provides Valuation Reports for pension plans for each city, one for Miscellaneous employees, one for Police, and one for Fire. Sometimes the Police and Fire plans are combined into a single Safety plan and sometimes plans are split into “Tier 1” and “Tier 2”, but it is always clear which plan applies to which city. (This structure is easily seen in Table 2.) *OCERS does not have a direct fiduciary relationship with any OC city for public safety employees*. The two agencies relevant to this report that OCERS has such a relationship with are the Orange County Fire Authority and County of Orange. The flow of unfunded pension liabilities from OCERS to the Orange County Fire Authority and to the County of Orange and then from the Orange County to the Orange County Sheriff’s Department is reasonably straightforward. But the flow from those agencies to individual cities which outsource public safety functions to them is far more convoluted and far less visible.

OCERS breaks down pension fund assets, liabilities, unfunded liabilities, and required annual contributions by "Rate Groups". OCFA has its own unique rate groups with OCERS, one for general personnel and one for safety. OCERS does not have a direct relationship with the Orange County Sheriff's Department; its fiduciary relationship is with the County of Orange. However OCERS pensions for Sheriff's department employees can be isolated in the Annual Valuation Report for the County of Orange. A separate rate group for Sheriff's Department personnel (Group 7) within the overall Annual Valuation is where data for fund assets, liabilities, unfunded liabilities, and required annual contributions for police personnel can be found.

OCERS has become more aware of the fact that their final pension "customers" are not only the County of Orange or even the OCSD and OCFA. In many cases individual OC cities that outsource fire and/or police services to OCFA and OCSD are their ultimate customers whose budgets are impacted as OCERS works to recover from unfunded liabilities. OCERS is working on developing better outreach to and communication with OC cities.

A further discussion on tracing unfunded pension liabilities to cities which outsource to OFCA

OCFA provides fire services to two classes of cities in Orange County, eight Structural Fire Fund (SFF) members and fifteen Cash Contract Cities (CCC) members. SSF cities have part of their property tax designated for fire protection, which is paid directly to the OCFA and is typically not shown on a city's budget. CCC cities are directly billed quarterly for fire services, and these expenditures are typically shown as an expenditure on a city's budget. Tracing the impact of OCFA's unfunded pension liabilities owed to OCERS to individual OC city budgets via material online does not appear possible.

The OCFA makes general statements[11] about reducing its unfunded pension liabilities:

"The policy …. was last updated on May 22, 2008 to require the OCFA to annually review the feasibility of accelerating payment of the unfunded pension liability."

"OCFA employer retirement rates for safety members were scheduled to decrease by about 2.3%, however, in order to help pay down OCFA's Unfunded Actuarially Accrued Liability (UAAL) the budget includes a carryover of the higher safety member employer rates

[11] Orange County Fire Authority 2013.2014 Adopted Budget, http://www.ocfa.org/_uploads/pdf/2013-14%20Adopted%20Budget_website1.pdf

from 2012/2013. This is a first small step to help address OCFA's intent to reduce long term liabilities."

However, since "Salaries and Employee Benefits" are lumped together as a single line item throughout the remainder of the budget, there is no way of really seeing actual dollar amounts for what this UAAL is nor for planned expenditures to reduce it, if any. No discussion of how pension costs are allocated to individual CCC cities is provided, and no discussion of how pension costs are incorporated into current and future quarterly billings for SFF cities is provided.

Interviews with City Human Resource Managers

Very early in the study interviews were held with the Human Resource (HR) Managers of three OC cities to get their perspective on how their city was dealing with pensions for their employees. The city HR managers were very open in answering Grand Jury questions, and all were consistent in describing their pension processes.

The Grand Jury was informed that benefits including pensions are part of labor negotiations conducted with unions representing different groups of employees. Memoranda of Understanding (MOUs) document the results of these negotiations. Specific terms of city pension plans vary depending on the negotiated labor agreements and are drawn from a menu of plans supported by CalPERS. Pension plans specify the minimum age of retirement and the pension benefit to be paid in terms of a percentage of the employee's highest year of salary times the number of years of service. The total percentage is capped, but for Legacy employees there is no cap on highest salary used in computing the pension benefit. Hence there is no cap on the annual pension benefit paid. However, post-PEPRA employees' pensions are currently capped at ~$130K.

When a person is hired, that employee is assigned to a particular pension plan based on position and job title. Typically movement across pension plans is rare for current employees. A more typical situation is when an employee is hired from another city to do the same type of work, in which case pension benefits will be grandfathered.

The HR managers helped clarify the impact of pension reform in the near term (not much since nearly all their employees are grandfathered as Legacy employees under the more generous pension agreements. Only New employees hired since January 1, 2013, fall under the PEPRA reformed pension rules. With the continued slowdown in hiring, only a small percentage of current employees are New (typically much less than 10%). The managers were well aware of the issues associated with pensions, their impact on city finances, and the impact of pension reform. In general they were confident that they had processes in place to avoid abuses of the pension rules by any attempt on the part of a retiring employee to include "non-PERSable" income as part of the base salary used to compute pension benefits. They (and city finance managers whom the Jury talked with separately) believe the PEPRA pension reforms will substantially reduce future unfunded pension liabilities. However, they were quick to point out that it will be many years before any significant effect falls to the bottom line of their city's pension liabilities.

Interviews with City Finance Managers

Interviews were held with the Finance Managers of the same three OC cities the Grand Jury had previously met with to interview the HR managers. These interviews sought their perspective on how their city was dealing with unfunded pension liabilities. The city finance managers were very open in answering Grand Jury questions and made helpful suggestions on some key areas on which to focus.

The Finance Managers the Grand Jury met with project revenues and expenditures one year out in their formal budgets. Current year budgets are posted online as they are first proposed to and then adopted by their city. None of the cities' budgets shows separate line items at the summary level for pension expenditures, although pension/retirement benefit expenditures are provided in substantial detail at lower levels in their budgets. The Finance Managers acknowledged that it would be arduous to sum up all the detailed pension expenditures to arrive at the total pension related expenditures. Planning budgets are developed for several years further into the future and discussed internally, but not typically posted.

When CalPERS does its Annual Valuation Report for a city's pension plan(s), CalPERS will discuss the report with the city and (very rarely) make adjustments based on those discussions. City Finance Managers use the Annual Required Contributions from the Annual Valuation Reports to develop the pension related expenditures for their budget.

Each city withholds employee pension contributions and sends them bi-weekly to CalPERS. The city's employer pension contributions and any city catch up pension contributions are paid from the city General Fund to CalPERS.

When asked about the recent move by CalPERS from an Actuarial Value basis for estimating current value of assets to a Market Value basis, no value judgment was expressed, but the resulting jump in unfunded liabilities was noted by all. The finance managers viewed the remaining actuarial assumptions used by CalPERS as reasonable under current economic conditions, but are aware that the assumptions can be expected to change if circumstances change. They are particularly sensitive to any downward adjustment to projected rates of return on investment of plan assets as such an adjustment could substantially increase the actuarial value of their unfunded liabilities and hence their catch up contributions.

Another concern discussed was the likely move by pension funds to use more realistic mortality assumptions based on Social Security tables, which will increase unfunded liabilities. In addition, Californians have the third highest life expectancy in the United States (only residents of Hawaii and Minnesota live longer, by 1.11 and 0.48 years, respectively) and have a life expectancy 1.7 years longer than the average expectancy for the United States total population. A further move to using mortality tables reflecting California's better than national average life expectancy, if implemented as expected, will further increase unfunded liabilities.

City Finance Managers were consistent with their HR managers in their evaluation of the impact of pension reform. Nearly all current employees are Legacy employees; "New" employees typically comprise a few percent and well less than 10% of their total employee population. Only employees hired after January 1, 2013 are New under the PEPRA definitions, and hiring of new employees has primarily occurred only in the cases of retirements of current employees. New hires to replace positions cut in response to the 2008 Great Recession have been on hold for the most part.

Except for one of the three cities which outsourced fire protection to OCFA, all three cities interviewed by the Grand Jury use CalPERS for their Miscellaneous employees and for their public safety employees. The city outsourcing fire protection is a Cash Contract City member of OCFA and is billed quarterly for fire services. The quarterly rate paid reflects an agreed to number of skilled personnel and physical assets such as fire stations, trucks, and ambulances. Pension costs including any catch up pension costs are included in the bottom line charge to the city and not separately accounted for.

The managers were well aware of the issues associated with dealing with unfunded pension liabilities and their impact on their city's finances. However, none of them saw the liabilities, even at their current size, as catastrophic and were making adjustments in planned city expenditures to deal with them. They acknowledge that the adjustments will not come without pain as valuable city services that were cut in response to revenue shortfalls caused by the Great Recession will not be reinstituted as quickly as they had hoped. Significant amounts of the revenue increases they are seeing as the recovery develops will be going to catching up on unfunded pension liabilities. For example, one city's *internal* budget shows pension contributions ramping up from 8% to 12% of their General Fund and remaining there for several years and then ramping back down to 8% *based on CalPERS projected Annual Required Contributions.* The link between CalPERS projected annual contributions and the city's budget is critical to establishing some confidence that unfunded pension liabilities, while painful, are not catastrophic. It must also be noted, of course, that as discussed earlier in this report, unfunded liabilities can be volatile, and budgets as they are updated annually must keep in synch with changes in annual required contributions from CalPERS.

Some of the finance managers were working to develop better ways to present future expenditures for pensions in their budgets and in their briefings to their City Councils. In one case the finance manager was already planning a proposed update to their budget structure to clearly identify and separate pension expenditures at the top level of the city budget, an approach which matched the model the Grand Jury had brought to the interview.

The ability of some of the finance managers to communicate the impact of unfunded pension liabilities to their City Councils and labor unions has led to some success in labor negotiations regarding pensions. Such agreements where employees have agreed to carry a larger portion of the burden of pension costs and in some cases agreed to reduced benefits have also made it possible for these cities to meet their overall pension funding obligations by offsetting increased amortization payments for unfunded liabilities with higher employee contributions.

This better understanding of unfunded pension liabilities has also led to the consideration of accelerated catch up payments to CalPERS to increase the amount of assets being managed and to obtain the projected returns on those assets.

Assessment of Budget Information Available Online

Since cities are expected to make their budget information available online, the Grand Jury examined a large sample of OC cities' online budget information. Significant effort was expended reviewing and assessing how well each city's posted budget disclosed how it was dealing with its unfunded pension liabilities. Although the original intent was to look at budgeting for pension liabilities, it quickly became apparent that the quality and usefulness of posted budget information in all areas varied greatly among the cities. *Fundamental deficiencies in budget information* posted by OC cities need to be addressed before looking in detail at pension information in those budgets.

Based on discussions with city Finance Managers and on its review of budget data posted by cities, the Grand Jury developed a conceptual "Ideal Budget Practices" model that will provide the necessary visibility to members of the public of how their cities are budgeting in general and budgeting for pension liabilities in particular. The paragraphs below describe the general criteria against which city budgets were assessed and then the criteria used to assess budgeting for pension expenditures.

Rather than scoring each city against each criterion, which would be very labor intensive and subject to possible error/oversight, the Jury has listed the key elements of the ideal model as separate recommendations to each city in this report. In some cases a city may already meet some of the recommendations, and some cities may agree to implement some of the recommendations and not others. However, as the recommendations are implemented, the members of the public of these cities will benefit from better budget information and from the discipline imposed on the cities in preparing *high quality and transparent budgets.*

General budget information available online

The Grand Jury assessed each city's web site for the general quality of budget information posted according to the following criteria:

1. Is annual budget information posted?
2. Are prior annual budgets posted, and if so, for how many years?
3. Does the current budget show prior year budgets, and if so, for how many years?
4. Does the current budget show future year budget projections, and if so, for how many years?
5. Are key assumptions about future revenues discussed?
6. Do budgets show prior, current, and projected future city General Fund reserves?
7. Is there any discussion of trends in city General Fund reserves?
8. Is there any discussion of a target for how much reserve the city deems desirable?
9. If the city reserves are below the desired level, is there a discussion of how the desired level of reserves will be accumulated?

Prior year budget data are important in order to discern trends in revenues and expenditures. Just having prior year budgets posted is helpful, but including at least one year's prior budget data in the city's current budget makes it far easier to make comparisons than to separately download multiple files and bounce back and forth among them to look for trends. Budget information should include at least two prior years, as projecting a "trend" based on only two data points (current and most recent prior year) is dubious at best.

Even more important than prior year budget information are projections of future year revenues and expenditures. *Future year budget projections are especially important for understanding the impact of unfunded pension liabilities.* Unfunded pension liabilities have five critical attributes:

1. Budgeted pension catch up contributions typically comprise a significant percentage of projected General Fund expenditures.
2. Projected annual contributions to catch up on unfunded liabilities are ramped up over two to five years by CalPERS and OCERS, so the impact of unfunded liabilities is not all revealed by looking only one year into the future.

3. Unlike most planned city expenditures, there is essentially no way to reduce or defer *required* pension contributions in future years.
4. Projected unfunded pension liabilities are at risk of large changes year to year because they are so dependent on the key actuarial assumptions used in calculating them.
5. The recent switch to Market Value of Assets used in calculating unfunded liability will introduce more volatility in the estimate of these unfunded liabilities.

Pension specific budget information available online

After assessing the general utility of city budget data, the Grand Jury looked for budget data relevant to assessing that city's budgeting for pension expenses and in particular for addressing unfunded pension liabilities. Each city's budget was assessed against the following criteria:

1. Are pension related sources of revenue and expenditures visible as separate line items under revenues and expenditures at the summary level of the budget?
2. Are city expenditures for pension related expenses broken out into at least 3 sub-categories: pension contributions withheld from employee pay, employer pension contributions for current employees, and employer catch up contributions for unfunded liabilities as assessed by the pension system?
3. Does the budget clearly specify the source of the Annual Required [Pension] Contributions (ARC) assessed by the pension system (typically CalPERS) used in its budget by document title and date?
4. Is there a clear mapping of the total Annual Required [Pension] Contributions (ARC) assessed by the pension system (typically CalPERS) into one or more line items at the Summary level of the budget?
5. Annual Required [Pension] Contributions (ARC) are updated annually by the pension system. Does the budget discuss the risks associated with these predictions of future catch up contributions? The city needs to state whether they are using the projections provided or whether they have adjusted them down or up because the city believes the projections are respectively too pessimistic or too optimistic.

The impact of OC cities' outsourcing for public safety on transparency of budget information – a tale of two cities

When cities outsource public safety services to OCFA and OCSD, the transparency and quality of information provided can decrease dramatically. The paragraphs below look at the impact of outsourcing fire protection to OCFA and to OCSD on transparency in two cities' budgets.

Santa Ana

In April 2012, the city of Santa Ana joined OCFA as its 23rd member city. OCFA added Santa Ana's 192 firefighters and 11 non-sworn personnel and 10 fire stations.[12] Santa Ana continued to maintain its own police department, as it had done since its founding. Santa Ana's Adopted 2013-2015 Budget[13] is an excellent example of what can happen to transparency of budget information when a city outsources a public safety service. The table below compares the information available in Santa Ana's budget for its police and fire services.

Budget Information Metrics	Police	Fire
Pages of budget information	47	9
FY 2013-2014 Budget (Millions)	$103.8	$40.2
Percent of total General Fund	51%	20%
Budget line items	23	1
Total Personnel (FY 13-14)	580	UNKNOWN
Line items for personnel assignments to department/ office positions	144	46
Line items for personnel assignments to department/ office positions *Containing Meaningful Data*	144	0

The page counts of budget information for Santa Ana fire and police look proportional, but once the data are examined in any detail, the lack of comparable information is remarkable. The budget for in-house police services breaks down personnel expenditures by office/department and for each of these down to expenditures for salaries, retirement, health services, and even to training and membership/dues, etc. The job titles of authorized personnel budgeted to work in each office/department are also listed separately. For example, the budget shows 3 Police Sergeants budgeted for Police Investigations and 24 Police Sergeants to Field Operations, etc. In particular, expenditures for each office/department for "Salaries Retirement" are provided. (Unfortunately, a further sub-division of these retirement expenditures into employee, employer matching, and amortization of unfunded liabilities is lacking, which is a problem for all OC cities.) The information provided for outsourced fire services is reduced a single line of data (the one containing the $40.2 million total cost in the Table above), and all 46 authorized positions are listed as "0"!

[12]Orange County Fire Authority 2013.2014 Adopted Budget, page 2, http://www.ocfa.org/_uploads/pdf/2013-14%20Adopted%20Budget_website1.pdf

[13] City of Santa Ana FY 2013-2015 Adopted Budget, http://www.ci.santa-ana.ca.us/finance/budget/2013-2015/documents/2013-2015_adopted_budget.pdf

Note that Santa Ana is a OCFA Cash Contract City (CCC), so at least the annual cost for fire protection does show up as a single line item on Santa Ana's budget. As we will see below, not even this single dollar value for the cost of fire protection is available in Lake Forest's budget.

Lake Forest

The city of Lake Forest outsources to OCFA for its fire protection and to OCSD for its police protection. A review of their Operating Budget for Fiscal Year 2013-2014[14] shows a wide variation of the budget information provided by the city even when they outsource both safety services. Because Lake Forest outsources both fire and police services, Lake Forest's budget for Public Works was looked at as an example of the extent and quality of budget information provided for work to be done with in house resources.

Lake Forest is a Structural Fire Fund (SFF) member of OCFA, and the cost of fire protection is deducted as a part of their property tax. As far as the cost of fire protection outsourced to OCFA to Lake Forest, the following is the entirety of the information provided in the their budget: "The Orange County Fire Authority funds its service in the City of Lake Forest using a formula derived from direct property tax income. The amount allocated is based on 11.11% of 1% of the total value of properties in Lake Forest." No dollar value is provided. Out-year projections, risks to cost of service and/or cuts in service if property tax values do not support current levels of service, etc., are not discussed.

Budget Information Metrics	**Public Works**	**Police**	**Fire**
Pages of budget information	**16**	**6**	**2**
FY 2013-2014 Budget (Millions)	**$9.4**	**$13.4**	**UNKNOWN**
Percent of total General Fund	**24%**	**34%**	**0%**
Budget line items	**56**	**36**	**NONE**
Total Personnel (FY 13-14)	**15**	**53.5**	**UNKNOWN**
Line items for personnel assignments to department/ office positions	**1**	**9**	**NONE**
Line items for personnel assignments to department/ office positions *Containing Meaningful Data*	**1**	**9**	**NONE**

As can be seen, the city does provide comparable levels of detail for planned expenditures for their public works and police services even though the first is done in-house and the latter is outsourced. In this instance there is actually better information about staffing levels for the

[14] City of Lake Forest, Operating Budget, Fiscal Year 2013-14, http://www.lakeforestca.gov/civica/filebank/blobdload.asp?BlobID=8219

outsourced work for police protection than for the in house work. It is worth noting that the fact that police services are outsourced to OCSD is not called out explicitly in the Lake Forest budget and even the fact that it is outsourced is only apparent because the expenditures are labeled as "Contract Personnel".

Mechanisms for closing the loop from the unfunded OCERS pension liabilities for OCFA and OCSD through those agencies to the individual OC cities which outsource one or both of their public safety functions to them must be developed. Otherwise it will be difficult for the taxpayers of these cities to feel confident in their city's budgeting for these services.

Conclusions

Orange County cities have large unfunded pension liabilities. They do appear to have sufficient resources to amortize these liabilities, but these liabilities are volatile and need to be clearly addressed in cities' budgets in order to gain the confidence of their residents that this is actually the case. Such confidence can only be achieved by far greater transparency in their budgets.

FINDINGS

In accordance with California Penal Code Sections 933 and 933.05, the 2013-2014 Grand Jury requires (or, as noted, requests) responses from each agency affected by the findings presented in this section. Although the findings are stated in terms of all Orange County cities, each city should respond to each finding as it applies to itself only. The responses are to be submitted to the Presiding Judge of the Superior Court.

Based on its investigation of Pension Funding Status of Cities in Orange County, the 2013-2014 Orange County Grand Jury has arrived at 12 principal findings, as follows:

F.1. OC cities have large unfunded pension liabilities both in terms of absolute dollar value and on a per capita basis and as a percentage of city General Fund revenues.

F.2. OC cities' unfunded pension liabilities have been increasing on a year over year basis over the past several years as a result of the 2007-2009 Great Recession and as key actuarial assumptions have been changed by CalPERS and OCERS.

F.3. There are risks to OC cities of changes to key actuarial assumptions including revisions downward of expected returns on investment and the likely move by pension funds to using more realistic mortality assumptions, which would increase unfunded liabilities.

F.4. Locating city budget information on a city web site is not always straightforward and prior year budgets are sometimes not posted by a city.

F.5. City budgets posted online project revenues and expenditures for at most one or two years into the future and sometimes do not show prior year data.

F.6. City budgets often lack footnotes explaining key assumptions, risks, and unusual changes in budgeted amounts or revenues and expenditures.

F.7. City budgets sometimes do not provide trend data on the accumulation/drawdown of reserves and lack details on the city's plan for the size of its reserves or their intended uses.

F.8. Cities can control most future expenditures by increasing or decreasing budgets for those expenditures as funds are available. However, increases to annual required contributions to their pension systems are imposed externally, change unpredictably, and when they occur, are ramped up over two to five years.

F.9. City budgets posted online do not explicitly show the link between planned city pension expenditures and pension system actuarial reports and those reports' annual required contributions. Risks associated with predictions of future annual required pension contributions based on risk assessment data provided by their pension systems and/or based on their own analysis are not discussed.

F.10. Pension costs for New (Post-PEPRA) employees will be substantially lower than for Legacy employees, but only a small percentage of current employees, typically only a few percent of total employees, are New. Substantially reduced pension costs for cities as a result of pension reform will not be realized for one or more decades.

F.11. CalPERS Annual Valuation Reports for Miscellaneous and Safety City employees are available to the public online for a very small number of cities.

F.12. OCERS provides pension plans for OCFA and OCSD employees, but there is no way to trace through publically available sources OCERS unfunded pension liabilities to the city budgets which outsource to OCFA and OCSD for fire and police services.

Penal Code §933 and §933.05 require governing bodies and elected officials to which a report is directed to respond to findings and recommendations. Responses are requested, from departments of local agencies and their non-elected department heads.

RECOMMENDATIONS

In accordance with California Penal Code Sections 933 and 933.05, the 2013-2014 Grand Jury requires (or, as noted, requests) responses from each agency affected by the recommendations presented in this section. The responses are to be submitted to the Presiding Judge of the Superior Court.

Based on its investigation of Pension Funding Status of Cities in Orange County, the 2013-2014 Orange County Grand Jury makes the following 8 recommendations:

R.1. Each city should post its current and at least three most recent prior year budgets on the city's web site, and these budgets should be easily located. Each city's web site should have a search engine and a single search on the word "budget" should immediately link to the current budget. **(F.1) (F.4)**

R.2. Each city's budget information should contain not only this year/next year budget projections, but should show at least five years of projected revenues and expenditures. Projections should be at the same level of detail and use the same line item structure as information for the current budget. **(F.1) (F.2) (F.3) (F.5) (F.8) (F.10)**

R.3. Each city's budget should show separate line items for predicted employee and predicted employer contributions for the city pension systems. **(F.8) (F.9)**

R.4. Each city's budget should provide trend data on the accumulation/drawdown of reserves and provide details on the city's policy for the size of its reserves and on the intended uses of such reserves. In particular any discussion of reserves should address possible use of reserves to accelerate amortization of unfunded pension liabilities. **(F.7)**

R.5. Each city using CalPERS for one or more of its pension plans should identify the names and dates of the CalPERS Annual Valuation Report(s) which call out Annual Required Contributions (ARCs) for these plans and should provide a separate expenditure line item for predicted city catch-up contributions for the city pension systems based on these ARCs. A discussion of the risks associated with these CalPERS projections should also be provided by the city. **(F.1) (F.2) (F.8) (F.9)**

R.6. Each city which outsources fire or police services to OCFA and/or OCSD should require them to provide projections of future costs of service out at least five years into the future and require that these projected costs explicitly show the relationship of projected pension costs including amortization of unfunded liabilities. This level of pension cost information should be provided in budgeted expenditures for outsourced services. A discussion of the risks associated with these projections should also be provided by the agencies and incorporated in the city's budgets. **(F.6) (F.12)**

R.7. Each city that has CalPERS as a provider for pensions should include a provision in their agreements with CalPERS that CalPERS will post their Annual Valuation Reports online. **(F.11)**

REQUIRED RESPONSES

The California Penal Code §933 requires any public agency which the Grand Jury has reviewed, and about which it has issued a final report, to comment to the Presiding Judge of the Superior Court on the findings and recommendations pertaining to matters under the control of the agency. Such comment shall be made no later than 90 days after the Grand Jury publishes its report (filed with the Clerk of the Court); except that in the case of a report containing findings and recommendations pertaining to a department or agency headed by an elected County official (e.g. District Attorney, Sheriff, etc.), such comment shall be made within 60 days to the Presiding Judge with an information copy sent to the Board of Supervisors.

Furthermore, California Penal Code Section §933.05 (a), (b), (c), details, as follows, the manner in which such comment(s) are to be made:

(a) As to each Grand Jury finding, the responding person or entity shall indicate one of the following:

(1) The respondent agrees with the finding

(2) The respondent disagrees wholly or partially with the finding, in which case the response shall specify the portion of the finding that is disputed and shall include an explanation of the reasons therefore.

(b) As to each Grand Jury recommendation, the responding person or entity shall report one of the following actions:

(1) The recommendation has been implemented, with a summary regarding the implemented action.

(2) The recommendation has not yet been implemented, but will be implemented in the future, with a time frame for implementation.

(3) The recommendation requires further analysis, with an explanation and the scope and parameters of an analysis or study, and a time frame for the matter to be prepared for discussion by the officer or head of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This time frame shall not exceed six months from the date of publication of the Grand Jury report.

(4) The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation therefore.

(c) If a finding or recommendation of the Grand Jury addresses budgetary or personnel matters of a county agency or department headed by an elected officer, both the agency or department head and the Board of Supervisors shall respond if requested by the Grand Jury, but the response of the Board of Supervisors shall address only those budgetary /or personnel matters over which it has some decision making aspects of the findings or recommendations affecting his or her agency or department.

Comments to the Presiding Judge of the Superior Court in compliance with Penal Code section §933.05 are required from:

Required/Requested Responses	F1	F2	F3	F4	F5	F6	F7	F8	F9	F10	F11	F12
Cities Councils of:												
Aliso Viejo	X	X	X	X	X	X	X	X	X	X	X	X
Anaheim	X	X	X	X	X	X	X	X	X	X	X	X
Brea	X	X	X	X	X	X	X	X	X	X	X	X
Buena Park	X	X	X	X	X	X	X	X	X	X	X	X
Costa Mesa	X	X	X	X	X	X	X	X	X	X	X	X
Cypress	X	X	X	X	X	X	X	X	X	X	X	X
Dana Point	X	X	X	X	X	X	X	X	X	X	X	X
Fountain Valley	X	X	X	X	X	X	X	X	X	X	X	X
Fullerton	X	X	X	X	X	X	X	X	X	X	X	X
Garden Grove	X	X	X	X	X	X	X	X	X	X	X	X
Huntington Beach	X	X	X	X	X	X	X	X	X	X	X	X
Irvine	X	X	X	X	X	X	X	X	X	X	X	X
La Habra	X	X	X	X	X	X	X	X	X	X	X	X
La Palma	X	X	X	X	X	X	X	X	X	X	X	X
Laguna Beach	X	X	X	X	X	X	X	X	X	X	X	X
Laguna Hills	X	X	X	X	X	X	X	X	X	X	X	X
Laguna Niguel	X	X	X	X	X	X	X	X	X	X	X	X
Laguna Woods	X	X	X	X	X	X	X	X	X	X	X	X
Lake Forest	X	X	X	X	X	X	X	X	X	X	X	X
Los Alamitos	X	X	X	X	X	X	X	X	X	X	X	X
Mission Viejo	X	X	X	X	X	X	X	X	X	X	X	X
Newport Beach	X	X	X	X	X	X	X	X	X	X	X	X
Orange	X	X	X	X	X	X	X	X	X	X	X	X
Placentia	X	X	X	X	X	X	X	X	X	X	X	X
Rancho Santa Margarita	X	X	X	X	X	X	X	X	X	X	X	X
San Clemente	X	X	X	X	X	X	X	X	X	X	X	X
San Juan Capistrano	X	X	X	X	X	X	X	X	X	X	X	X
Santa Ana	X	X	X	X	X	X	X	X	X	X	X	X
Seal Beach	X	X	X	X	X	X	X	X	X	X	X	X
Stanton	X	X	X	X	X	X	X	X	X	X	X	X
Tustin	X	X	X	X	X	X	X	X	X	X	X	X
Villa Park	X	X	X	X	X	X	X	X	X	X	X	X
Westminster	X	X	X	X	X	X	X	X	X	X	X	X
Yorba Linda	X	X	X	X	X	X	X	X	X	X	X	X

Required/Requested Responses	R1	R2	R3	R4	R5	R6	R7
Cities Councils of:							
Aliso Viejo	X	X	X	X	X	X	X
Anaheim	X	X	X	X	X		X
Brea	X	X	X	X	X		X
Buena Park	X	X	X	X	X	X	X
Costa Mesa	X	X	X	X	X		X
Cypress	X	X	X	X	X	X	X
Dana Point	X	X	X	X	X	X	X
Fountain Valley	X	X	X	X	X		X
Fullerton	X	X	X	X	X		X
Garden Grove	X	X	X	X	X		X
Huntington Beach	X	X	X	X	X		X
Irvine	X	X	X	X	X	X	X
La Habra	X	X	X	X	X	X	X
La Palma	X	X	X	X	X	X	X
Laguna Beach	X	X	X	X	X		X
Laguna Hills	X	X	X	X	X	X	X
Laguna Niguel	X	X	X	X	X	X	X
Laguna Woods	X	X	X	X	X	X	X
Lake Forest	X	X	X	X	X	X	X
Los Alamitos	X	X	X	X	X	X	X
Mission Viejo	X	X	X	X	X	X	X
Newport Beach	X	X	X	X	X		X
Orange	X	X	X	X	X		X
Placentia	X	X	X	X	X	X	X
Rancho Santa Margarita	X	X	X	X	X	X	X
San Clemente	X	X	X	X	X	X	X
San Juan Capistrano	X	X	X	X	X	X	X
Santa Ana	X	X	X	X	X	X	X
Seal Beach	X	X	X	X	X	X	X
Stanton	X	X	X	X	X	X	X
Tustin	X	X	X	X	X	X	X
Villa Park	X	X	X	X	X	X	X
Westminster	X	X	X	X	X	X	X
Yorba Linda	X	X	X	X	X	X	X

APPENDICES

Appendix A – Acronyms

ARC – Annual Required Contribution

CAFR – [CalPERS] Consolidated Annual Financial Report

CalPERS - California Public Employees' Retirement System

COLA – Cost of Living Adjustment

GDP - Gross Domestic Product (GDP)

OC - Orange County

OCERS - Orange County Employee Retirement System

OCFA- Orange County Fire Authority

OCSD – Orange County Sheriff/Coroner's Department

PEPRA - Public Employees' Pension Reform Act

PERF – Public Employees' Retirement Fund

Appendix B – Glossary

Accumulated Plan Benefits - Benefits attributable under the provisions of a pension plan to employees for services rendered to the benefit information date.

Actuarial Assumptions - Assumptions used in the actuarial valuation process as to the occurrence of future events affecting pension costs, such as mortality, withdrawal, disablement and retirement; changes in compensation and national pension benefits; rates of investments earnings and asset appreciation of depreciation; procedures used to determine the actuarial value of assets; characteristics of future entrants for open group actuarial cost methods and others relevant items.

Accrual Basis - The recording of the financial effects on a government of transactions and other events and circumstances that have cash consequences for the government in the periods in which those transactions, events and circumstances occur, rather than only in the periods in which cash is received or paid by the government.

Actuarial Accrued Liability - The portion, as determined by a particular cost method, of the total present value of benefits that is attributable to past service credit.

Actuarial Gain (Loss) - A measure of the difference between actuarial and expected experience based upon a set of actuarial assumptions. Examples include higher than expected salaries increases (loss) and a higher return on fund assets than anticipated (gain).

Actuarial Present Value - The discounted value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of actuarial assumptions.

Amortization - (1) The portion of the cost of a limited-life or intangible asset charged as an expense during a particular period. (2) The reduction of debt by regular payments of principal and interest sufficient to retire the debt by maturity.

Annuity - A fixed sum of money paid to someone each year, typically for the rest of their life.

Auditor's Report - In the context of a financial audit, a statement by the auditor describing the scope of the audit and the auditing standards applied in the examination, and setting forth the auditor's opinion on the fairness of presentation of the financial information in conformity with generally accepted accounting principles (GAAP) or some other comprehensive basis of accounting.

Comprehensive Annual Financial Report (CAFR) - The official annual report of a government. It includes the basic financial statements and their related notes prepared in conformity with GAAP. It also includes supporting schedules necessary to demonstrate compliance with finance-related legal and contractual provision, required supplementary information, extensive introductory material and a detailed statistical section.

Defined Benefit Pension - A company pension plan in which an employee's pension payments are calculated according to length of service and the salary they earned at the time of retirement.

Defined Contribution Pension - A defined contribution plan, unlike a defined benefit plan, does not promise a specific amount of benefits at retirement. In these plans, the employee or the employer (or both) contribute to the employee's individual retirement account.

Entry Age Actuarial Cost Method - A method under which the actuarial present value of the projected benefits of each individual included in an actuarial valuation is allocated on the level basis over the earnings or services of the individual between entry age and assumed exit age(s).

Normal Cost - The ongoing annual cost allocated to the system by a particular actuarial cost method for providing benefits (future cost). Normal cost payments are made during the working lifetime of the member.

Pension - a regular payment made during a person's retirement from an investment fund to which that person or their employer has contributed during their working life.

Pension Contribution - The amount paid into a pension plan by an employer (or employee), pursuant to the terms of the plan, state law, actuarial calculations or some other basis for determinations.

Pension Trust Fund - A fund used to account for public employee retirement benefits. Pension trust funds, like nonexpendable trust funds, use the accrual basis of accounting and have a capital maintenance focus.

PERS-able – payments to an employee which can be included as “salary” in calculation of pension benefits.

UAAL Amortization Payment - The portion of pension contributions, which is designed to pay off (amortize) the unfunded actuarial accrued liability in a systematic fashion. Equivalently, it is a series of periodic payments required to pay off a debt.

Unfunded Actuarial Accrued Liability (UAAL) - The excess of the actuarial accrued liability over the actuarial value of assets.

Appendix C – A Brief Primer on Pensions

A discussion on pensions is needed as background to this report for those members of the public who may be aware of and concerned about problems with unfunded pension liabilities, but are not familiar with the sometimes arcane terms used in discussing them. The primer below is a synthesis and simplification of material publically available from various sources including:

1. Comprehensive Annual Financial Reports from CalPERS and OCERS
2. Discussions with senior management and technical staff of CalPERS and OCERS
3. Discussions with senior financial managers from three Orange County cities
4. Wikipedia

Any violation of Einstein's (possibly apocryphal) dictum, "Everything should be made as simple as possible, but no simpler," is solely the responsibility of the Grand Jury and not of the various sources listed above.

The paragraphs below briefly examine:

1. Pensions and their purpose
2. Two major types of pension plans
3. How pension benefits are specified
4. How pension benefits (actuarial liabilities) for retired members are computed
5. How pension benefits (actuarial liabilities) for active members are computed
6. Actuarial Accrued Liability (AAL)
7. Actuarial Value of Assets
8. What it means to say a pension has unfunded liabilities

Pensions and their purpose

A pension is a contract for a fixed sum to be paid regularly to a person, typically following retirement from service. There are many different types of pensions, including defined benefit plans, defined contribution plans, as well as several others. A retirement plan is an arrangement to provide people with an income during retirement after they are no longer earning a steady income from employment. Often retirement plans require both the employer and employee to contribute money to a fund during their employment in order to receive defined benefits upon retirement. A recipient of a retirement pension is known as a pensioner or retiree. Retirement pensions are typically in the form of a guaranteed life annuity, thus insuring against the "risk of longevity" (i.e., outliving one's savings).

Two major types of pension plans

Retirement plans are classified as defined benefit or defined contribution according to how the benefits are determined and by their associated methods of funding. A defined benefit plan guarantees a certain payout at retirement, according to a fixed formula which usually depends on the member's salary and the number of years' of membership in the plan. A defined contribution plan will provide a payout at retirement that is dependent upon the amount of money contributed and the performance of the investment vehicles utilized.

Defined benefit plans

A defined benefit (DB) plan is a plan in which an employee's benefit on retirement is determined by a set formula, rather than depending on investment returns on that employee's savings. Traditionally, retirement plans have been administered by institutions which exist specifically for that purpose. A typical form of defined benefit plan is the final salary plan, under which the pension paid is equal to the number of years worked, multiplied by a percentage of the member's salary at retirement. Normally a minimum number of years worked and/or a minimum retirement age are specified.

The employer's cost of a defined benefit plan is not easily predicted since it depends so much on the plan's ability to achieve the predicted rate of return on investment of the plan's assets as they are accrued. Since the pension benefit to the employee is defined, any shortfall in investment returns or longer than actuarially predicted employee life span post retirement for example must be made up by the employer. The employer assumes all the risk in providing the defined benefit.

Defined contribution plans

In a defined contribution plan, contributions are paid into an individual account for each member. The contributions are invested, for example in the stock market, and the returns on the investment (which may be positive or negative) credited to the individual's account. On retirement, the member's account is used to provide retirement benefits, sometimes through the purchase of an annuity which then provides a regular income. Defined contribution plans have become widespread all over the world in recent years, and are now the dominant form of plan in the private sector in many countries.

In a defined contribution plan, investment risk and investment rewards are assumed by each individual/employee/retiree and not by the sponsor/employer, and these risks may be substantial. In addition, participants do not necessarily purchase annuities with their savings upon retirement, and bear the risk of outliving their assets.

Despite the fact that the participant in a defined contribution plan typically has control over investment decisions, the plan sponsor retains a significant degree of fiduciary responsibility over investment of plan assets, including the selection of investment options and administrative providers.

Both the CalPERS and OCERS plans used by OC cities are defined benefit plans.

How pension benefits are specified

Pension benefits are specified as a percentage of highest annual average compensation times the number of years of service at the age of retirement. For example, "3% at 50", a benefit held by many city public safety employees, means that such an employee can retire at age 50 and receive 3% of his/her highest salary times the number of years of service. For example, a police officer hired at age 25 and retiring at age 50 with his/her highest annual salary at $160,000 will receive an annual pension of $120,000 (3% times 25 years times $160,000).

How pension benefits (actuarial liabilities) for retired members are computed

The pension liability for a retired member is computed based on his/her current pension payment, current age, and predictions of cost of living increases, inflation, and mortality.

How pension (actuarial liabilities) for active members are computed

The pension liability of an active member is computed based on his/her current salary, age, and predictions of the age at which the member will retire, salary increases occurring until retirement, inflation, and mortality. Other factors taken into consideration are the probabilities the member will become disabled or will terminate his/her service earlier than anticipated.

Actuarial Accrued Liability

The present value of the sum of active and retired members' pension benefits is the actuarial accrued liability

Actuarial Value of Assets

The value of pension plan investments and other property used by an actuary for the purpose of an actuarial valuation is the actuarial value of assets (sometimes referred to as valuation assets). Actuaries often select an asset valuation method that smoothes the effects of short-term volatility in the market value of assets.

What it means to say a pension has unfunded liabilities

The difference between the actuarial accrued liability and the actuarial value of assets accumulated to finance a public pension is its unfunded liability.